



# Carpe Diem

Interest rate pivot  
sets the pace for 2024



Group Investment Strategy

## 2024 Yearly Outlook

December 2023

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# Summary

Carpe Diem



## MACROECONOMIC UPDATE

Global economic growth is likely to slow further from 3.0% this year to 2.7 next year. Central banks' interest rate hikes are gradually filtering through to the economy, while important support factors, such as the savings surplus of private households and fiscal policy support, are shrinking or disappearing. Nevertheless, we believe a hard landing for the global economy is unlikely.

In the US, we expect gross domestic product (GDP) to grow by 1.0% in both 2024 and 2025, following on from 2.4% this year. The Eurozone economy is expected to grow by 0.5% next year, the same rate as in 2023, while survey indicators suggest that GDP will stagnate or shrink moderately in the fourth quarter of this year. In China, we expect GDP growth to slow to 4.5% in 2024 and 4.3% in 2025, after around 5.2% growth this year. Although this means that China will achieve its self-imposed growth target of 5% this year, the economic recovery following the lifting of all pandemic-related restrictions has been significantly less dynamic than many expected.



## INFLATION AND MONETARY POLICY

In the US we anticipate inflation to fall to around 2% by the end of 2024, with core inflation also reaching this level one to two quarters later. Inflation in the services sector, in particular, is keeping core inflation stubbornly high. We do not expect the Federal Reserve (Fed) to raise interest rates any further. Before the Fed cuts interest rates permanently, it will probably ensure that core inflation declines sustainably and that the labour market continues to weaken. We expect a rate cut of 25 basis points (bps) per meeting from June to December 2024, followed by a cut every other meeting until 2025. This would mean that the target range for the key interest rate would be 3.00% to 3.25% by the end of 2025.

In the Eurozone overall inflation is expected to approach the 2% mark by the end of 2024 and fall below it in 2025. The subdued growth and spreading disinflation make it very likely that the ECB has reached the interest rate peak. Mid-2024 appears to be the earliest possible time for the ECB to initiate a turnaround in interest rates. It is likely to proceed only gradually with the easing cycle, as there is great uncertainty as to what interest rate level is compatible. We anticipate quarterly interest rate cuts of 25 bps from the ECB, which would bring the deposit rate down to 3.25% by the end of 2024 and to 2.25% by the end of 2025.



## FINANCIAL MARKETS

Fixed income securities should head for calmer waters in 2024 and government bonds should deliver positive yields as key interest rates in the major economies should now have peaked. As a result, we expect bond yields to fall next year and the inversion of the yield curve to decline as central banks are likely to start cutting interest rates towards the middle of the year. Two-year yields could fall towards 4% (US Treasuries) or well below 3% (Bunds) by the end of next year. We also see a downward trend for the long end of yields, although the extent of this is more difficult to estimate and is likely to be less pronounced.

Regarding equities, the market environment next year is likely to be characterised by fairly low corporate earnings growth, although earnings estimates for the next 12 months are still close to their all-time highs. As a result, we believe that the potential for a renewed rise in valuations in 2024 is based less on earnings growth and more on the development of interest rates. Equities are likely to offer additional upside potential, especially if the trend towards lower yields and signs of economic stabilisation become clearer in 2025.





# CIO's Letter

Carpe Diem

The year 2023, which is drawing to a close, has once again made us very aware of the following – that the development of the capital markets is strongly characterised by the expectations of market participants. It is not only which development they themselves consider to be the most likely that plays a role, but also what the market, i.e., the consensus, is pricing in – and how these expectations might shift in the coming months. The consensus currently assumes that inflation rates will fall so much in the coming year that the central banks in both the US and Europe will be able to initiate interest rate cuts around mid-year. This in turn would result in lower interest rates for short-term interest-bearing investments, such as fixed-term deposits. At the same time, yields on longer-term bonds are likely to fall. Investors who want to secure what are currently still higher interest rates should therefore act in good time.

While expectations regarding interest rate developments are more or less unanimous, many market observers' forecasts regarding the extent of the expected interest rate cuts, as well as the economic environment underlying the interest rate cuts, differ more or less significantly. The **"bulls"**<sup>1</sup> expect a robust economic environment and only moderate interest rate cuts. The **"bears"**, on the other hand, are forecasting a significant phase of economic weakness and are expecting interest rate cuts on a larger scale. Alternatively, one could also say that the bulls are betting that the central banks will cut interest rates due to declining inflationary momentum, while the bears believe they know that the central banks will have to cut interest rates due to pronounced economic weakness.

So, the key question is: how much will the economy cool down in the coming year? The respective arguments of the bulls and bears can help to assess the risks. The bears argue that in recent decades, the US economy, which has a signalling character as the world's leading economy, has always slipped into recession within a few quarters after noticeable interest rate hikes. The argument is therefore based on historical experience. However, if one analyses current economic data in the US, there are currently hardly any signs of such a development. Accordingly, the bulls argue that the current interest rate cycle is special this time, i.e., different from previous ones, and that the US economy can avoid the usual recession. The reason for this is the expansionary monetary and fiscal policy, which provided companies and private households with a noticeable "cushion" in the initial phase of the pandemic – which is still having an effect to this day.

As is so often the case, the actual trend is probably somewhere in the middle, between the two extremes. There are many indications that economic momentum in the US is indeed likely to cool down – possibly to such an extent that zero growth or even slightly negative growth can be expected towards the middle of next year. However, there could be no real noticeable recession. Such a scenario would then be a classic "soft landing".

The reason for this is that – statistically speaking – the short-term braking force of a tighter monetary policy does not result so much from the higher interest rate level, but from the scope and speed of the interest rate hikes themselves. However, the Federal Reserve's (Fed) biggest interest rate hikes took place more than a year ago, when it raised interest rates by as much as 0.75% several times in succession from the summer months of last year. The US economy has so far coped surprisingly well with this aggressive monetary tightening. This year, interest rate hikes have been much more measured, and the Fed has recently made it clear that it is not planning any further steps. Of course, the current high interest rate level itself is also having a dampening effect. However, it would be somewhat surprising if the admittedly high but unchanged interest

<sup>1</sup>The optimists on the stock market are symbolically called "bulls" and are firmly convinced that prices will rise. The bull is chosen as a symbol because it always pushes upwards from below with its horns. On the contrary, the "bear", whose paw strikes from top to bottom, is seen as a sign of falling prices.

rate level were to suddenly accelerate tensions in the economy, while the latter has remained stable under the burden of sharply rising interest rates. The “soft landing” scenario therefore seems quite likely.

And even if the economic slowdown does become more pronounced than the consensus currently expects, it is reassuring to note that even the bears do not expect a deep and prolonged recession in the US. On the contrary, even some bears expect growth rates in the US in 2025 to be in the order of **potential growth**<sup>2</sup>. This means that even in a less favourable scenario, volatility, but probably not a sustained downward trend on the equity markets, could be expected, as most equity investors would probably simply sit out a temporary and manageable dip.

<sup>2</sup>In an economy, potential growth is defined as the long-term development of gross domestic product with optimum utilisation of existing capacities.

What implications do these considerations have for investment strategy? Firstly, the difference in potential returns between bonds and equity markets no longer appears to be as great as in previous years. This is good and reassuring news, as it puts the well-known and established long-term oriented multi-asset investment strategy back at the centre of considerations. The days of having to look for potential returns in little-known niches of the markets in order not to fall behind are over for the time being. With the higher yield level, the fixed-interest parts of the portfolio can once again deliver adequate performance contributions. The reinvestment risk can be reduced by shifting assets from fixed-term deposits into longer-term bonds. In particular, investors who expect interest rates to fall in the coming months can consider such a shift. A falling yield environment could also bring price gains for bonds. However, even if the risks have decreased, it cannot be ruled out that market expectations will turn again and that a turnaround in monetary policy will take longer than currently expected.

Furthermore, we see higher return potential for equities in the base scenario for the coming year - despite our assessment of the potentially strong performance of bonds and despite the aforementioned risk of a limited dip in growth. For this reason, the equity side of portfolios should not be neglected without abandoning a selective approach. Investing in shares of companies from very cyclical sectors still seems a little too early due to the expected slowdown in growth. Such shares could possibly come into focus during the second half of the year once the cooling phase is behind us. However, the expectation of higher interest rates for longer could slow down valuation growth. In the event of a prolonged, deep recession (which we do not currently expect), share prices would come under pressure and could fall well short of earnings expectations.

In the bond segment, corporate bonds with good credit ratings appear particularly attractive in view of moderate but stable economic growth. Here too, it is probably still too early for more aggressive positioning, for example in the high-yield bond segment. In the currency area, no significant currency fluctuations are to be expected due to the presumably reasonably synchronised interest rate reduction policy across the currency areas of the major industrialised nations, although the euro could have moderate upside potential against the US dollar in 2024.

This means that, in our view, there is much to suggest that investors can be cautiously optimistic about the new year. Despite numerous challenges, the outlook for the most important asset classes certainly appears constructive.

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# In Focus

## Megatrends – What we expect for the future

The global economy is subject to powerful forces of change, which we refer to as megatrends. These trends have the potential to profoundly influence the way the world develops economically – not only in terms of what is prioritised in politics and society, but also as drivers of innovation and the reshaping of business models. Their influence extends beyond the lifestyles and consumption habits of private households and has an impact on political decisions and corporate strategies. The following seven megatrends, which are closely interlinked and interdependent, are of particular importance for our investment strategy. Their implications are far-reaching and diverse. They offer both enormous opportunities that must be utilised and risks that must be correctly assessed. The complexity of the challenges arising from these megatrends requires solutions for business and society alike. We believe that they harbour enormous growth potential, and we are therefore gradually aligning our traditional portfolios with these megatrends to achieve recognisable outperformance.

### **I. HIGHER FOR LONGER – FOCUS ON EURO CORPORATE BONDS**

In 2023 the fixed income market has been significantly shaped by major central banks, which have been firmly committed to implementing restrictive monetary policy in order to bring consumer price dynamics back to their target levels. In particular, the US Federal Reserve (Fed) raised official rates by a total of 100 basis points (bps) and the European Central Bank (ECB) by 200 bps. Despite the challenging environment this year, Investment Grade (IG) credit has returned a positive result (3.94% year-to-date as of 27/11/2023), supported by the resilience of the economic cycle and investors' persistent search for yield. Only in March and in September to October did the market record risk-off phases respectively due to the liquidity crisis of US regional banks and the rescue of Credit Suisse in Europe, which in March led to a widening of credit spreads and to the sharp increase in Treasury yields that took place this fall.

Looking ahead, we remain positive on high quality corporate bonds. For 2024, UniCredit Research forecasts a mild recovery for the Eurozone economy after stagnating growth in the second half of 2023 and a significant decline in inflation. The stabilization of growth, a softer inflation picture, and the expected end of the rate hike cycle set up an ideal environment for high quality corporate bonds. Indeed, the asset class, in terms of risk/reward ratio, represents an attractive opportunity, combining good credit fundamentals and compelling yields (for example, the highly rated Euro IG segment offers interesting yields – 4.31% as of 27/11/2023 – the same yield provided by the Euro High Yield sector at the beginning of 2022), while offering resilience in the event of a weakening economy.

Overall, IG corporate fundamentals are expected to remain solid thanks to healthy balance sheets, better-than-expected earnings, strong cash balances, and low leverage levels relative to long-term averages. In addition, the technical backdrop will remain strong, allowing credit risk premiums to move roughly sideways going forward. Notably, net supply is expected to remain low, thanks to companies' strong liquidity positions, limited M&A activity, and prudent financial policies pursued by companies. Inflows in the asset class should remain strong, containing any spread widening in the coming months. Even for investors that have a very low risk profile, the IG credit universe presents a good opportunity. The 1-3 years segment has an attractive yield to maturity (4.29% as of 27/11/2023) with very low exposure to interest rate volatility (duration at 1.9).

But there are risks too. In 2024 we expect default rates in Europe to pick up, but only gradually, with a ratio expected to remain well below 4%. Looking forward, higher interest costs will affect corporate balance sheets. This will be particularly the case for High Yield names, the weaker segment of the market, where for some companies refinancing costs currently exceed 10%. Against this backdrop, investors should focus on their ability to select companies with solid balance sheets and strong fundamentals, avoiding names that will face particularly high refinancing risks.

In terms of sector allocation, going forward we continue to adopt a cautious stance, preferring defensive sectors such as Telecoms, Utilities and Healthcare versus Retail, Chemicals, Travel & Leisure and Industrial Goods.

With regards to Financials, banks' credit fundamentals will likely remain strong, supported by net interest income, resilient asset quality, and the high capitalization of the banking sector. Despite the gradual increase in corporate credit default rates and growing non-performing loans in 2024, banks' profitability will likely remain high if compared to the levels seen over the last decade.

## 1. EURO IG CORPORATE BOND YIELDS

● ICE BofA Euro Corporate Index



Note: Past performance, simulations and forecasts are not a reliable indicator of future performance. The indices cannot be purchased and therefore do not include any costs. In the case of an investment in commodities, acquisition and custody costs incurred are not taken into account. In the case of an investment in foreign currency, the return may also rise or fall as a result of currency fluctuations.

Source: LSEG Datastream, UniCredit Group Investment Strategy

Observation period: 27.11.2013-27.11.2023

## II. GEOPOLITICS: FOCUS ON “A NEW JAPAN”

In geopolitical terms, Asia is becoming an area which deserves more attention. In fact, in terms of portfolio de-risking, foreign investors have been reducing their holdings of Chinese equities given the increasing number of problems (real estate crisis, ageing population, worsening corporate governance, political leadership issue). Japan is clearly benefitting from this positioning shift in foreign investor portfolios.

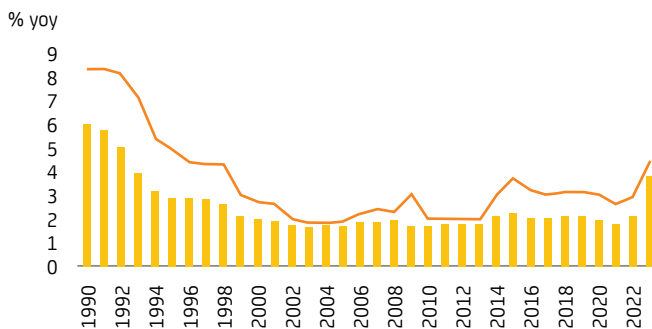
In detail, a “New Japan” is emerging from a decade-long phase of deflation, thanks to rising wage growth and inflation, while risks of a restrictive policy from the Bank of Japan (BoJ) and a sharp appreciation of the Japanese yen look so far manageable. The BoJ has for now just tweaked its Yield Curve Control policy by increasing the cap for 10-year bond yields to 1%. The increase in corporate profits and the reform of the Tokyo Stock Exchange, which are encouraging intense share buyback activity, are further factors supporting the investment case for Japanese equities.



## 2. JAPAN: WAGES ON THE RISE

2023 SHUNTO RESULT SEES THE HIGHEST OVERALL PAY RISE FOR 30 YEARS

● Agreed pay raise (overall pay) ● Rengo demand

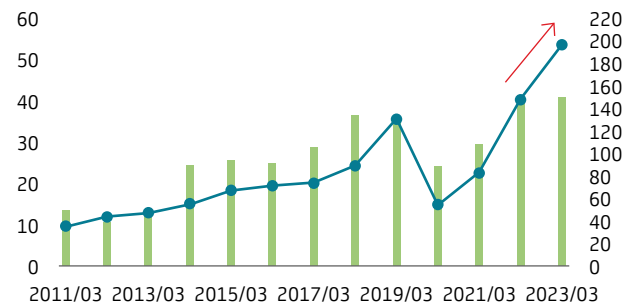


\*Based on TOPIX companies with fiscal year ending in March. Share buybacks aggregated from April 1 to May 15 for each year.  
Source: Rengo, World Gold Council, BoFA Global Research, QUICK, UniCredit Group Investment Strategy

AGGREGATE NET INCOME OF TOPIX\* AND NUMBER OF SHARE BUYBACK ANNOUNCEMENTS

● Net profit in JPY trillion (left scale)

● Aggregate number of buyback plans during FY earnings season (right scale)

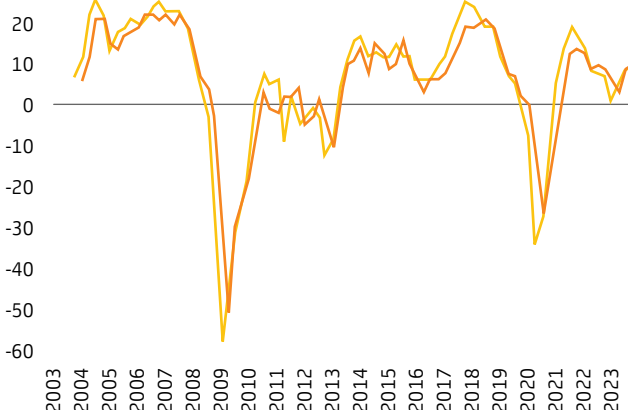


Evidence of a new more favourable business climate have been confirmed by the September BoJ Tankan Survey, given the improving corporate sentiment and a strong capex appetite.

## 3. JAPAN: IMPROVING BUSINESS SENTIMENT

MANUFACTURERS SENTIMENT IMPROVED FOR 2 QUARTERS IN A ROW

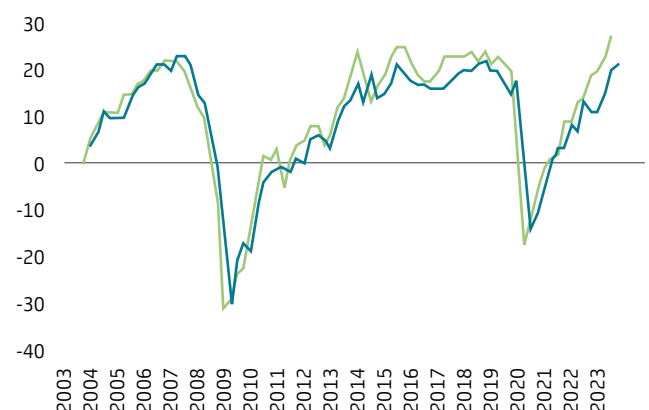
● Business condition DI ● Outlook DI



Source: BoJ Tankan, BoFA Global Research, September 2023

NON-MANUFACTURERS SENTIMENT IMPROVED FOR 6 QUARTERS IN A ROW

● Business condition DI ● Outlook DI



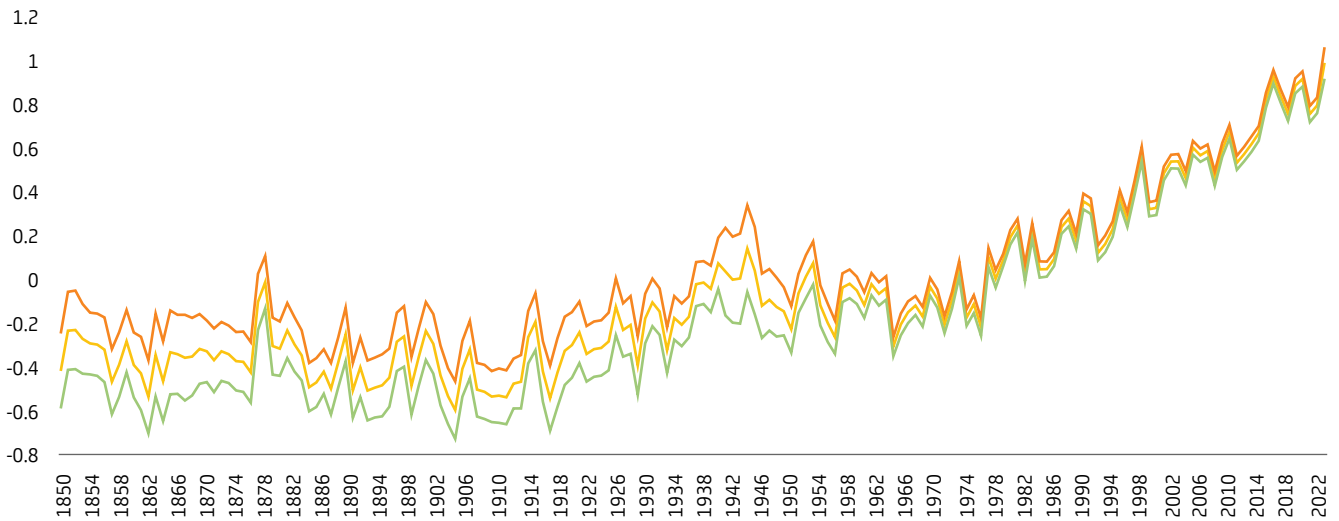
## III. CLIMATE CHANGE

Climate change is a challenge of unprecedented proportions and requires coordinated efforts at a global level. It is causing extreme weather events, rising sea levels and changing ecosystems. According to 2023 studies, the year 2023 is likely to be the warmest year since records began (see chart 4). Climate change is caused by a variety of factors, including greenhouse gas emissions from human activities such as fossil fuel burning, deforestation and agriculture. Understanding these causes and tackling climate change require complex solutions in the context of comprehensive international cooperation, as climate change is closely linked to other global challenges such as poverty, food security and health. The impacts of climate change are unevenly distributed, with particularly vulnerable regions and communities being hit harder. This leads to social inequalities and injustices (see also Megatrend "Inequality").



#### 4. 2023 – THE WARMEST YEAR SINCE MEASUREMENTS BEGAN

- Global average temperature anomaly relative to 1961-1990 (°Celsius)
- Upper bound of the annual temperature anomaly (95% confidence interval)
- Lower bound of the annual temperature anomaly (95% confidence interval)



Note: The grey lines represent the upper and lower limits of the 95% confidence intervals.

Source: Our World in Data, UniCredit Group Investment Strategy

At the same time, the transition to renewable energies is creating new economic sectors and jobs and can offer considerable investment opportunities. This is because the need for innovative solutions requires increased efforts in research and development. Investments in green technologies (such as solar energy, wind energy and hydropower) can help reduce dependence on fossil fuels and accelerate the transition to a low-carbon economy. Accordingly, investing in companies that offer products and services to increase energy efficiency can pay off in the long term. With the growing interest in electric vehicles, investment opportunities in the field of electromobility are also increasing. In addition, investments in infrastructure, technologies, and services for adapting to the effects of climate change are likely to gain in importance, as are investments in solutions for overcoming water scarcity and water pollution.

#### IV. TECHNOLOGICAL INNOVATIONS

Technological innovations do not emerge and develop in a linear fashion. Most of the time they start slowly but, as soon as the feedback mechanisms that allow for extremely fast and unexpected changes are activated, they quickly assume an exponential trajectory. The consequences of this process, which starts with a convergence of technologies, spill over not only across all sectors of the economy, but throughout society itself.

For example, since the smartphone was launched in 2007, sales have reached USD1 trillion in just 10 years and its penetration has exceeded 80% of the market. The adoption of the smartphone has not been linear and has followed an S-curve, following a pattern already observed for many other innovative technologies of the past: a slow pace at the beginning, with a market penetration of 1%-2%, but accelerating exponentially until it reaches a penetration of around 80%, the point from which the growth moderation and market saturation phase begins. However, there is something even deeper (non-linear) that accompanies this phenomenon: the new technology influences not only the industry from which it originates, but also other sectors, the economy as a whole and society as a whole. This is because there are a plurality of interconnections, new and old, activated before and after the advent of innovation. In short, a network develops, the size of which grows rapidly until it affects every aspect of our daily lives.

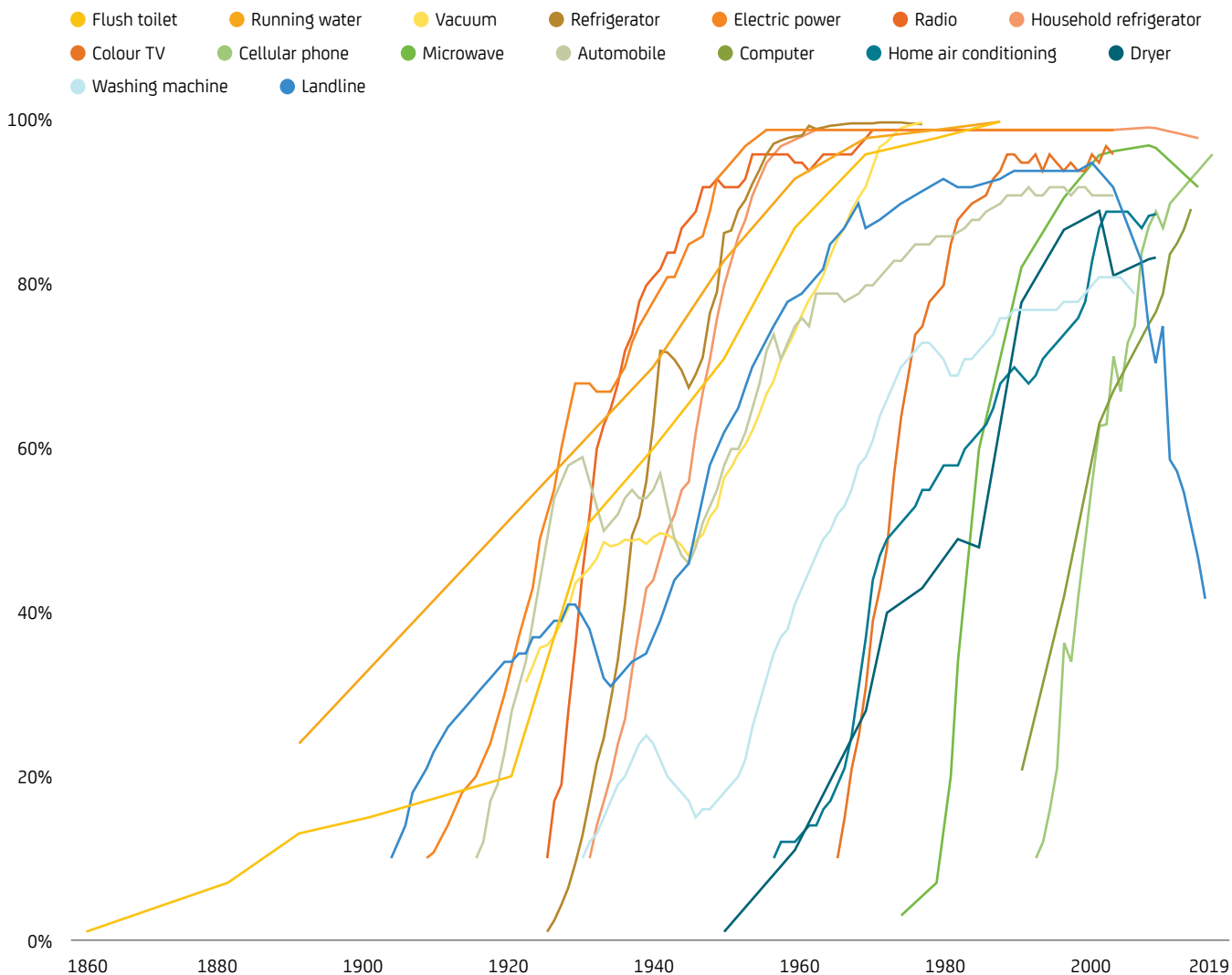
Understanding these interconnections, before and after, is extremely important for understanding the innovation process. Sticking with the smartphone example, why did the iPhone appear in 2007? Why not in 2005 or 2009? The reason lies in the fact that it was built on a series of underlying technologies from different sectors, each of which had to be developed to the point where it was possible to produce a USD600 smartphone. The cost and characteristics (size, weight, reliability, functionality) of these individual technologies had to reach a level where, when combined together (technological convergence), they would create a product good enough to satisfy consumer desires and affordable enough for them to buy. On the other hand, the smartphone has created enormous

possibilities far beyond the narrow confines of the mobile phone market. The Internet itself has moved from PCs to smartphones. Sectors ranging from music, finance, information, restaurants, education and travel have been totally transformed.

Smartphones have almost completely replaced cameras. The same can be said for MP3 players, GPS navigators and game consoles. Social life has been transformed because the smartphone has revolutionised the way we communicate, make friends and find work. And the taxi market in many countries, often protected by old regulations and licenses, has not been able to protect itself except by transforming itself.

This chain of complex causal connections has not yet come to an end. On the contrary, the technological convergence of smartphones, the cloud and Artificial Intelligence (AI), will drive even more change – which we believe is for the better – in industries, sectors and social life, with likely political and financial consequences.

## 5. SHARE OF UNITED STATES HOUSEHOLDS USING SPECIFIC TECHNOLOGIES

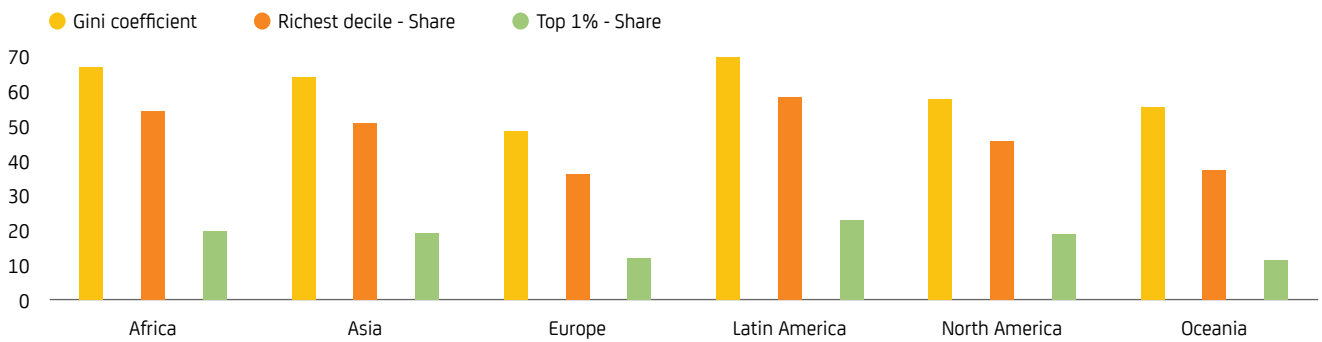


Source: Our World in Data, UniCredit Group Investment Strategy

## V. INEQUALITY

Inequalities between social groups, such as in income distribution, whether due to differences in age, gender, race, ethnicity, migration status or disability, are widespread in industrialised and developing countries alike. According to the United Nations, over 70% of the world's population live in countries where income inequality has increased over the last three decades. This is due to a variety of factors, including historical, economic, social and political causes. The Gini coefficient (or Gini index) indicates the degree of inequality in income distribution, e.g. in a country or region, according to the per capita income of a household (see chart 6). It makes it clear that income inequality is not limited to a specific country or region.

## 6. GINI-INDEX: INCOME INEQUALITY VARIES FROM REGION TO REGION



Note: The year 2021 is shown. The Gini coefficient is a measure of relative concentration or inequality and can assume a value between zero and one (Gini coefficient) or scaled from 0 to 100 (Gini index). The calculation of the Gini coefficient is based on the so-called Lorenz curve. In the case of equal distribution, the Gini coefficient has a value of zero and in the case of concentration of total income on just one person, a value of 1. In general, countries with a Gini coefficient of between 0.50 and 0.70 (Gini index between 50 and 70) are described as having very unequal incomes, and those with a Gini coefficient of between 0.20 and 0.35 (Gini index between 20 and 35) as having relatively equal incomes.

Source: Our World in Data, UniCredit Group Investment Strategy

In the economic context, the promotion of diversity, equality and inclusion is becoming increasingly important, as it is now undisputed that companies that do not actively focus on equality and diversity lose decisive competitive advantages, especially in times of a growing shortage of skilled labour. These companies run the risk of losing the global competition for talent and being left behind in the market. In other words, inequality and a lack of diversity represent a financial risk for companies. At the same time, tackling these issues holds enormous growth potential. Accordingly, investing in companies or projects that help to combat inequality or capitalise on this trend can offer both potentially financially attractive returns and a positive social impact.

## VI. HEALTHY LIFESTYLE

The emphasis on a healthy lifestyle has gradually increased, and with the advent of the pandemic came a substantial change in the perception and prioritisation of individual well-being. The health crisis has acted as a catalyst, pushing towards the pursuit of healthier habits, evidenced by an interest in nutritious foods, an increase in home exercise and a greater focus on mental health. This trend reflects the collective awareness and commitment that investing in health is indispensable for a sustainable future and has increased consumers' willingness to purchase related products and services. At the same time, the ageing of the population and the high demand for quality care have generated an increase in healthcare costs and have also prompted governments to intervene, supporting the search for innovative solutions in the most relevant sub-sectors such as diabetes care, cardiology and orthopaedics.

This new scenario has placed the emphasis on the transition from a curative to a preventive approach and this philosophy has led to the development of a revolutionary drug aimed at addressing one of the health system's main enemies: obesity.

Obesity has historically been considered an issue in the developed world due to the accessibility and affordability of highly processed foods. However, rapid urbanisation and rising per capita incomes have also led to an increase in calorie consumption in emerging countries, which are estimated to contribute significantly to the spread of the problem over the next decade. Despite efforts to promote greater individual awareness, global obesity levels are expected to rise: while around one billion people worldwide suffer from obesity in 2023, according to the World Obesity Atlas, by 2035 51% of the world's population will be affected, across all global macro-regions.

This trend generates an increasing pressure of healthcare expenditure on national budgets and makes the development of more effective treatments a priority on a global scale. The cost of healthcare already accounts for 10% of GDP in OECD countries, of which 3% is attributable to obesity at the aggregate level and with a variable but significant impact in all countries, with the United States bearing the greatest burden (see chart 7).

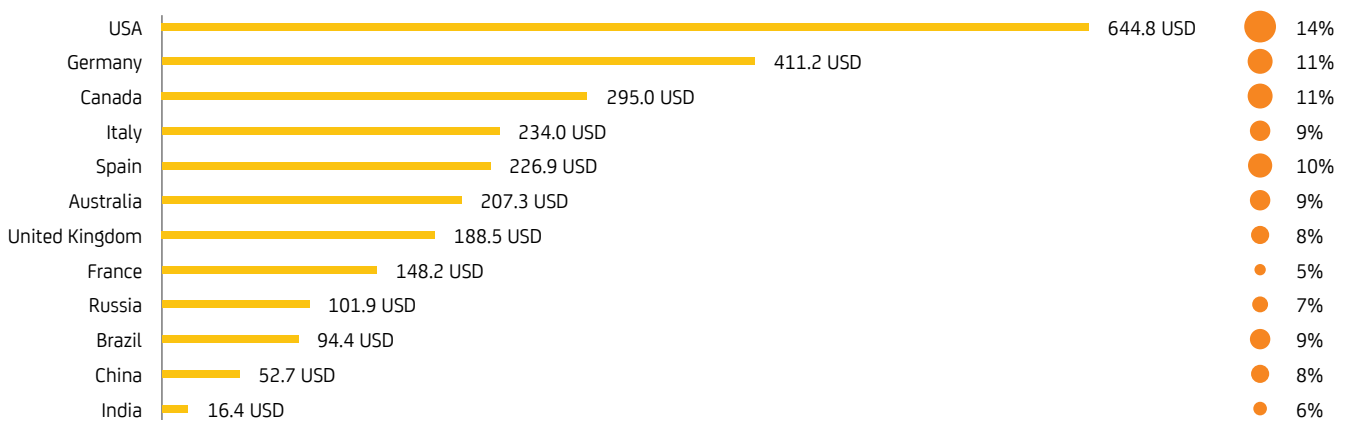


## 7. WHERE OBESITY PLACES THE BIGGEST BURDEN ON HEALTHCARE

Average annual health expenditure per capita due to obesity from 2020-2050

● Expenditure per capita

● % of total health expenditure



Source: Statista, Where Obesity Places The Biggest Burden On Healthcare, <https://www.statista.com/chart/19621/annual-health-expenditure-per-capita-due-to-obesity>, UniCredit Group Investment Strategy

The new needs therefore pushed some of the major insulin manufacturers to go beyond the traditional treatment of diabetes and develop a new weight loss drug, semaglutide. This initiative was prompted by the high correlation between obesity and the development of diabetes and 200 other serious complications, including cardio-vascular diseases and various types of cancer. Semaglutide promotes the loss of about 20% of the baseline body weight, thus lowering the risk factors for the patient and offering the opportunity for significant relief for healthcare systems, with savings estimated at around USD170 billion per year in the US alone, plus numerous indirect impacts that further contribute to the economic burden relief such as increased productivity.

The success of the drug, further reinforced by recent research findings showing that semaglutide results in a 20% reduction in the risk of heart attack, stroke or death from cardiovascular disease, and ever-increasing obesity rates make it unlikely that demand for weight-loss drugs will reverse direction anytime soon. This creates compelling investment opportunities, with the global anti-obesity drug market expected to reach USD100 billion by 2030, growing at a faster rate than GDP and the market average.

## VII. INFRASTRUCTURE 2.0

While in 2023 investments in infrastructure have been penalised by rising rates given their “utilities-like” status, in 2024 we expect the reversal, given expectations of major central banks easing interest rates around May to June.

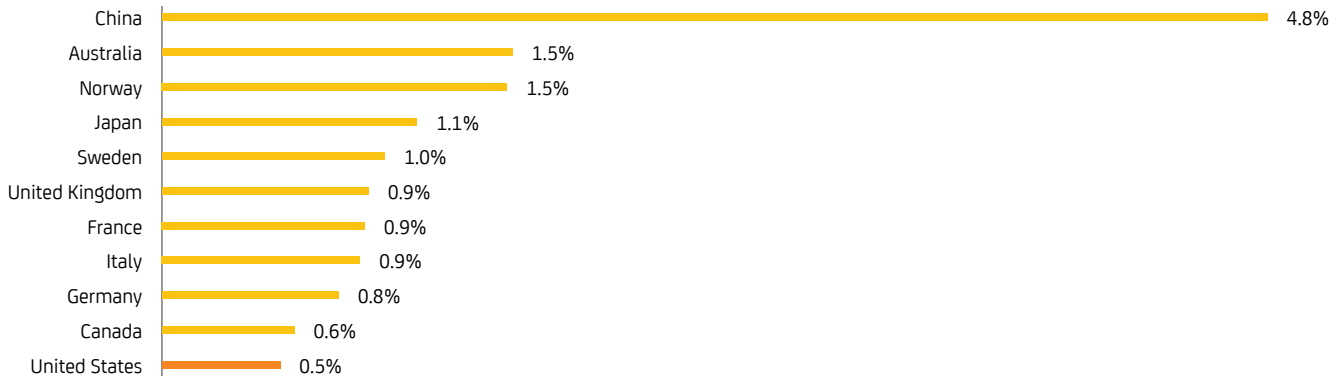
Further, we reiterate the long-term importance of investing in the Infrastructure 2.0 investment theme, due to the fact that it is a “metatrend”, i.e. its growth is functional to that of other sectors such as technology (e.g. broadband infrastructure), climate protection (low-impact transport, electricity grids, etc.), education and health (construction of public schools and hospitals).

The United Nations Sustainable Development Goals report emphasises the importance of resilient infrastructure. Economies with a diversified industrial sector and strong infrastructure (e.g., transport, internet connectivity and utility services) sustained less damage from the pandemic and are experiencing faster recovery.

In addition, in the US the government is implementing the largest federal infrastructure spending in decades, amounting to USD1.2 trillion by 2029. The renewal of the very obsolete US infrastructure system includes not only roads, bridges, ports, airports, mass transit and railways, but also high-speed internet, the electricity grid and the water supply as well as investments for climate protection.

## 8. U.S. INVESTS LESS IN TRANSPORTATION THAN OTHER DEVELOPED COUNTRIES, CHINA

Annual inland infrastructure investment as a percentage of GDP, selected countries

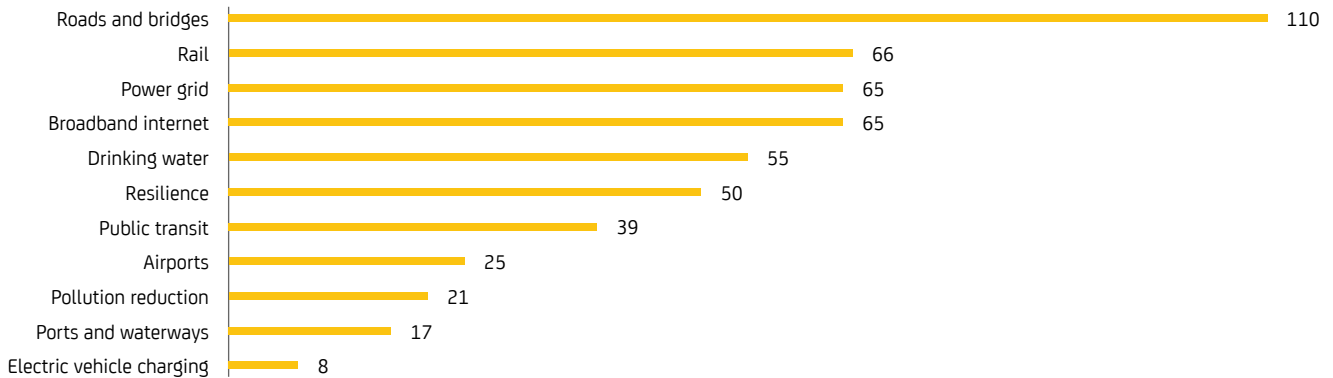


Note: Data is from 2021 or the most recent year available. Inland infrastructure includes roads, rail, inland waterways, maritime ports, and airports. All sources of financing are accounted for.

Source: Organization for Economic Cooperation and Development

## 9. WHAT DOES THE BIPARTISAN INFRASTRUCTURE LAW FUND?

New financing included in the Infrastructure Investment and Jobs Act. Data in USD billion.



Note: "Resilience" projects include cybersecurity and climate change mitigation initiatives.

Source: The State of U.S. Infrastructure, Council on Foreign Relations

# Macro & Markets

## Growth outlook: soft landing of the global economy

Global economic growth is likely to slow further from 3.0% this year to 2.7% next year, as central banks' interest rate hikes are gradually filtering through to the economy, while important support factors are disappearing. For example, the savings surplus of private households has largely been used up in the Eurozone and has also shrunk significantly in the US. Fiscal policy is also likely to be less supportive than last year. In China, the economic weakness is likely to persist for some time in view of a deflationary property market and worsening demographic trends. Nevertheless, we believe a hard landing for the global economy is unlikely. Private sector household balance sheets remain quite solid, the expected rise in unemployment is likely to be more moderate than in previous downturns, and we are seeing the first signs of a possible bottoming out in global trade. However, there are also downside risks. In addition to the tense global geopolitical situation (Middle East conflict, Russia-Ukraine conflict and tensions between China and the US), it remains unclear to what extent the delayed effects of the aggressive monetary tightening of the last year and a half will materialise across the economy.

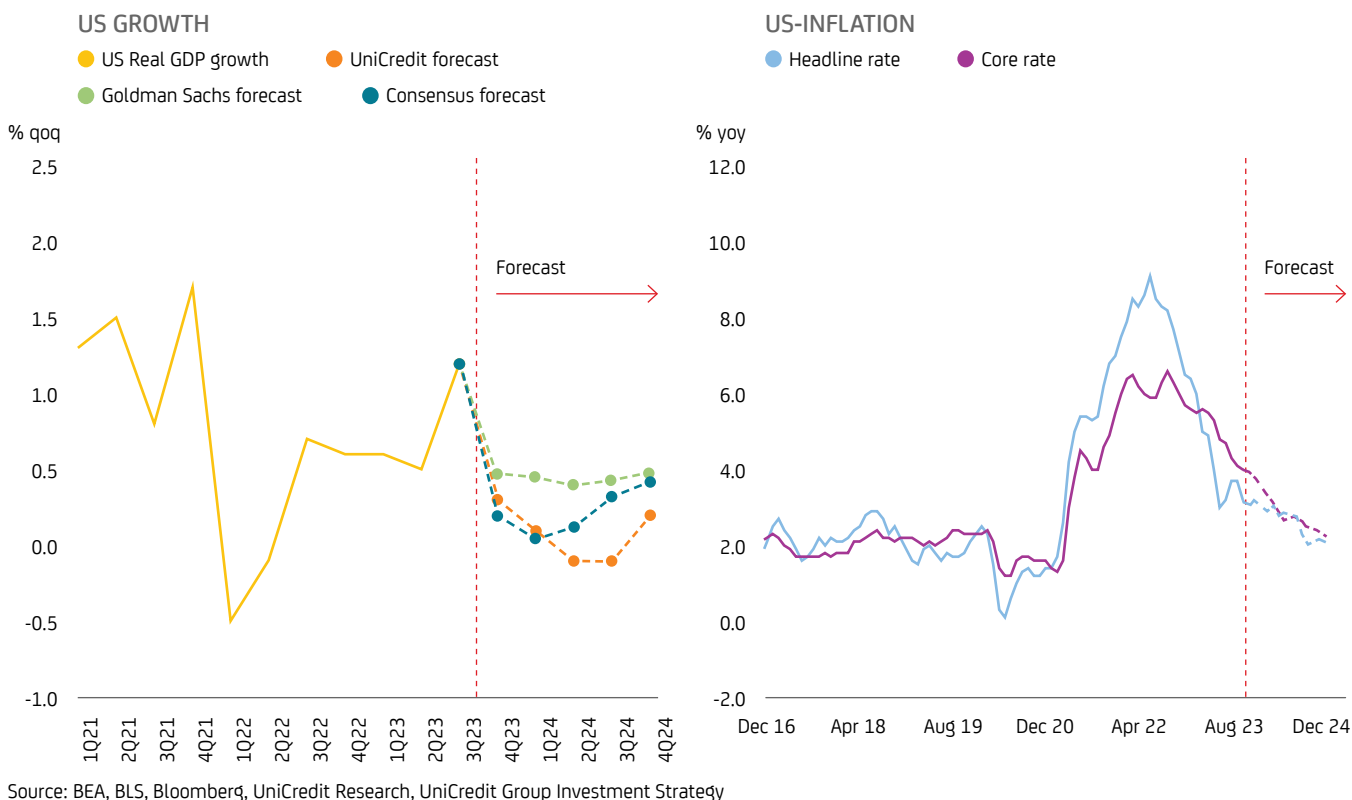
### **US FACING SLOWDOWN, BUT GROWTH LIKELY TO IMPROVE TOWARDS THE END OF 2024**

In the US, we expect gross domestic product (GDP) to grow by 1.0% in both 2024 and 2025, following on from 2.4% this year. On a quarterly basis, growth is likely to largely stagnate next year before recovering in 2025, although it will remain below its long-term growth trend. The slowdown next year is likely to be primarily due to the lower buffer of excess savings and the delayed effects of monetary policy tightening. Fiscal policy is also unlikely to provide any supportive impetus. On the inflation side, we expect inflation to fall to around 2% by the end of 2024, with core inflation also reaching this level one to two quarters later. Inflation in the services sector, in particular, is keeping core inflation stubbornly high. However, further progress is expected in terms of disinflation in the residential sector (where new lettings point to a significant disinflation of official average rents) and inflation in services outside the residential sector. The latter is likely to be due to the further weakening of the labour market, in particular.

As far as monetary policy is concerned, we do not expect the Federal Reserve (Fed) to raise interest rates any further. The next interest rate move is likely to be a rate cut. However, in view of the recent robust economy, we do not expect the first rate cut before June 2024. Before the Fed cuts interest rates permanently, it will probably ensure that core inflation declines sustainably and that the labour market continues to weaken. Due to the time lag in the impact of its monetary policy, it would normally have to act well before inflation reaches 2%. However, it has stated that it will give more weight to the actual economic data than to the forecast models. We expect a rate cut of 25 basis points (bps) per meeting from June to December 2024, followed by a cut every other meeting until 2025. This would mean that the target range for the key interest rate would be 3.00% to 3.25% by the end of 2025.



## 10. US ECONOMY WEAKENS, INFLATION CONTINUES TO FALL



Another important topic for the financial markets in 2024 will be the election of the US president. It will take place on 5 November 2024, as will the complete re-election of the House of Representatives and the election of 33 of the 100 senators. While the Democratic Party is supporting incumbent President Joe Biden as its candidate, the Republican Party will hold its primaries between January and June. Provided there are no legal obstacles due to ongoing court cases, former US President Donald Trump is likely to become the Republican Party's candidate. Although it is still too early to make any meaningful predictions about a possible winner, national opinion polls currently point to a narrow lead for Donald Trump over the current incumbent Joe Biden. The congressional elections are also subject to a high degree of uncertainty. They are likely to be crucial in terms of how much of the new president's agenda can be implemented. The Democrats currently have a majority of 51 to 49 votes in the Senate, while the Republicans narrowly control the House of Representatives. Recent opinion polls suggest that a split in Congress is very likely, with the Senate falling to the Republicans and the House of Representatives to the Democrats.

## EUROZONE LIKELY TO OVERCOME STAGNATION DURING THE COURSE OF 2024

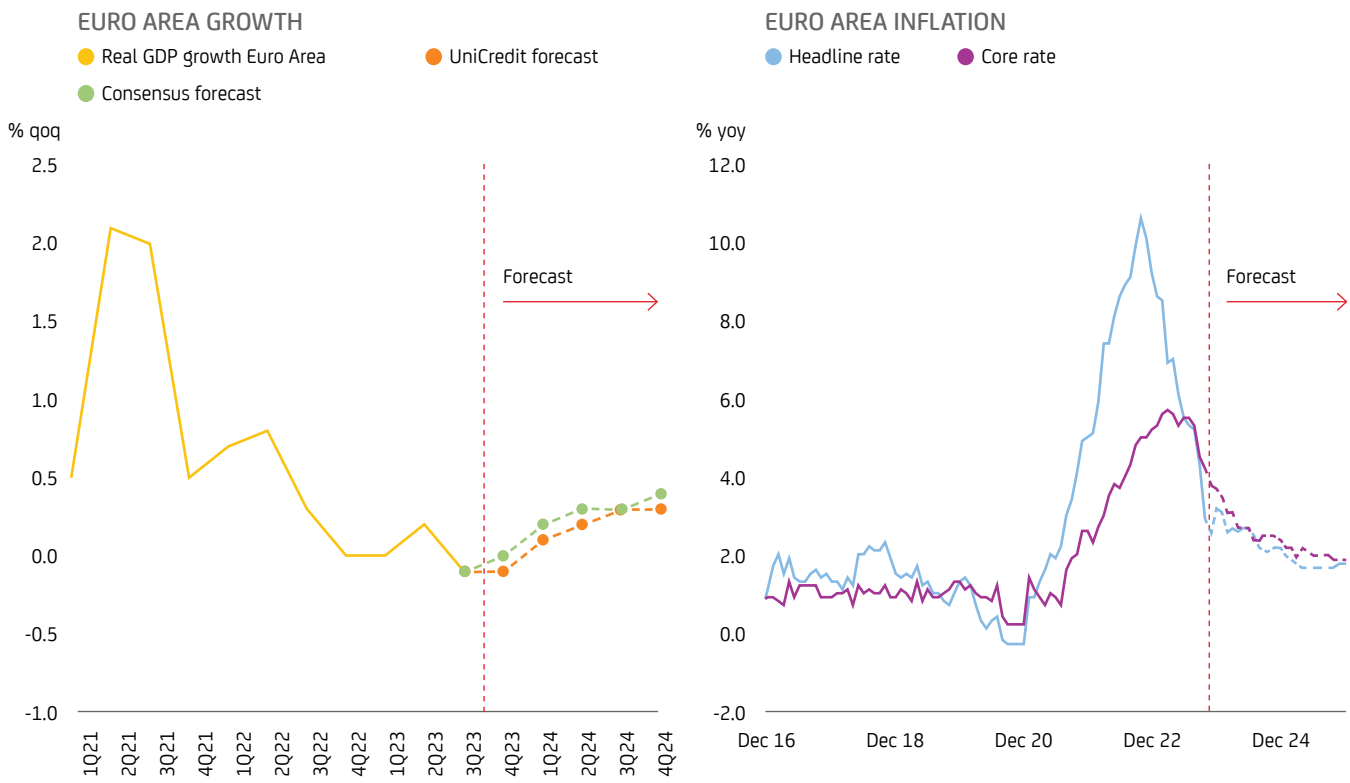
We expect the Eurozone economy to grow by 0.5% next year, the same rate as in 2023, while survey indicators suggest that GDP will stagnate or shrink moderately in the fourth quarter of this year. The negative factors are also likely to persist in 2024, as the European Central Bank (ECB) will continue its restrictive monetary policy (at least in the first half of the year), while the savings surpluses of private households have largely been exhausted. Fiscal policy is also likely to be less expansive than in previous years, which will weigh on consumption. However, disinflation and a possible revival in global trade should have a supporting effect. We expect growth in the Eurozone to accelerate again to 1.2% in 2025. Inflation in the Eurozone has weakened further in all price categories in recent months. Prices for basic consumer goods and food have had the greatest impact on the slowdown in inflation (excluding the energy price component). Prices for services are also moving in the right direction, although they will remain more stubborn due to wage increases in this sector. We expect overall inflation to approach the 2% mark by the end of 2024 and fall below it in 2025. Core inflation will probably weaken more slowly and only reach around 2% in 2025.

The subdued growth and spreading disinflation make it very likely that the ECB has reached the interest rate peak. It should therefore start cutting rates next year when it is clear that wage growth has entered a sustained downward trend that is compatible with its 2% inflation target.

Mid-2024 appears to be the earliest possible time for the ECB to initiate a turnaround in interest rates. It is likely to proceed only gradually with the easing cycle, as there is great uncertainty as to what interest rate level is compatible with a largely **neutral stance**<sup>3</sup>. We anticipate quarterly interest rate cuts of 25 bps from the ECB, which would bring the deposit rate down to 3.25% by the end of 2024 and to 2.25% by the end of 2025.

<sup>3</sup>A neutral stance is the degree of monetary policy orientation that is compatible with a neutral interest rate. The neutral interest rate is the interest rate that neither stimulates nor weakens a country's economic activity and inflation.

## 11. EUROZONE ECONOMY LIKELY TO PICK UP SPEED AGAIN IN 2024, DISINFLATION TREND CONTINUES



Source: Eurostat, Bloomberg, UniCredit Research, UniCredit Group Investment Strategy

## CHINA: STRUCTURAL FACTORS WEIGH ON GROWTH OUTLOOK

In China, we expect GDP growth to slow to 4.5% in 2024 and 4.3% in 2025, after around 5.2% growth this year. Although this means that China will achieve its self-imposed growth target of 5% this year, the economic recovery following the lifting of all pandemic-related restrictions has been significantly less dynamic than many expected. One of the reasons for this is the reluctance of Chinese consumers, whose confidence has fallen to its lowest level since 1991. This is putting pressure on consumption and is expected to continue into 2024.

Several factors are weighing on consumer sentiment. Firstly, the Chinese government has not announced any comprehensive fiscal incentives to support private consumption. In addition, around 70% of Chinese households' assets are tied up in property, meaning that falling property values are having a negative impact on wealth. Increasing regulation in the areas of property, education and technology is also weighing on consumer confidence. And due to the historically high youth unemployment rate, the economic downturn is hitting the younger generation in particular, who have a high propensity to consume. As a result of all this, the economic recovery in China is likely to be less dynamic than has often been the case in the past.

The fundamental slowdown in growth is likely to continue in the coming years, as China is still in the process of transforming its decades-long export-orientated growth model. Major fiscal stimulus measures by the government to strengthen growth are currently not in sight. In addition, China is busy reducing the enormous overcapacity in the property sector, meaning that major rescue packages are unlikely, even if the government continues to ease liquidity conditions for property developers to reduce potential contagion risks. Finally, the current crisis of confidence is partly due to other structural factors – such as a poorly developed social safety net and pension system – which need to be improved through structural reforms.

## REVIEW OF FINANCIAL MARKETS IN 2023: GAINS (IN SOME CASES SIGNIFICANT) ACROSS MOST ASSET CLASSES

Although the financial markets have continued to be characterised by various risk scenarios in 2023, there was a significant upturn this year following last year's sharp correction, as investors began to reinvest surplus free funds.

After two consecutive years of negative performance, large parts of the fixed income universe were able to generate positive returns this year, even though the major Western central banks continued to tighten their monetary policy significantly in 2023 in order to stabilise inflation expectations. For a long time, market participants underestimated the sustained restrictive monetary policy of most central banks, which caused bond yields to temporarily rise to long-term record highs at the beginning of the fourth quarter (see chart 12). For a few weeks now, however, expectations of an interest rate reduction have been gaining the upper hand again, causing yields to fall.

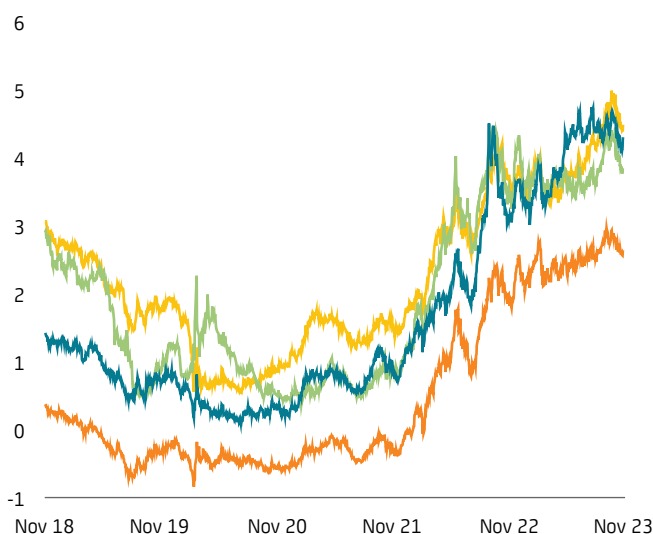
Although the performance of equities was very volatile in 2023, with temporary losses in the double-digit range, it was ultimately largely pleasing. The turbulence in the US regional banking sector and the Credit Suisse crisis initially led to significant losses in value in the spring. The outperformance of US equities over the whole year was largely due to the **"Magnificent Seven"** – the hype surrounding artificial intelligence drove the prices of technology shares up significantly. However, the performance of the broad market (in the US) was less impressive overall. Emerging market equities, on the other hand, also lagged European equities due to the temporary sell-off in Chinese stocks. Japanese equities surprised positively and are on the upswing. Ultimately, most share indices are likely to end the year with gains, which in some cases are double-digit (see chart 12).

<sup>4</sup>This includes the seven American heavyweightweights Alphabet (Google), Amazon, Apple, Meta (Facebook), Microsoft, Nvidia and Tesla.

### 12. 2023 A YEAR OF RECOVERY, ESPECIALLY ON THE STOCK MARKETS

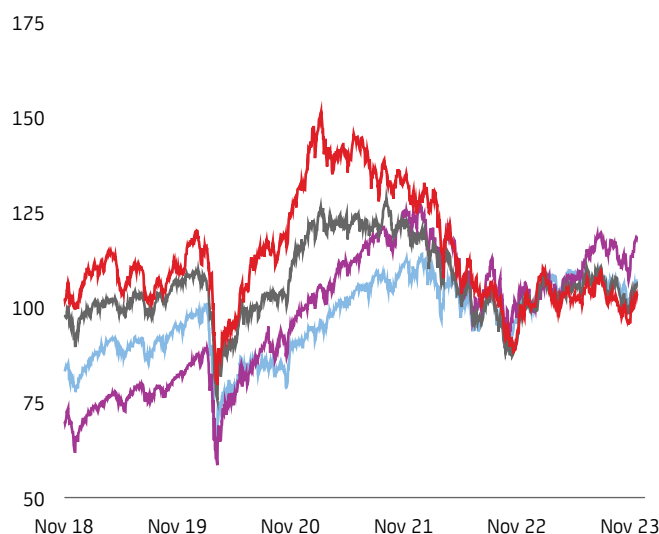
YIELDS ON 10-YEAR GOVERNMENT BONDS (IN %)

● USA ● Germany ● Italy ● UK



MSCI PRICE INDICES (INDEXED, 01.01.2023 = 100)

● Europa (in EUR) ● North America (in USD)  
● Pacific (Ind. Countries., in USD) ● Emerging markets (in USD)



Note: Past performance, simulations and forecasts are not a reliable indicator of future performance. So-called synthetic bonds are calculated to reflect the performance of government bonds in a fixed maturity range. The most "suitable" real (real) government bond at the relevant time is used as a reference for the synthetic bond's yield potential. The development of the expected yield to maturity is shown under the following conditions: interest payments are serviced and redeemed in accordance with the terms and conditions and the bond is held to maturity. In this respect, it is a yield opportunity. The yield opportunities reflect the different risk assessments of the investors for the respective products or countries (higher yield opportunity = higher risk assessment). The indices or synthetic bonds cannot be purchased and therefore do not include any costs. When investing in securities, costs are incurred which reduce the performance. When investing in foreign currencies, the return may also rise or fall because of currency fluctuations.

Source: Bloomberg, UniCredit Group Investment Strategy, observation period: 25.11.2018-25.11.2023

While the US dollar reacted very sensitively to the dynamics of US Treasury yields this year, differing growth prospects and interest rate expectations between the Eurozone and the US, as well as geopolitical uncertainties, weighed on the euro against the dollar (see chart 13), which has recently weakened again.

Except for precious metals, commodities lost some ground this year after two solid years. The prolonged uncertainty regarding future interest rate policy contributed to volatility, and the production cuts by OPEC+ countries were only able to support crude oil prices temporarily (see chart 13). However, the fall in commodity prices and the decline in global demand for crude oil had a positive impact on disinflation of producer and consumer prices. In the case of natural gas,



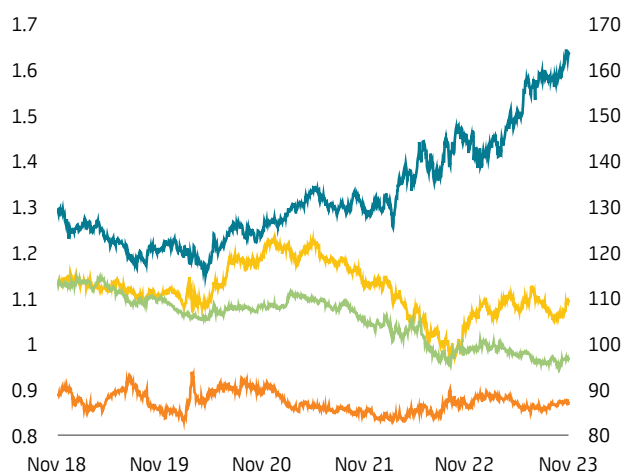
the sharp decline in TTF benchmark prices since summer 2022 (see chart 13) was primarily due to (lower) demand. Price volatility has increased in recent months because of several overlapping factors, including extraordinary maintenance work on gas plants in Norway, strikes at LNG terminals in Australia, the war between Israel and Hamas and acts of sabotage on a pipeline between Finland and Estonia.

In 2023, gold temporarily benefited from the turbulence in the banking sector (in the US and Switzerland), which briefly pushed the gold price above the USD2,000 per troy ounce mark. However, the sharp rise in interest rates, and thus in US yields, weighed on the non-interest-bearing precious metal for a long time. Since the Hamas terrorist attack on Israel, however, gold has been on the upswing again (see chart 13).

### 13. COMMODITIES BURDENED BY CYCLICAL HEADWINDS

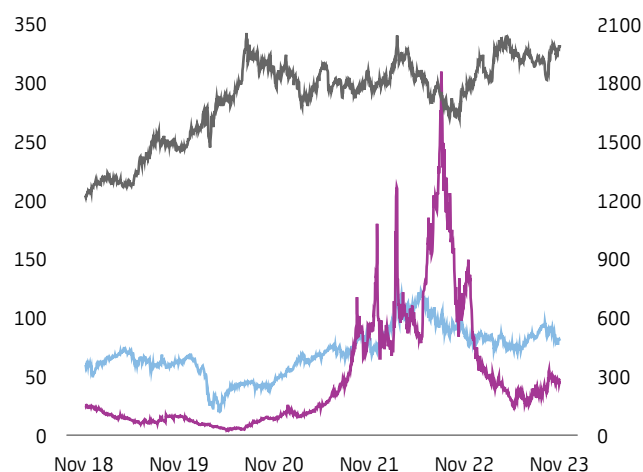
#### EXCHANGE RATES

● EUR-USD ● EUR-GBP ● EUR-CHF ● EUR-YEN (R\$)



#### DEVELOPMENT OF NATURAL GAS, OIL AND GOLD PRICES

● Oil (Barrel Brent, in USD) ● Gold (Fine ounce, in USD, R\$)  
● Natural gas, forward TTF index (in EUR/MWh)



Note: Past performance, simulations and forecasts are not a reliable indicator of future performance. The indices cannot be purchased and therefore do not include any costs. When investing in currencies or commodities, acquisition and custody costs incurred are not taken into account. When investing in foreign currencies, the return may also rise or fall because of currency fluctuations.

Source: Bloomberg, UniCredit Group Investment Strategy, observation period: 25.11.2018-25.11.2023

## 2024 FINANCIAL MARKETS OUTLOOK: MEDIUM-TERM RISK/RETURN EXPECTATIONS HAVE IMPROVED

Medium-term risk/return expectations have improved significantly compared to recent years thanks to the highest bond yields in more than 10 years and somewhat more favourable valuations of equities. Against this backdrop, both bonds and equities are expected to perform constructively in the coming year, although significant sources of risk cannot be dismissed. The effects of monetary policy tightening have yet to fully materialise, while fears of recession and increased refinancing risks, in addition to geopolitical tensions, are likely to contribute to the overall fragile sentiment.

Fixed income securities should head for calmer waters in 2024 and government bonds should deliver positive yields as key interest rates in the major economies should now have peaked. As a result, we expect bond yields to fall next year and the inversion of the yield curve to decline as central banks are likely to start cutting interest rates towards the middle of the year. Nevertheless, yields are likely to remain very sensitive to incoming macroeconomic data. Two-year yields could fall towards 4% (US Treasuries) or well below 3% (Bunds) by the end of next year. We also see a downward trend for the long end of yields, although the extent of this is more difficult to estimate and is likely to be less pronounced. A certain degree of caution regarding the possible decline in long-term yields in the coming quarters seems appropriate in any case. One risk in particular is that, contrary to expectations, inflation remains stubbornly high and interest rate cuts could be delayed accordingly, which would mean that renewed yield increases could be expected at the long end. Conversely, if the restrictive monetary policy leads to a much more pronounced slowdown in growth than expected and the central banks (must) cut interest rates more aggressively, this could lead to a more pronounced rally, particularly at the short end.

Regarding equities, the market environment next year is likely to be characterised by fairly low corporate earnings growth, although earnings estimates for the next 12 months are still close to their all-time highs. As a result, we believe that the potential for a renewed rise in valuations in 2024 is based less on earnings growth and more on the development of interest rates, which

should have peaked. If, as expected, bond yields gradually fall over the course of the year, this will have a positive impact on valuations (price/earnings ratio or P/E ratio), as future corporate earnings will be discounted at a lower interest rate. Equities are likely to offer additional upside potential, especially if the trend towards lower yields and signs of economic stabilisation become clearer in 2025. Thus, it does not seem out of the question that share prices in the Eurozone could see double-digit gains in the coming year. In the US, the upside potential could even be somewhat greater due to the generally higher interest rate sensitivity because of the technology-heavy industry structure. The more pronounced economic sensitivity of the European economy could still prove to be a dampening factor compared to the US in 2024.

In our view, the expected start of the easing cycle by the Fed should only have a moderately negative impact on the US dollar in 2024. The growth differential between the US and the Eurozone should also slow down any rally in the euro against the US key currency. Nevertheless, we see further, moderate potential for the euro to appreciate against the US dollar in this environment. However, if the Fed were to maintain its current restrictive stance for longer than expected or the ECB were to move earlier and to a greater extent towards lowering interest rates, this would certainly have a noticeable negative impact on the euro.

In the coming year, crude oil could benefit from the acceleration in global economic growth in the second half of the year. We assume that the conflict between Israel and Hamas will remain localised and as such will not continue to have a major impact on the oil market. However, should it escalate, and other regional players (particularly Iran) intervene, this would likely result in a significant jump in Brent prices. In such a scenario, however, the OPEC countries will presumably step in with stabilizing measures. Several factors such as weather anomalies are likely to continue to weigh on the demand outlook for natural gas. According to projections by the EU agency Copernicus, the 2023/2024 winter season in Europe is expected to be warmer and wetter than average due to the El Niño weather effect. Due to reduced production capacities in energy-intensive sectors, continued energy efficiency gains and the growing importance of renewable energies, European gas demand in 2024 is likely to remain well below the level before the start of the war in Ukraine. In addition, natural gas storage facilities are completely full this year before the onset of winter.

The expected interest rate cuts in the coming year could favour the development of the gold price. Irrespective of this, the precious metal can always be helpful as an addition to a portfolio in terms of risk diversification and, in view of the numerous (potential) trouble spots, can be an important, stable asset component.

# Asset Allocation – How we manage our portfolio mandate

		Investment View			
Asset	Investment Universe	Underweight	Neutral	Overweight	
Main Asset Classes	Global Equities	○	●	○	
	Global Bonds	○	○	●	
	Money Markets	●	○	○	
	Alternatives	○	●	○	
Main Asset Classes in Detail	Equities	US	○	●	○
		Europe	○	●	○
		Pacific (DM <sup>1</sup> )	○	○	●
		Emerging Markets	○	●	○
	Bonds	EMU Government Bonds	○	●	○
		Non-EMU Government Bonds	○	●	○
		EUR IG Corporate Bonds	○	○	●
		HY Corporate Bonds	●	○	○
		Emerging Market Bonds (Hard Currency)	○	●	○
		Emerging Market Bonds (Local Currency)	○	○	●
	Commodities	Oil	○	●	○
		Gold	○	●	○

<sup>1</sup>DM= Developed Markets (Australia, Japan, Hong Kong, New Zealand, Singapore)



# UniCredit Group Investment Strategy

## – Asset Allocation Stances

### NEUTRAL ON GLOBAL EQUITIES

Equities are showing resilience as investors are confident that the hard landing will be avoided, and that central banks could start their easing cycles by mid-2024. However, the negative lagged effect of higher interest rates is yet to be fully felt in the economy – and consumption will likely come under pressure as excess savings wane and the job market cools.

### NEUTRAL EUROPEAN EQUITIES

A weakening macro momentum with the credit impulse approaching GFC lows. However, the job market remains solid, while falling inflation will increase real income. European equities offer good opportunities for value and quality investors.

### NEUTRAL US EQUITIES

Supported by a strong economy and earnings results, but valuations are high and the concentration of megacaps in the S&P 500 is extreme.

### NEUTRAL EMERGING MARKET EQUITIES

As for Emerging Markets Asia, in China Q3 GDP was higher than consensus due to targeted fiscal stimuli, but the stress in the real estate sector is rising. In Latin America, Brazil is a bright spot due to expectations of rate cuts, as inflation is falling, and fiscal reforms are likely. Overall, valuations are cheap for EM equities. Countries and sectors selectivity among EMs is strongly recommended.

### POSITIVE ON PACIFIC EQUITIES

Wage growth and rising inflation – with the BoJ set to remain expansive – are positive factors for Japan, which is emerging from a long phase of deflation. In addition, the increase in corporate profits and the reform of the Tokyo Stock Exchange are encouraging intense share buyback activity.

### POSITIVE FROM NEUTRAL ON GLOBAL BONDS

We have upgraded Global Bonds to overweight from neutral, as they present an attractive risk-reward profile. In detail, weakening growth and a cooling inflation support our preference for “high quality bonds”, such as Euro Investment Grade corporate and government bonds.

### OVERWEIGHT EURO INVESTMENT GRADE CORPORATE BONDS

Supported by the resilience of the economic cycle and investors' persistent search for yield. Overall, IG corporate fundamentals are expected to remain solid thanks to healthy balance sheets, better than expected earnings, strong cash balances and low leverage levels relative to long-term averages.

### NEGATIVE HIGH YIELD CORPORATE BONDS

The spreads in the asset class do not yet fully discount a material economic slowdown, especially in the US, due to more restrictive lending conditions. Also, the asset class is relatively less liquid.

### NEUTRAL EMU GOVERNMENT BONDS

A weakening macro picture, cooling inflation, and the expectation of the ECB cutting rates around mid-2024 lead us to an increasingly constructive view on this asset class. We also consider a gradual increase in duration, given that inflation, apart from some unfavourable base effect in the short term, is on a downtrend path.

### NEUTRAL NON-EMU GOVERNMENT BONDS

Supported by expectations of falling inflation and Fed easing around mid-next year.

### NEUTRAL ON EMERGING MARKET BONDS IN HARD CURRENCY

Interesting carry but we prefer focusing on “high quality bonds”. We stay defensive and selective, avoiding countries with high external debt and current account deficit.

### POSITIVE ON EMERGING MARKET BONDS IN LOCAL CURRENCY

Supported by expectations of Fed easing around mid-next year and US dollar weakening. In LatAm, falling inflation opens the way for material central banks easing.

### NEGATIVE FROM NEUTRAL ON MONEY MARKETS

Interesting yields, but we prefer to invest in fixed income asset classes such as government bonds and Euro corporate IG given expectations that the Fed and ECB will start their the easing cycles around mid-2024.

### NEUTRAL ALTERNATIVES

They offer portfolios de-correlation opportunities, while real assets benefit from their inflation-hedging role.

### NEUTRAL COMMODITIES

We expect a more balanced market for oil and see a low risk of major and widespread escalation of the Israel-Hamas conflict.

### NEUTRAL GOLD

Supported by expectations of lower interest rates and a weakening US dollar.

### CURRENCIES

We expect a mildly weaker US dollar. The Fed will likely cut rates in 2024 and 2025 but slow growth outside the US, and with other major central banks possibly starting their easing cycles, will limit the fall in the US dollar.



# Columns

Local CIOs in dialogue with the clients

## Answers from Italy

### WHAT IS YOUR VIEW FOR THE US DOLLAR IN 2024?

Among a number of key principles, our investment philosophy focuses on the construction of portfolios with a global geographical scope. This creates the potential to achieve an adequate level of diversification, while also the potential to capture the best investment opportunities around the world.

This approach also means that our portfolios take positions on foreign currencies, as a consequence of investments made on the US stock market for example, or in the bonds of emerging markets countries. Given the wide variety of instruments available, especially when these investments are made in funds or ETFs, it is possible to choose whether to use these instruments in the currency unhedged share classes or in the currency hedged share classes. It is therefore an active choice that can also have a significant impact on the return of the position and the portfolio as a whole. In fact, it is important not to forget that currency risk is the risk on which there is typically the greatest concentration.

For example, imagine building a portfolio of 50 equally weighted US dollar instruments and assigning them an overall weight of 30%. The result of the portfolio will depend on the movements of 50 different prices, each of which will have an impact equal to 0.6%. In addition to this, there is also the impact of the US dollar – but this will have a weight of 30%! We therefore understand well how much these choices must also be weighed. It is therefore useful to take a look at the prospects of the US dollar, which during the year moved within a range of 1.05-1.12 and is preparing to record a slight loss having opened the year at 1.06 and currently quoting around 1.09.

In 2023, the Fed raised rates aggressively and reduced its balance sheet by around USD2,000 billion, and the US economy was the one that held up best among the developed countries – and, unfortunately, during the year there were various dramatic events of a financial (bank failures) or geopolitical nature (Hamas attack against Israel). All these factors, in theory, should have been supportive of the US dollar, yet they turned into only temporary appreciation against the euro. So, there are evidently other underlying contrasting forces that are pushing for the weakening of the greenback. Let's try to analyse what they might be.

The US finds itself in a macroeconomic situation defined as twin deficits. The government budget deficit in 2023 is equal to 8.2% and expected at 7.4% for 2024. Therefore, in both cases, it is more than double that of the euro area. In the case of the current account balance, however, the deficit is equal to 3% for 2023 and expected at 2.7% for 2024. The euro area, on the other hand, presents a current account surplus given the export vocation of its main economies. These deficits imply a constant and substantial flow of dollars leaving the US economy, which are collected by foreign economic operators. The latter can decide to buy shares on US stock exchanges and US Treasury securities, thus creating a counter inflow that keeps the value of the dollar constant. But evidently, this mechanism is not in balance and the prevailing underlying movement is that of a sale of US dollar in favour of other currencies. This phenomenon is probably also determined by the desire of the most important central banks of emerging countries (China, Brazil, India, South Africa) to diversify their currency reserves, traditionally held in dollars, in a geopolitical context which sees ever greater opposition to the US hegemony. There are not many currencies that can

accommodate these flows given that large, diversified capital markets with great liquidity and great reliability are needed. And the financial markets of the euro area offer these characteristics.

The elements we have represented above will continue to influence the EUR-USD exchange rate with an additional factor of weakness for the dollar. In fact, during 2024, we think that the Fed has room to cut rates, starting from the second quarter, in a more aggressive manner than the ECB, bringing the short-term interest rate differential from the current 150 bps (5.5 % FED - 4% ECB) to approximately 100 bps at the end of 2024 (4.25% FED - 3.25% ECB). Furthermore, given that this level also determines the cost of hedging currency risk for domestic investors buying US dollar-denominated instruments, its contraction will likely make hedging more attractive.

To complete our analysis, however, we cannot ignore a characteristic behaviour of the US dollar, which tends to strengthen during correction phases of US stock markets. In fact, in 2023, the period of strengthening of the dollar largely coincided with the downward movement of the stock markets between the end of July and the end of October.

In conclusion, our forecast is for the continuation of the current trend of a slight weakening of the US dollar against the euro. However, knowing the historical behaviour of the dollar, we must try to put a good risk management policy in place. For this reason, when we buy bonds in USD we tend to hedge, at least in part, the exchange rate risk. However, when we buy shares on the US market, we prefer to also expose ourselves to exchange rate risk, given that in the event of a correction in the stock markets the dollar tends to appreciate – and therefore limits the overall drawdown of the position.

**ALESSANDRO CAVIGLIA**, *Chief Investment Officer Italy, UniCredit SpA*

## Answers from Austria

### A CHALLENGING YEAR COMES TO AN END. WHAT BALANCE CAN WE DRAW?

After an unprecedented 2022, there were high hopes on the financial markets that 2023 would show a much more positive side.

But this hope was only partially realised. Many global economies proved surprisingly resilient to the increasingly restrictive monetary policy of many central banks. However, this resilience is built on a fragile foundation. While the European economy has already slipped into recession, the US economy could manage a soft landing and avoid negative economic growth. But there are still many questions behind these assumptions.

The next few quarters will show how much the tightening of monetary policy will actually impact the real economy. Many companies are still benefiting from the historically low interest burden of recent years – but interest expenses are expected to be significantly higher in the coming years.

The picture on the equity markets has already been very mixed over the course of the year. A few AI-related companies (the “Magnificent Seven”: Amazon, Alphabet (Google), Apple, Meta (Facebook), Microsoft, Nvidia, Tesla), which enjoy a high weighting in the indices, rushed from one share price high to the next and eventually turned into the primary driver of US equity markets. However, the broad market has hardly been convincing this year. This lack of market breadth is unusual and harbours risks. A look at history confirms that very one-sided market developments tend to be balanced out again in the following years.

Meanwhile, Japanese equities provided a positive surprise. An improved structural environment, strong company reports, and a favourable valuation attracted the interest of many long-term investors. The significantly higher returns compared to other equity regions were only dampened by the weak performance of the Japanese yen.

Expectations on the bond markets were also high following last year’s turbulence. Many investors had to bury their premature hopes of interest rate cuts over the course of the year – the inflationary momentum was too strong. Nevertheless, the vast majority of bond segments managed a turnaround and have achieved a slightly positive performance year-to-date. The high current interest rate (“carry”) provides a sufficient buffer to compensate for slight increases in yields.

Emerging markets bonds in local currency, in particular, have been the winners so far in 2023. Many emerging countries raised their interest rates very aggressively during the high inflation phase. The positive downward trend in inflation rates is now enabling many central banks in these regions to turn interest rates around quickly. The first central banks have already started the cycle of interest rate cuts, with rising bond prices as a logical consequence.

We remain cautiously optimistic for the coming year. Interest-bearing securities in particular are likely to be the beneficiaries of growing hopes for interest rate cuts. Next year could also be favourable for equities. A hard economic landing should be avoided and low interest rates and moderate inflation figures should ensure that an equity-friendly environment develops. Risks such as a resurgence in inflation and a slide into recession are not part of our base scenario. However, we must keep a watchful eye on them.

We would like to take this opportunity to wish all our clients a successful investment year in 2024!

**OLIVER PRINZ**, *Co-Chief Investment Officer of UniCredit Bank Austria AG and Schoellerbank AG*

## Answers from Germany

### WHAT ARE THE IMPLICATIONS OF THE RECENT JUDGEMENT BY THE FEDERAL CONSTITUTIONAL COURT, PARTICULARLY REGARDING THE GERMAN ECONOMY?

The German government was recently caught off guard by the ruling of the Federal Constitutional Court. In mid-November, the court prohibited the reallocation of EUR60 billion (which is around 1.5% of German GDP) in funds, originally earmarked for combating the pandemic, to the Climate and Transformation Fund (KTF). The KTF is intended to finance programmes for more climate protection and the development of a climate-neutral economy, among other things. The focus is also on the establishment of technologies such as semiconductors and battery technology. At the same time, the judges ruled that the state may not reserve emergency loans for later years. However, in addition to the KTF, the federal government had done this in several special funds, including for the energy price brakes.

In his government statement at the end of November, Federal Chancellor Olaf Scholz made it clear that Germany was facing “challenges of a concentration and severity that our republic has probably never experienced before”. However, he remained vague on the question of how the coalition government intends to manage the economy over the next two years. The positions are far apart: on the one hand, the FDP, led by Finance Minister Christian Lindner, are jumping over their shadow and suspending the debt brake for 2023 once again – the fourth consecutive suspension since 2020. On the other hand, the SPD, which still does not want to cut social spending, and the Greens, for whom the climate protection projects to be funded from the KTF are not up for discussion. The traffic light parties are likely to face long, intensive debates in which they will have to agree on spending and priorities for 2024 and beyond. Scholz now wants to sound out “existing leeway in the budget”, “set priorities”, “naturally also restrict spending”, but also “invest heavily in modernising Germany”. He avoided making a clear statement as to whether the federal government intends to declare an exception again in 2024 or comply with the debt brake.

In its current autumn forecast, the German government expects GDP to fall by 0.4% this year, while an increase of 1.3% was previously predicted for next year. According to the German government, the loss of the EUR60 billion could mean a decline in economic growth of just over 0.5 percentage points next year. Even though the risks of the German economy remaining stuck in stagnation or mild recession if fiscal policy is tightened further have increased, we expect a slight recovery with GDP growth of 0.4% in 2024. Austerity measures and a lack of investment are likely to dampen economic growth, while fiscal policy stimulus is urgently needed in view of the economic slowdown. The greater danger lies in the potentially negative impact on the longer-term growth potential of the German economy – if public investment is cut after years characterised by under-spending on the country’s green transformation. This is because cutting spending on investment projects, the positive effects of which can often only be seen (far) in the future, is likely to meet with less resistance from many voters than, for example, a reduction in social security contributions today. To ensure that Germany does not run into a persistent investment crisis, alternative ways must be found for the country to invest in its infrastructure, the sustainable transformation of the economy, and the skills of its population.

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## DEVELOPMENT OF SELECTED FINANCIAL MARKET INDICES

From	27.11.22	27.11.18	27.11.19	27.11.20	27.11.21	27.11.22	27.11.18	01.01.23
To	27.11.23	27.11.19	27.11.20	27.11.21	27.11.22	27.11.23	27.11.23	27.11.23
<b>Stock market indices (total return, in %)</b>								
MSCI World (in USD)	13.7	18.1	15.4	23.2	-13.8	13.7	67.6	17.9
MSCI Emerging Markets (in USD)	7.1	10.7	20.2	1.9	-22.4	7.1	15.4	5.0
MSCI US (in USD)	15.2	20.3	20.0	27.9	-14.8	15.2	85.3	20.7
MSCI Europe (in EUR)	7.7	18.2	-2.6	21.6	-4.4	7.7	48.7	11.6
MSCI AC Asia Pacific (in USD)	7.5	12.4	19.8	2.9	-19.3	7.5	21.9	6.1
STOXX Europe 600 (in EUR)	7.5	18.9	-1.4	21.7	-5.6	7.5	49.1	11.4
DAX 40 (Germany in EUR)	9.8	17.5	0.7	14.8	-8.7	9.8	40.6	14.7
MSCI Italy (in EUR)	25.2	25.8	-5.6	18.9	-3.4	25.2	76.3	30.2
ATX (Austria, in EUR)	4.4	9.5	-16.4	44.8	-10.0	4.4	28.2	9.1
SMI (Switzerland, in CHF)	-0.1	22.3	3.2	19.6	-7.7	-0.1	41.5	4.0
S&P 500 (USA, in USD)	14.9	20.0	17.5	28.4	-13.0	14.9	85.5	20.3
Nikkei (Japan, in JPY)	20.8	9.1	16.1	10.2	-2.0	20.8	69.5	30.7
CSI 300 (China, in Yuan)	-4.6	26.4	31.7	0.6	-21.2	-4.6	24.5	-7.1
<b>Bond market indices (total return, in %)</b>								
US Government Bonds 10Y (in USD)	-1.6	15.2	11.9	-3.0	-15.0	-1.6	3.0	-0.9
US Government Bonds (ICE BofA, in USD)	-0.1	10.2	7.8	-2.1	-12.0	-0.1	1.0	0.1
US Corporate Bonds (ICE BofA A-BBB, in USD)	3.6	15.7	9.4	0.0	-14.6	3.6	10.8	3.6
German Bunds 10Y (in EUR)	-2.0	7.9	2.4	-1.9	-17.2	-2.0	-12.7	3.0
EUR Government Bonds 1Y-10Y (iBOXX, in EUR)	-1.7	9.2	4.0	-2.1	-15.4	-1.7	-8.1	2.8
EUR Corporate Bonds 1Y-10Y (iBOXX, in EUR)	3.0	6.5	2.5	-1.0	-12.9	3.0	-2.9	4.5
<b>Bond yields (change in basis points = 0.01 percentage points)</b>								
US Government Bonds 10Y (in USD)	69	-128	-94	60	208	69	133	57
US Government Bonds (ICE BofA, in USD)	52	-118	-119	52	288	52	169	47
US Corporate Bonds (ICE BofA A-BBB, in USD)	33	-148	-106	41	306	33	138	28
German Bunds 10Y (in EUR)	55	-72	-22	25	222	55	216	-4
EUR Government Bonds 1Y-10Y (iBOXX, in EUR)	68	-91	-39	28	227	68	200	3
EUR Corporate Bonds 1Y-10Y (iBOXX, in EUR)	29	-94	-29	35	321	29	259	-13
<b>Spreads on government bonds (credit spreads, change in basis points)</b>								
US Corporate Bonds (ICE BofA US Corporate Master)	-26	-29	2	-13	44	-26	-24	-24
US Corporate Bonds (ICE BofA US High Yield)	-63	-32	36	-71	120	-63	-37	-90
Euro Corporate bonds (ICE BofA Euro Corporate AAA-A)	-21	-29	-7	21	57	-21	14	-9
Euro Corporate Bonds (ICE BofA Euro High Yield)	-60	-119	27	-8	150	-60	-25	-62
<b>Money market rates (change in basis points)</b>								
Libor (USD, 3 months)	92	-79	-168	-5	456	92	295	89
Euribor (EUR, 3 months)	203	-8	-13	-4	250	203	427	182
<b>Euro exchange rates (change in %)</b>								
US Dollar (EUR-USD)	5.6	-2.8	8.3	-5.1	-7.6	5.6	-3.6	2.7
British Pound (EUR-GBP)	0.9	-3.7	5.0	-5.1	1.9	0.9	-2.0	-2.3
Swiss Franc (EUR-SFR)	-2.0	-2.9	-1.5	-3.4	-6.1	-2.0	-14.9	-2.1
Japanese Yen (EUR-JPY)	12.6	-6.6	3.1	3.9	11.8	12.6	26.5	15.8
<b>Commodities (change in %)</b>								
Commodity Index (GSCI, in USD)	14.2	19.0	19.2	-2.1	-2.0	14.2	56.2	10.2
Industrial metals (GSCI, in USD)	-5.8	-2.6	19.2	28.2	-12.5	-5.8	22.8	-10.1
Gold (in USD per fine ounce)	14.8	19.9	22.6	-0.6	-2.2	14.8	64.2	10.7
Crude oil (Brent, in USD per barrel)	-4.9	5.0	-23.7	52.6	2.1	-4.9	31.4	-5.8

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