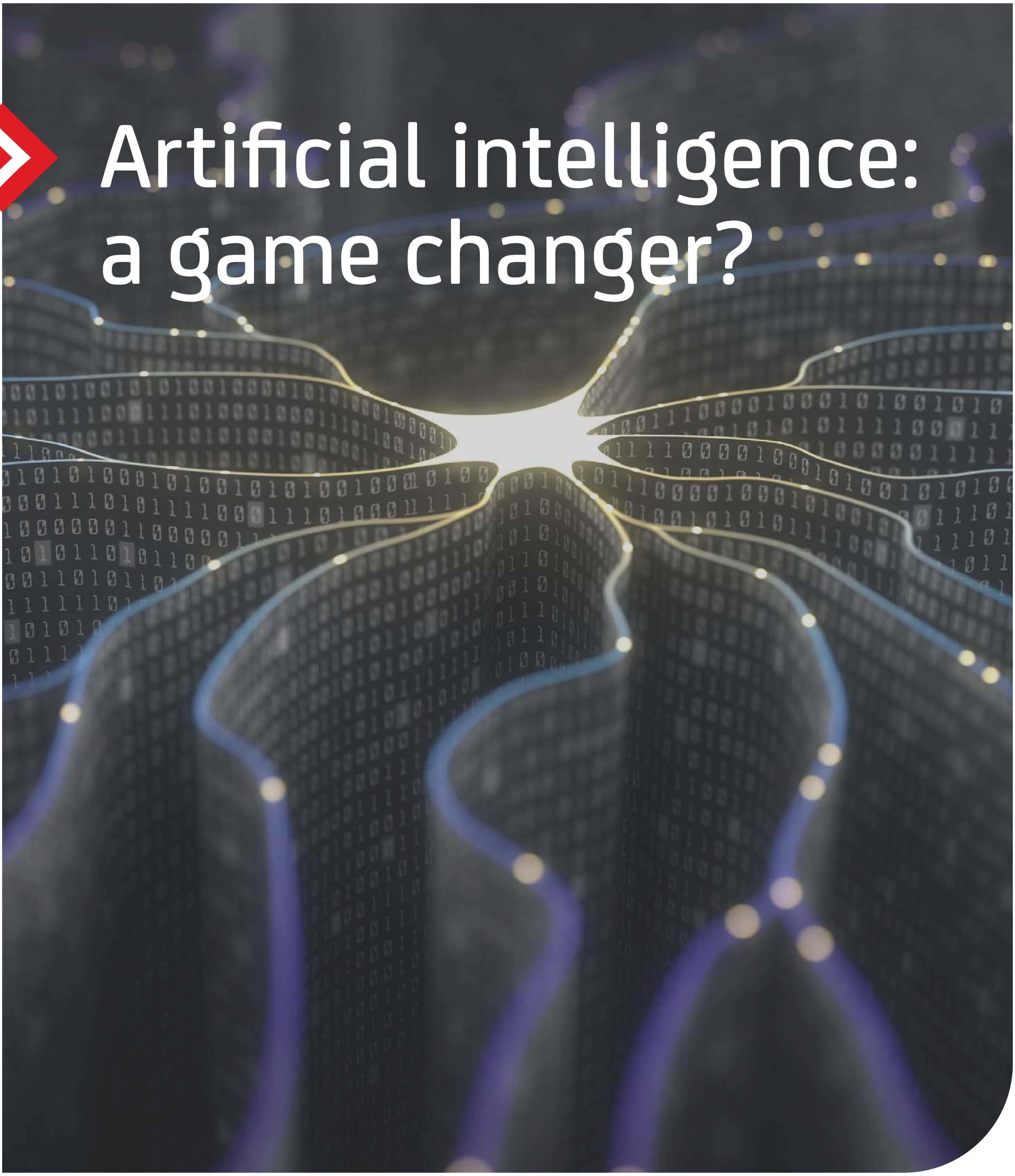
Artificial intelligence: a game changer?

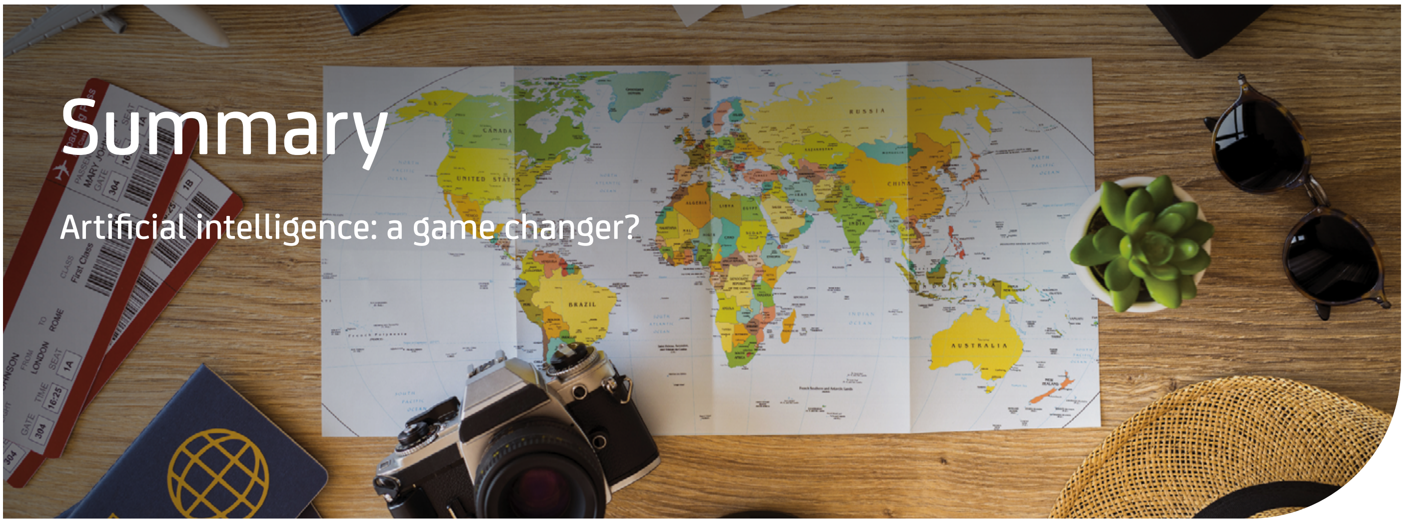


Group Investment Strategy

Monthly Outlook

August 2023

Index



Summary

Artificial intelligence: a game changer?

MACROECONOMIC UPDATE

The US economic data for the first and second quarters present a still rather solid picture. Consumption continues to be robust and the weakening real estate market also seems to have stabilised. Accordingly, we have revised our growth expectations for the second and third quarters of this year slightly upwards, but we continue to expect the US economy could enter a mild recession in the second half of 2023.

The recent downward revisions in growth figures show that the Euro area has been in a mild technical recession since the turn of the year. The weaker economic momentum continues to reflect a large gap between the industrial and service sectors. Although supply chains and input prices have normalised, the manufacturing sector is facing declining orders and high inventories. In contrast, the services sector continues to benefit from solid (post-pandemic) pent-up demand.

After the strong upswing in the wake of the reopening of the Chinese economy in January, the latest leading indicators already signalled a loss of economic momentum in the second quarter of this year. The current growth figures do confirm that growth accelerated in the second quarter, but, at 6.3% year-on-year, fell short of consensus expectations (of 7.1%).

INFLATION AND MONETARY POLICY

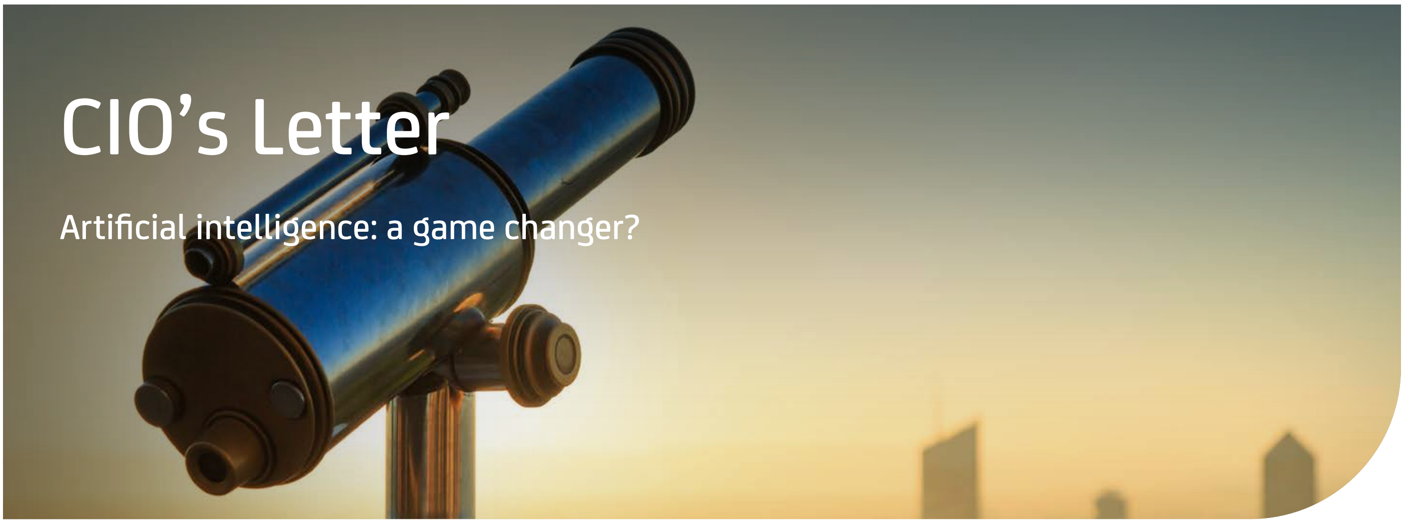
Meanwhile, headline inflation figures declined to 3.0% in June, which is why we expect an average inflation rate of around 4% in 2023 and around 2% in 2024. The US Federal Reserve left the upper policy rate unchanged at 5.25% at its June meeting, but it signalled that the interest rate peak this year is likely to be 50 bp higher than previously expected. Even though there are risks for monetary tightening on such a scale, we still only expect another 25 bp hike at the upcoming July meeting and continue to see rate cuts of 150 bp only next year, with the first cuts likely to start in the first quarter.

In Eurozone we expect an average inflation rate of 5.5 % this year and around 2.5 % next year. At its June meeting, against the backdrop of a core inflation rate that continues to fall too slowly, the ECB raised the deposit rate by 25 bp, bringing it to 3.50%. We expect the ECB to raise its key rates by a further 25 bp each in July and probably also in September, as announced at its last meeting. We expect the deposit rate to peak at 4.00% and that the central bank could start cutting rates from the second quarter of 2024.

FINANCIAL MARKETS

The overall outlook for investors remains positive, in our view, provided inflationary dynamics will cool further. In addition to the developments in the field of artificial intelligence, from which technology stocks in particular should continue to benefit in the future, the upcoming investments in the transformation of energy supply towards climate neutrality in Europe and the US should especially favour industrial companies active in plant and infrastructure construction.

Regarding asset allocation, our current neutral positioning on equities does not reflect a sceptical or cautious view on equities, but a risk-return trade-off in an environment that again allows for positive real returns with longer-dated bonds.



CIO's Letter

Artificial intelligence: a game changer?

After the remarkable first half of 2023, which, in addition to the stock market rally fuelled by the **artificial intelligence (AI)**[1] hype, also had some challenging topics to offer (especially the US regional banking crisis and the US debt dispute), investors are now turning to the second half of the year and the exciting phase after the summer break.

Important central bank decisions are imminent in the coming months, and they will likely have a significant influence on market developments going forward. According to consensus, the capital market expects the Federal Reserve (Fed) to hike the interest rate by 25 basis points (bps) at the end of July. For the European Central Bank (ECB), two more interest rate hikes are expected, one each by 25 bps in July and in September. Accordingly, both central banks are likely to have reached the end of their rate hike cycle shortly. However, if inflationary dynamics do not cool down as expected, there is a risk that further interest rate hikes could become necessary.

What is important for investors, however, is not only the path to the interest rate peak, but also what could happen when it is reached. The markets assume that the turnaround in monetary policy will not be long in coming. For the Fed, they expect a first rate cut as early as the beginning of next year, followed by five more that would bring the central bank rate down from currently over 5% to below 4% by the end of next year. For the ECB, rate cuts are also priced in for the first half of 2024. They are accompanied by implicit market expectations that the inflation rate in Europe and the USA should fall in the course of the coming year towards the target of 2% – without a noticeable slump in growth. For the Eurozone, a slight acceleration of economic growth is even expected in 2024.

Given the optimistic consensus expectations underlying current equity market developments, some investors are concerned that possible disappointments regarding expected interest rate cuts could lead to negative market reactions. However, it is important to stress that a delay of a few months in expected interest rate cuts does not necessarily weigh on equity markets. The real risk, in our view, is that the economy, especially in the US, cools more than expected and the Fed could be forced to cut rates faster. In other words, it is less about the timing of rate cuts than the economic environment in which they take place. Rapid interest rate cuts due to a noticeable recession ("hard landing") in the US are, however, only a risk and not a base scenario in our view.

Nevertheless, investors should keep an eye on the risks. What is clear is that the strong rally in US technology stocks was vigorously driven by the euphoria in the AI sector. To be sure, this rally broadened somewhat towards the end of the second quarter. Nevertheless, the lion's share of the half-year performance on the US equity market is attributable to the "Magnificent Seven" (this includes the seven US technology giants Alphabet, Amazon, Apple, Nvidia, Meta, Microsoft and Tesla). This concentration on a small number of US stocks, which have in the meantime reached extraordinary valuation levels, results in a risk of setbacks if there are disappointments or phases of uncertainty.

The latest developments clearly show once again that for medium- to long-term wealth preservation or accumulation, a broad diversification in the equity portfolio across different companies, sectors and regions fundamentally helps to reduce the overall risk and cushion potential losses. However, this can sometimes cost a diversified portfolio in markets with high concentration – as is currently the case in the US equity market – performance compared to a benchmark index.

[1] Artificial intelligence (AI) refers to the human-like thinking or actions of a computer, robot or machine. The system learns from its mistakes and can react differently to the same task or problem without reprogramming. So far, however, many of the applications are still in development.

Despite the risks mentioned, which can be reduced through comprehensive diversification, the overall outlook for investors remains positive, in our view, provided inflationary dynamics will cool further. In the US, the signs of this are visibly increasing. This would give central banks room to cut interest rates and should also moderately accelerate economic activity. In addition to the aforementioned developments in the field of AI, from which US technology stocks in particular should continue to benefit in the future, the upcoming investments in the transformation of energy supply towards climate neutrality (which are being promoted by corresponding programmes in Europe and the US) are fundamentally opening up new opportunities for investors. In particular, European industrial companies active in plant construction and infrastructure should benefit from these. And the first half of 2023 has shown (once again) that stock markets can deliver strong performance despite major challenges.

Regarding asset allocation, however, in addition to the opportunities and risks outlined for equities, another factor must be taken into account – the significant rise in bond yields. The rise in yields, which led to considerable price losses for bonds last year, is now narrowing the gap between the expected future returns on equities and bonds. In view of the lower risk and the meanwhile adequate yields of bonds, the asset allocation of shares and bonds should be weighed even more carefully. This is also in the context that future interest rate cuts, even if they are already expected and thus priced in, have the potential to lower long-term yields somewhat.

Our current neutral positioning on equities therefore does not reflect a sceptical or cautious view on equities, but a risk-return trade-off in an environment that again allows for positive real returns – i.e. inflation-adjusted returns – with longer-dated bonds. Overall, we believe the investment environment should turn out to be constructive in the medium term.

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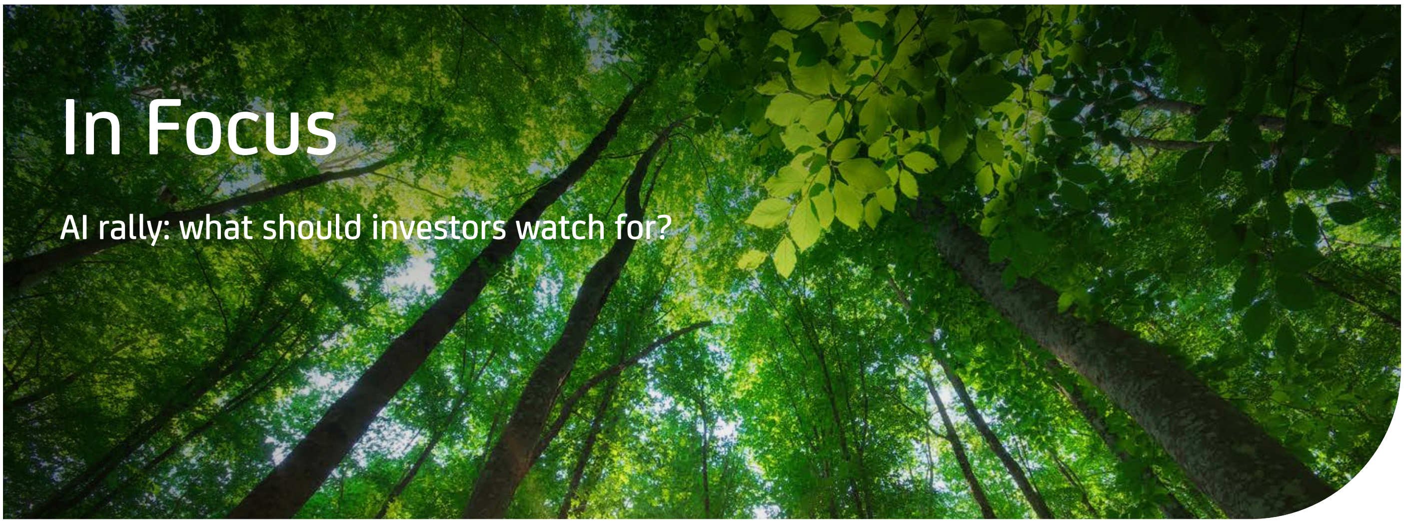
OLIVER PRINZ, *Co-Chief Investment Officer of UniCredit Bank Austria AG and Schoellerbank AG*



In Focus

AI rally: what should investors watch for?

2023 has been, and will undoubtedly continue to be, dominated by artificial intelligence (AI). After Russia's war of aggression on Ukraine put some of the stock markets under significant pressure last year, the euphoria about the new opportunities that AI could bring to both companies and individuals has created an unexpected amount of momentum in the global financial markets in the first half of 2023. Shares in companies whose business models involve AI have rallied impressively in the first six months as investors sense the next great digital revolution. There is no question that AI not only has huge **potential for the future**[2] but is also likely to change many areas of the economy and society in the long term. What is less obvious, however, is whether the trend of the first half of the year will continue on the global financial markets, and what risks investors should be aware of in light of the latest developments.

[2]According to an analysis by Bloomberg Intelligence, global GDP will be up to 14% higher in 2030 due to the accelerated development and growth of AI.

While AI is not a new phenomenon, the launch of the online software ChatGPT by the US tech company OpenAI at the beginning of this year brought the topic into public consciousness. It is primarily the large US corporations that are currently profiting from the hype surrounding AI, after the technology sector initially drew attention to itself at the beginning of the year with mass layoffs and declining growth expectations. In the first months of 2023, the shares of the "Magnificent Seven" (Alphabet, Amazon, Apple, Nvidia, Meta, Microsoft and Tesla) have performed in a way that actually contradicts the logic of the market. In principle, one might expect that the significant tightening of monetary policy by the major Western central banks, especially the US Federal Reserve (Fed) – i.e. a mixture of rising interest rates and a deteriorating economic outlook – would slow down growth stocks that are particularly **sensitive to changes in interest rates**[3]. In any case, this was also the case for a long time last year.

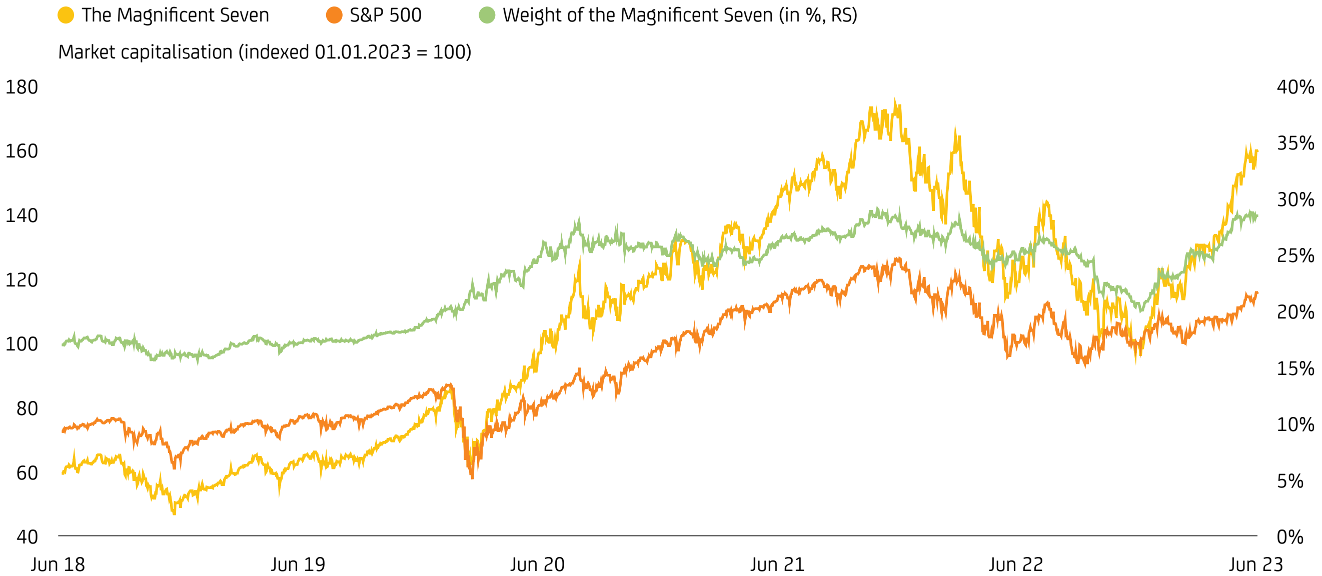
[3]Growth stocks are particularly vulnerable to concerns about rising interest rates and yields, as they are valued on the basis of earnings forecasts that lie years in the future.

CONCENTRATION RISK IN THE S&P 500 HAS INCREASED SIGNIFICANTLY

In fact, the opposite has been true so far this year.: The technology-heavy S&P 500 performed very strongly in the first half of the year, with the Magnificent Seven being responsible for most of the gains in the index. Taken together, these seven major companies gained around 60% on average between the beginning of January and the end of June, while the overall index gain was more modest at around 16% (see chart 1). If one excludes the Magnificent Seven from the index, the gain of the remaining companies amounted to only 4.5%, even though there have recently been signs of an expansion of the rally to other sectors and an increasingly broad distribution of price gains. Driven by the AI hype, the concentration risk in US equities has thus increased significantly. As a result of the rally, the Magnificent Seven account for around 30% of the total market capitalisation of the S&P 500, which now has the highest **concentration**[4] in almost 20 years (see chart 1).

[4]Nasdaq announced in early July that it would rebalance its NASDAQ 100 index, which lists companies mainly from the tech sector, to "address overconcentration in the index by rebalancing the weights". Changes to the index force mutual funds that track it to adjust their portfolios and sell shares of companies whose weight in the index has been reduced.

1. THE MAGNIFICENT SEVEN ACCOUNT FOR AROUND 30% OF THE MARKET CAPITALISATION OF THE S&P 500 AFTER THE RECENT RALLY



Note: Past performance, simulations and forecasts are not a reliable indicator of future performance. The indices cannot be purchased and therefore do not include costs. When investing in securities, costs are incurred which reduce the performance. In the case of an investment in foreign currency, the return may also rise or fall as a result of currency fluctuations.
Source: Bloomberg, UniCredit Group Investment Strategy

Such a concentration, or such a dominance of individual companies in terms of contributions to index profits and, associated with this, weight in the index, makes one wonder – and some caution seems appropriate. Has an AI bubble formed that could burst like the dotcom bubble did at the beginning of the millennium? There may be parallels, but the differences are beyond question: unlike back then, the latest hype is being carried by highly profitable companies that have "earned" their market position over years, sometimes decades (for example, in the case of Apple and Microsoft, both of which were founded as early as the mid-1970s). That the increasing use of AI could justify further share price gains is also the result of an analysis by Goldman Sachs – namely if it is accompanied by increases in productivity and corporate profits. Indeed, it seems plausible to assume that AI could boost productivity growth. Whether the companies will also succeed in generating profit increases to the extent implied by their partially exceptionally high valuations remains open, at least so far.

So while the current valuations of the technology groups assume that their rapid sales and profit growth will continue not only in the next few quarters but also in the next few years, there seems to be little room for improvement from a valuation perspective at present. In the short term, i.e. in the second half of this year, the headwind from restrictive monetary policy could persist. Admittedly, in view of the latest inflation figures, the probability of further interest rate hikes by the Fed, beyond the generally expected 25 bps at the end of July, seems to have diminished somewhat and the end of the rate hike cycle is within reach. However, inflation, especially the core rate, is still well above a level acceptable to central banks (incidentally, not only in the US but also in the euro area). Since market expectations regarding possible interest rate cuts in the second half of this year have already been priced out, the monetary policy turnaround could be initiated even later than some hope, given the still robust labour market in the US.

IMPLICATIONS FOR INVESTMENT

Even though the risk of a more pronounced economic slowdown has increased, a **"soft landing"**[5] of the US economy still seems the most likely scenario. However, the gains that the stock markets made in the first half of the year as a result of the AI boom are unlikely to be repeated in the second half of the year, even in such a scenario. Against this backdrop, a broad diversification of risks and a healthy balance between growth and **quality stocks**[6] seems appropriate to us, as implemented in a broadly diversified portfolio as a rule. Admittedly, this broad diversification may sometimes, in the short term, also be to the detriment of performance – as could be observed in the past months. Due to its structure, which limits the weight of individual stocks more than a broad equity index, the broadly diversified portfolio was only able to participate in part in the upswing of the past months, which was essentially shared by a handful of companies. In the medium to long term, however, we are convinced that – depending on the risk appetite – a well-structured high-quality portfolio is characterised by the right mix of different investments, spreads risk and can thus avoid losses, especially in phases of downturn, is often the right way to preserve or build up wealth.

[5] A soft landing in the business cycle is the process by which an economy transitions from growth to slow growth to eventual stagnation as it approaches but avoids recession.

[6] In simple terms, value stocks are stocks that are considered undervalued, i.e. listed at a discount to their "intrinsic value". Quality stocks are often characterised by sustainable growth, low risks, a high return on capital and a favourable valuation.

Macro & Markets

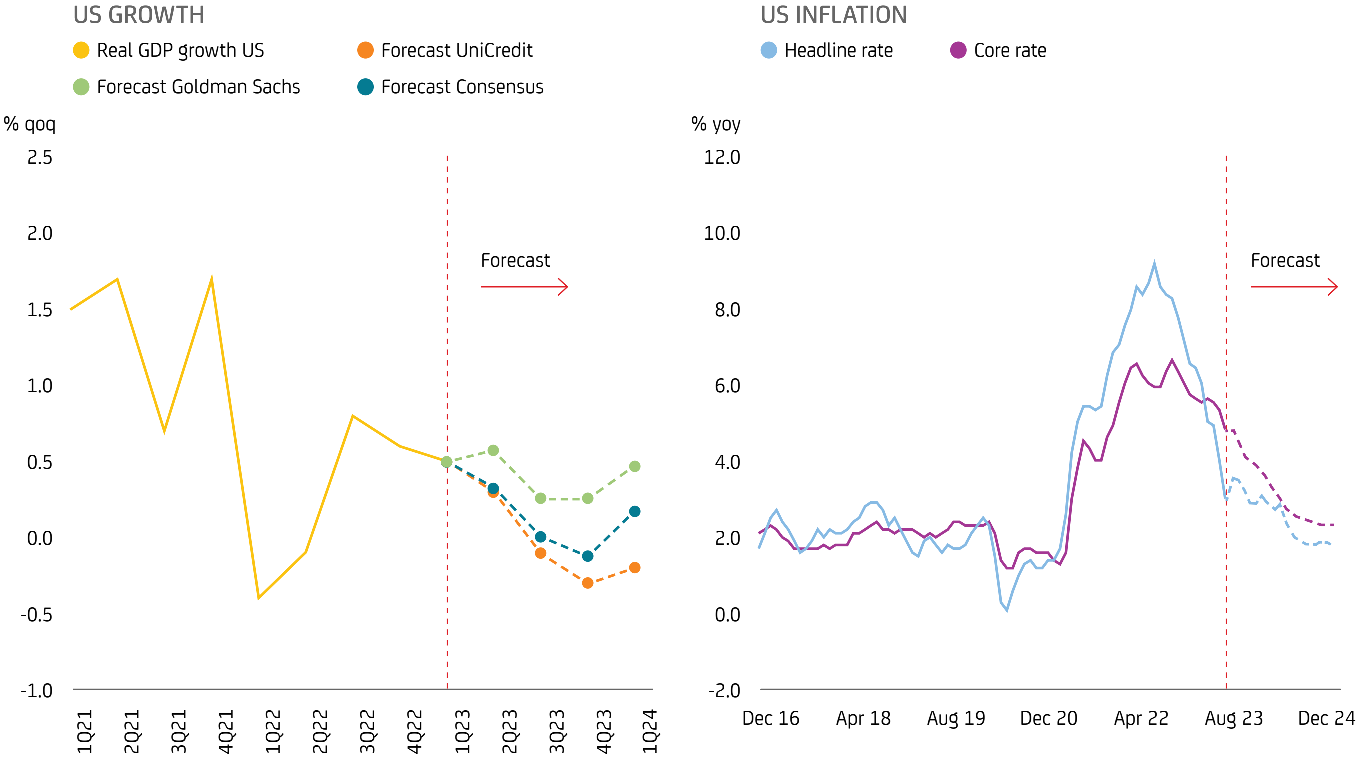
Growth revisions: economy on both sides of the Atlantic facing further slowdown

US INDICATORS POINT TO COOLING

Due to the still quite solid economic figures from the USA in the first and second quarters of this year, we have raised our previous growth forecast for this year to 1.3% (previously 0.7%), but lowered it for 2024 to 0.1% (previously 0.8%) (see chart 2). Consumption in particular continues to be robust, and the weakening real estate market also seems to have stabilised in recent months. Accordingly, we have revised our growth expectations for the second and third quarters of this year slightly upwards, but continue to expect the US economy could enter a mild recession in the second half of 2023. Our expectation is supported by many economic surveys that continue to point to weakening economic activity. In particular, the weakness in the industrial sector is likely to increasingly spread to the service sector. In addition, credit conditions have tightened considerably, which also points to a recession later in the year. Consumer expectations have recovered somewhat recently. However, the stock of “excess savings” of private households has been reduced by more than half since the pandemic, and the labour market is also showing signs of weakening. All this is likely to weigh on consumption and thus on economic growth in the second half of the year. Meanwhile, inflation figures declined to 3.0% in June at the headline rate, which is why we expect an average inflation rate of around 4% in 2023 and around 2% in 2024 (see chart 2).

Although the US Federal Reserve left the (upper) policy rate unchanged at 5.25% at its June meeting, it signalled that the interest rate peak this year is likely to be 50 bp higher than previously expected. Even though there are risks for monetary tightening on such a scale, we still only expect another 25 bp hike at the upcoming July meeting, as we believe both economic activity and inflation rates in the US will continue to cool down until the September meeting, and thus are likely to be below the Fed’s expectations. We continue to see rate cuts of 150 bp only next year, with the first cuts likely to start in the first quarter.

2. RECESSION PRESUMABLY PUSHED BACK CORE RATE INFLATION LIKELY TO FOLLOW HEADLINE RATE



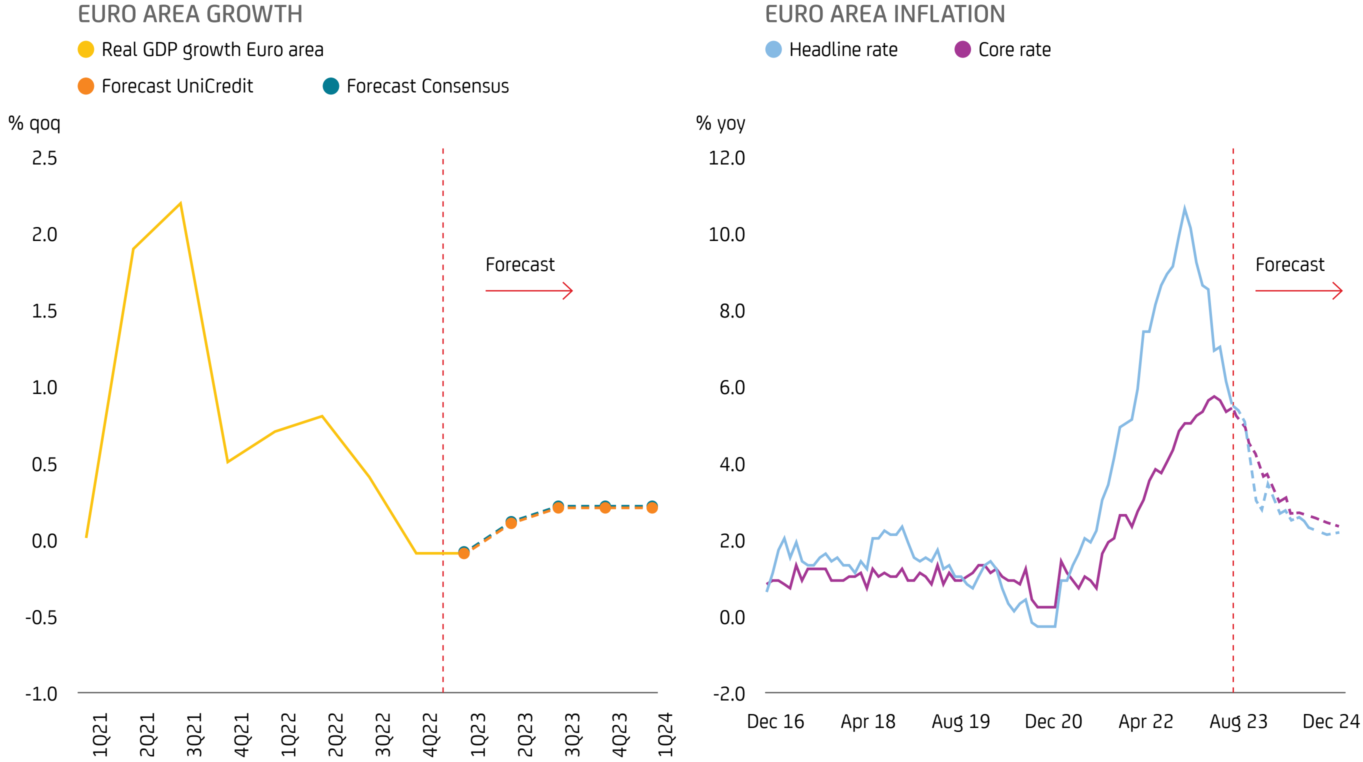
Source: BEA, BLS, Bloomberg, Goldman Sachs Research, UniCredit Research, UniCredit Group Investment Strategy

EURO AREA: ECONOMIC MOMENTUM REMAINS WEAK – ECB AGAIN HINTS AT INTEREST RATE MOVES

The recent downward revisions in growth figures show that the euro area has been in a mild technical recession since the turn of the year. Both the fourth quarter of 2022 and the first quarter of the current year show a mild contraction compared to the previous quarter. In addition, companies' assessments of the economic development in the euro area have recently become more gloomy again and have thus cancelled out the previously emerging recovery (after the energy crisis had subsided). In this context, the weaker economic momentum continues to reflect a large gap between the industrial and service sectors. Although supply chains and input prices have normalised, the manufacturing sector is facing declining orders and high inventories. In contrast, the services sector continues to benefit from solid (post-pandemic) pent-up demand, especially in leisure and travel. Meanwhile, the credit cycle remains under pressure, reflecting a reduction in short-term corporate borrowing and signs of a decline in household lending. Accordingly, we have lowered our growth forecast for the euro area this year to 0.5%, but continue to project growth of 1.0% in 2024. On the inflation side, we expect an average inflation rate of 5.5% this year and around 2.5% next year (see chart 3).

At its June meeting, against the backdrop of a core inflation rate that continues to fall too slowly, the ECB raised the deposit rate by 25 bp, bringing it to 3.50%. In addition, the central bank updated its inflation forecast, raising its estimate for 2025 slightly to 2.2% (+0.1 percentage points) in light of stronger expected core inflation. The GDP forecast was lowered only slightly, so the ECB's growth path is still too strong in our view. However, since there has been no significant decline in core inflation so far and the central bank has adjusted its inflation forecast, we expect the ECB to raise its key rates by a further 25 bp each in July and probably also in September, as the ECB announced at its last meeting. We expect the deposit rate to peak at 4.00% and that the central bank could start cutting rates from the second quarter of 2024.

3. EURO AREA IN TECHNICAL RECESSION – ECB SIGNALS FURTHER INTEREST RATE CUTS AS CORE RATE REMAINS TOO HIGH



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

CHINA: CENTRAL BANK LIKELY TO COUNTER SLOWING RECOVERY

After the strong upswing in the wake of the reopening of the Chinese economy in January, the latest leading indicators already signalled a loss of economic momentum in the second quarter of this year. The current growth figures do confirm that growth accelerated in the second quarter. However, at 6.3% year-on-year, the recovery fell short of consensus expectations (of 7.1%). In addition to a weakening real estate sector, depressed consumer sentiment in particular poses a risk to further economic development. In particular, the high youth unemployment rate of around 20% is worth mentioning here, since it is precisely the 16-24 age group that is among the consumers who spend the most money on rent, clothing, transport, entertainment and culture. On the business side, we expect investments to increase by about 5% in the current year, mainly due to government support measures (e.g. in infrastructure projects). Especially technology-related sectors (such as semiconductors, electric cars, etc.), which are the focus of the government's five-year plan, should see a boost. Meanwhile, residential investment continues to decline and is likely to remain negative or stagnate for the time being.

Weak domestic demand is having a lasting impact on price developments in China. The latter has recently been on the verge of deflation (headline rate was 0.0% in June, core rate 0.4%), which is a completely different picture than in advanced economies. Due to this ongoing weakening trend, it can be assumed that the government's envisaged economic policy support is likely to be strengthened in the course of the year. However, it is likely to be characterised by a targeted rather than broad set of measures. In recent weeks, the Chinese central bank has already announced cuts in its short-term interest rates. We expect further steps of this kind in the second half of the year. However, we think a prolonged easing cycle leading to a sustained credit upswing is unlikely. We continue to expect the Chinese economy to reach the government's growth target of "around 5%" this year. For 2024, we expect lower gross domestic product growth of around 4%.

PROSPECT OF AN EARLY END TO US MONETARY TIGHTENING BOOSTS INVESTOR SENTIMENT

In early July, equity markets broadly trended lower on solid US economic data for the month of June and related concerns that the US Federal Reserve would move forward with further tightening steps. Sentiment then turned, however, after US inflation figures for June signalled a noticeable slowdown. As a result, the S&P 500 ultimately gained just over 2% in the period from the end of June to 18 July (after around 5.5% in June), while the STOXX Euro 600 moved largely sideways (after just over 3% in June). On the bond markets, US and German government bonds recovered their initial price losses in the course of the month, as a result of which their yields are currently (as of 18 July) trading largely unchanged compared to their level at the end of June. The latter were mainly driven by the prospect of an imminent end to interest rate hikes as a result of weaker US inflation figures. In this environment, the EUR-USD exchange rate was able to make significant gains and is currently (as of 18 July) trading well above the 1.10 mark. The prospect of a "soft landing" for the US economy (still our base scenario) and the weaker US dollar exchange rate again supported oil prices. In addition, production outages in some important oil-producing countries contributed to the price increase, so that the price of Brent crude (as of 18 July) rose to just under US$80. Falling US yields also helped the price of gold to recover a little, although it is still below the US$2,000 mark per fine ounce.

Asset Allocation – How we manage our portfolio mandate

Asset		Investment Universe	Investment View: Negative	Investment View: Neutral	Investment View: Positive
Main Asset Classes		Global Equities	○	●	○
		Global Bonds	○	●	○
		Money Markets	○	●	○
		Alternatives	○	●	○
Main Asset Classes in Detail	Equities	US	○	●	○
		Europe	○	●	○
		Pacific (DM[1])	○	○	●
		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	○	○	●

[1]DM= Developed Markets (Australia, Japan, Hong Kong, New Zealand, Singapore)

UniCredit Group Investment Strategy – Asset Allocation Stances

NEUTRAL ON GLOBAL EQUITIES

Equities resilience due to investor expectations of a Fed policy pivot and confidence that the hard economic landing will be avoided. However, the lagged effect of higher interest rates has yet to be felt.

NEUTRAL EUROPEAN EQUITIES

Weakening macro momentum while the ECB remains restrictive in the short term. However, European equities offer good opportunities for value and quality investors.

NEUTRAL US EQUITIES

Robust (though weakening) job market and earnings resilience, but uncertainty around the magnitude of the economic slowdown. Excessive S&P 500 market concentration.

NEUTRAL EMERGING MARKET EQUITIES

China's economic recovery is losing steam and we expect targeted monetary and fiscal easing. In LatAm, Brazil is becoming a bright spot due to expectations of rate cuts as inflation is falling, and fiscal reforms. Overall, valuations are cheap for EM equities. Countries and sectors selectivity among the EMs is strongly recommended.

POSITIVE ON PACIFIC EQUITIES

Wage growth and rising inflation – given that the Bank of Japan is 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.

NEUTRAL GLOBAL BONDS

A weakening growth and a cooling inflation in 2H-23 support our preference for "high quality bonds", such as Euro Investment Grade corporate bonds and government bonds.

OVERWEIGHT EURO INVESTMENT GRADE CORPORATE BONDS

Appealing yields but given the relatively tight spreads we are increasing our high quality, selective and defensive tilt in case of a sharp weakening of the macro picture.

NEGATIVE HIGH YIELD CORPORATE BONDS

Spreads do not yet fully discount the possible slowdown of the economies, especially in the US, due to more restrictive lending conditions. Also, they are not liquid enough.

NEUTRAL EMU GOVERNMENT BONDS

Worsening macro picture and cooling inflation maintain our constructive view on this asset class despite a still hawkish ECB.

NEUTRAL NON-EMU GOVERNMENT BONDS

Supported by expectations of falling inflation and Fed easing in 1H-24.

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 in 1H-24 and dollar weakening. In LatAm, falling inflation opens the way for material central bank policy easing.

NEUTRAL MONEY MARKETS

Interesting yields, but we prefer to invest in higher yielding fixed income asset classes such as government bonds and Euro corporate IG.

NEUTRAL ALTERNATIVES

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

NEUTRAL COMMODITIES

Penalised by fears of global slowdown with a potential relief in case of more aggressive than expected monetary and fiscal easing in China.

POSITIVE GOLD

Supported by medium term expectations of falling US interest rates / weakening USD.

CURRENCIES

After the softer June US CPI, the USD should marginally weaken vs Euro. However, Eurozone macro momentum looks more concerning than the US one.

How to invest

Investment ideas in the current scenario

BOND INVESTMENTS

OUR IDEA: EURO CORPORATE BOND UPDATE

After ending 2022 as the worst year ever in terms of absolute returns for Euro Corporate Investment Grade bonds (-14%), let's take stock of the first half of 2023.

In general, corporate bonds, one of our preferred asset classes for 2023, and carry strategies, recorded a positive absolute return in the first six months of the year – close to 2% for Investment Grade Bonds.

The environment was 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 raised official rates by a total of 75 basis points (bps) and the European Central Bank by 150 bps in the half-year.

Yields have therefore been volatile, with aggressive central bank rhetoric penalising short-term maturities and, conversely, long maturities holding up well on expectations of an upcoming economic slowdown.

The credit component experienced a very positive half-year supported by the resilience of the economic cycle and the persistent search for yield by investors. Only in March did the market witness a risk-off phase due to the liquidity crisis of US regional banks and the rescue of Credit Suisse in Europe, which led to a widening of credit spreads (which have not yet fully recovered in the financial sector). Our asset allocation stance, which favours corporate bonds over government bonds, has rewarded in the first part of the year with positive returns and a more stable market.

Looking ahead, we remain positive on high quality corporate bonds. The asset class, in terms of risk/reward ratio, represents an attractive opportunity, combining good credit fundamentals and high yields (for example, the highly rated Euro IG segment offers yields similar to those offered by Euro High Yield just over a year ago), and also offering resilience in the event of a weakening economy.

Overall, corporate IG fundamentals remain solid: healthy balance sheets, better-than-expected earnings, strong cash balances and low leverage levels relative to long-term averages, with default rates still low (although defaults are expected to increase as a result of the expected economic slowdown). In addition, net supply is expected to remain low for the remainder of the year, thanks to companies' strong liquidity positions, limited M&A activity, and prudent financial policies pursued by companies.

Finally, expectations of the end of the rate hike cycle after this summer – likely in a context of weakening economic conditions and diminishing volatility in base yields – represent a favourable backdrop for high quality Investment Grade bonds.

In terms of sector allocation, going forward we prefer to adopt a more cautious stance on cyclicals given the increasing risk of an economic slowdown, preferring defensive sectors such as Telecoms and Health Care 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 capitalisation of the banking sector. We expect a gradual increase in corporate credit default rates and growing Non-Performing Loans in 2024, but banks' profitability will likely remain high in particular when compared to the levels seen over the last decade.

EQUITY INVESTMENTS

OUR IDEA: ARTIFICIAL INTELLIGENCE – A NEW ERA FOR THE INDUSTRIES

The word is moving rapidly towards a dimension where humans and machines will not be of much use without the other. People and computers will come together in a constant exchange of information and goals.

As with many technological innovations in the past, artificial intelligence (AI) will cost many jobs and possibly worsen or even trigger the next recession. However, it's arrival is inevitable and ultimately the source of our future growth. At the same time, innovations that seem harmless today once triggered as much fear as AI does currently – but if we had listened to that fear, we would all still be farming.

We identify five industries in which we believe there will be major material changes that will create opportunities for value-added investing. The industries are auto, health care, robotics, financial services, and technology.

AUTO

In our opinion, the auto industry will see the biggest change, possibly eliminating dominant players and completely shifting the business model from car sales to mobility services. The conjunction of two innovative technologies, self-driving cars and electric vehicles, would change the auto market as we know it today. The electric engine enables a shift towards a curve of cost-performance per vehicle much lower than that of internal combustion engines (ICE). Essentially, electric vehicles will be more powerful and will cost less. On the other hand, autonomous driving will allow for the development of new business models that are not yet thought of. Imagine moving from your own car to a rented vehicle, that picks us up at home, brings us to the destination, and finishes the day in a battery charger outside the city.

HEALTHCARE

Meanwhile, the healthcare industry is uniquely positioned to benefit from the rise of AI. Ideal sector conditions are supply-constrained, data-rich environments with a high dependence of cognitive processes. For example, imagine the use of a patient's full medical profile like genetic data, medical history, environmental factors, and even lifestyle to create a customised, unique treatment and prevention protocol for that individual. A relevant development in this field is the use of therapeutic mRNA vaccines to treat cancer.

INDUSTRIAL AUTOMATION

Big data and machine learning are extending the potential, impact, and capability of industrial-automation solutions. Since the entire smart-factory concept depends on data, broader adoption of IoT will directly benefit sensor and machine-vision makers. Sensors can detect failures, and that is great. However, predicting failures is even better. "Predictive analytics" is highlighted as 'the most important advanced manufacturing technology'. In addition, optimisation software will take an existing machinery programme and look for ways to improve it. Finally, a significant cost component of a robot is the program, accounting for 30-40% of the total cost of the robot solution. Huge cost savings could be achieved if the robots could figure out how to program themselves.

FINANCIAL SERVICES

Intuitively, financial services, banking, insurance, and asset management sit right at the epicentre of the looming tsunami of AI disruption. In sectors like securities trading where data is abundant and digitisation already the norm, AI solutions are developing quickly. However, it is not just these fields. We see progress in robo-advisors for wealth management, robo-quantitative driven portfolio management products, and telematics sensors in motor vehicles for auto insurance pricing. We should see safer autonomous motor vehicles gain reduced insurance premiums.

TECHNOLOGY

A change in IT architecture is taking place as new types of processors are developed to carry out massive, complex computations. This will benefit the semis ecosystem on several fronts: from foundry, outsourced assembly and testing to intellectual-property and electronic-design automation tools. Leaders in each segment with the capability to design and manufacture these advanced chips will likely be the winners.

DEVELOPMENT OF SELECTED FINANCIAL MARKET INDICES

From	**18.07.22**	18.07.18	18.07.19	18.07.20	18.07.21	18.07.22	18.07.18	**01.01.23**
To	**18.07.23**	18.07.19	18.07.20	18.07.21	18.07.22	18.07.23	18.07.23	**18.07.23**
Stock market indices (total return, in %)								
MSCI World (in USD)	**21.2**	5.3	6.8	34.7	-13.4	21.2	58.7	**18.4**
MSCI Emerging Markets (in USD)	**7.7**	1.3	3.1	30.9	-24.5	7.7	10.1	**9.0**
MSCI US (in USD)	**21.1**	8.5	10.9	37.9	-12.1	21.1	76.2	**20.2**
MSCI Europe (in EUR)	**14.1**	3.7	-2.1	24.9	-3.8	14.1	39.8	**11.4**
MSCI AC Asia Pacific (in USD)	**10.7**	-1.0	6.4	27.7	-21.5	10.7	16.5	**9.7**
STOXX Europe 600 (in EUR)	**14.0**	3.6	-0.9	25.4	-5.2	14.0	39.5	**11.3**
DAX 40 (Germany in EUR)	**24.4**	-4.2	5.7	20.7	-16.6	24.4	27.4	**15.8**
MSCI Italy (in EUR)	**41.6**	5.8	-8.1	21.8	-10.2	41.6	49.9	**24.0**
ATX (Austria, in EUR)	**14.5**	-7.4	-21.1	51.2	-10.1	14.5	15.2	**6.1**
SMI (Switzerland, in CHF)	**4.0**	15.7	7.5	18.7	-5.9	4.0	46.9	**6.6**
S&P 500 (USA, in USD)	**21.0**	8.6	9.8	36.7	-10.2	21.0	76.9	**19.7**
Nikkei (Japan, in JPY)	**24.1**	-5.7	10.2	25.0	-2.5	24.1	58.3	**26.0**
CSI 300 (China, in Yuan)	**-7.9**	12.3	23.3	14.8	-14.0	-7.9	24.4	**1.4**
Bond market indices (total return, in %)								
US Government Bonds 10Y (in USD)	**-3.3**	10.5	17.4	-4.0	-12.4	-3.3	5.4	**2.6**
US Government Bonds (ICE BofA, in USD)	**-2.0**	7.2	11.4	-3.1	-9.9	-2.0	2.3	**2.0**
US Corporate Bonds (ICE BofA A-BBB, in USD)	**1.6**	10.1	11.0	2.8	-14.0	1.6	9.7	**3.8**
German Bunds 10Y (in EUR)	**-7.5**	7.7	1.5	-0.6	-12.9	-7.5	-12.3	**3.5**
EUR Government Bonds 1Y-10Y (iBOXX, in EUR)	**-5.4**	7.0	2.1	0.6	-12.6	-5.4	-9.1	**3.0**
EUR Corporate Bonds 1Y-10Y (iBOXX, in EUR)	**-0.7**	5.0	-0.3	3.4	-11.9	-0.7	-5.3	**3.2**
Bond yields (change in basis points = 0.01 percentage points)								
US Government Bonds 10Y (in USD)	**83**	-83	-141	69	166	83	93	**-4**
US Government Bonds (ICE BofA, in USD)	**113**	-79	-148	41	228	113	154	**12**
US Corporate Bonds (ICE BofA A-BBB, in USD)	**80**	-79	-116	-7	269	80	147	**0**
German Bunds 10Y (in EUR)	**119**	-64	-13	11	155	119	206	**-21**
EUR Government Bonds 1Y-10Y (iBOXX, in EUR)	**114**	-64	-19	0	172	114	202	**-16**
EUR Corporate Bonds 1Y-10Y (iBOXX, in EUR)	**101**	-63	23	-44	271	101	288	**-18**
Spreads on government bonds (credit spreads, change in basis points)								
US Corporate Bonds (ICE BofA US Corporate Master)	**-27**	-4	27	-56	64	-27	5	**-10**
US Corporate Bonds (ICE BofA US High Yield)	**-135**	55	163	-258	207	-135	32	**-89**
Euro Corporate bonds (ICE BofA Euro Corporate AAA-A)	**-34**	-9	20	-35	93	-34	36	**-4**
Euro Corporate Bonds (ICE BofA Euro High Yield)	**-186**	15	127	-198	329	-186	88	**-49**
Money market rates (change in basis points)								
Libor (USD, 3 months)	**287**	-7	-201	-14	258	287	324	**81**
Euribor (EUR, 3 months)	**NA**	-5	-7	-10	60	NA	NA	**NA**
Euro exchange rates (change in %)								
US Dollar (EUR-USD)	**11.1**	-3.4	1.9	3.4	-14.2	11.1	-3.9	**5.5**
British Pound (EUR-GBP)	**1.3**	0.8	1.4	-6.1	-0.7	1.3	-3.3	**-3.2**
Swiss Franc (EUR-SFR)	**-2.7**	-4.7	-2.8	0.6	-8.7	-2.7	-17.2	**-2.0**
Japanese Yen (EUR-JPY)	**10.9**	-7.7	1.4	6.4	7.8	10.9	17.9	**10.5**
Commodities (change in %)								
Commodity Index (GSCI, in USD)	**15.5**	15.7	24.5	-1.4	-6.4	15.5	53.1	**8.4**
Industrial metals (GSCI, in USD)	**0.6**	-4.2	-3.6	44.8	-10.4	0.6	21.7	**-7.8**
Gold (in USD per fine ounce)	**15.9**	16.2	27.0	0.4	-5.6	15.9	61.5	**9.2**
Crude oil (Brent, in USD per barrel)	**-25.2**	-14.1	-30.1	69.4	44.4	-25.2	10.4	**-6.2**

Please note: Past values and forecasts are not a reliable indicator of future performance. Indices cannot be purchased and therefore do not include costs. When investing in securities, costs are incurred which reduce the performance. The return on investments in foreign currencies may also rise or fall as a result of currency fluctuations. So-called synthetic bonds are calculated to reflect the performance of government bonds in a fixed maturity range. In each case, the most "suitable" real federal bond at the relevant time is used as a reference for the yield opportunity of the synthetic bond. The development of the expected yield to maturity is shown under the following conditions: servicing of interest payments and redemption in accordance with the terms and conditions and holding until 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 synthetic bonds cannot be purchased and therefore do not include any costs. In the case of currencies and commodities, acquisition and/or custody costs incurred are not included. Source: Refinitiv Datastream. Data as at 18.07.2023.

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