Navigating volatile markets

Group Investment Strategy

Monthly Outlook

April 2023

Index

Summary

Navigating volatile markets

MACROECONOMIC UPDATE

Despite continued signs of a weakening US economy, key economic indicators remain robust. The labour market report for February delivered an unexpectedly strong increase in new jobs.

Regarding the current situation in the U.S. banking sector, Fed Chairman Powell said that the banking system is "sound and resilient," but that the Fed must assume that recent developments will have lasting effects due to a tightening of bank lending standards.

According to the latest publications on GDP growth, economic output in the euro area stagnated in the fourth quarter of 2022, which means that it may have escaped a technical recession. This is because leading indicators also clearly exceeded market expectations in March. Purchasing managers' indices at sector level were mixed: the services sector recorded robust growth, while the index for the manufacturing sector declined further. Economic development in the euro zone is likely to slow further in the first quarter but pick up again in the second quarter and over the rest of the year.

INFLATION AND MONETARY POLICY

February's US inflation figures indicated that headline disinflation continued – driven mainly by declines in the volatile components of energy and food, while the much-watched core rate remained broadly unchanged at a high level. The main factor here was the stubborn inflation in the services sector. The continued solid state of the US economy and the still high inflation rates indicate that the US Federal Reserve (Fed) cannot yet consider its fight against inflation to be over. The latest macro data led the Fed to raise its key interest rates by a further 25 basis points (bp) at its March meeting. We still expect another 25 bp rate hike in May, but this should then also mark the interest rate peak (with a maximum key rate of 5.25%). We do not see interest rate cuts of 100 bp, as priced in by the markets for later this year.

The European Central Bank (ECB) raised its key interest rate by 50 bps in March and thus increased its deposit rate to 3%. Nevertheless, the ECB has become more cautious in its assessment of its future monetary policy stance and refrained from giving hints on further interest rate steps. It also reaffirmed its commitment to provide emergency liquidity support if needed. The containment of inflation remains the ECB's primary goal, which is why it continues to adhere to its tendency to tighten monetary policy. Most recently, consumer prices were down only slightly (8.5% year-on-year), whereas the core rate continued to rise at 5.6% year-on-year.

FINANCIAL MARKETS

In the financial markets, the recent events in the US and Swiss banking sectors were the dominant theme. They resulted in significantly more restrictive financing conditions.

In the second week of March, in particular, the sharp sell-off in bank stocks following the collapse of two US regional banks, and the news coverage surrounding a major Swiss bank, led to significant price adjustments. The yields of 10-year US government bonds fell noticeably and within a few days completely priced out the yield increases that had ceased in February. For 10-year Bunds, the decline in yields even exceeded the February increases.

In both the US and Switzerland, however, the supervisory authorities and central banks reacted quickly, decisively and comprehensively and were initially able to calm investors. Nevertheless, the stock markets, especially in Europe, recorded significant price losses. For example, the EuroStoxx50 and the DAX40 indexes have fallen by more than 3.5% since the beginning of March (as of 20 March 2023).

CIO's Letter

Navigating volatile markets

The year 2023 so far has had a lot to offer in terms of volatility. After a brilliant start for the stock markets – which was spurred largely by hopes that the danger of inflation had been all but averted and that the peak of the interest rate hike cycle could be imminent – there followed a phase with strong economic data, as well as also strong inflation data. The latter caused the rhetoric of the major Western central banks to intensify and led to noticeably higher rates across the markets, as much more far-reaching interest rate hikes were priced in. And stock prices tended to weaken again, especially in the US. Then, a US regional bank that had run into difficulties due to the rapid and significant interest rate hikes and insufficient risk management initiated a new change of course on the stock markets. Interest rates fell again, but so did stock prices – a correlation between shares and bonds that corresponded to familiar patterns. As a result, the interest rate markets have shifted with breathtaking speed from a scenario with further drastic interest rate increases until the end of this year, to one with noticeable interest rate cuts until the end of 2023.

This change of mood was driven by memories of the financial crisis 15 years ago. Back then, troubled US banks triggered a global financial crisis. So it is not surprising that the markets reacted nervously to the headlines. In the current situation, however, there are three key things to keep in mind, in my view:

1. There is no banking crisis, and certainly not a global one, but a crisis of individual banks.
2. The problems of these banks are very specifically linked to their respective business models and are partly related to weaknesses in risk management. The EU banking system is much more regulated than, for example, the US banking system.
3. Between October 2022 and the beginning of March 2023, the share prices of European banks rose by about 40%, of which about 20% in this year alone. The main reason for this is rising interest rates. Provided **careful management of interest rate risks**[1], rising interest rates are generally seen as a supportive factor rather than a burden for banks.

European bank stocks have meanwhile have given back a large part of their year-to-date performance (as of 24 March), but still have a positive performance (MSCI Europe Banks 2.5%), albeit somewhat lower than the market average in Europe (MSCI Europe 5.2 % in euros) and in the US (MSCI North America 2.8 % in USD).

However, recent events make it clear that the central banks' fight against high inflation is not likely to remain without undesirable side-effects or effects on the real economy. What is unsettling the markets can be illustrated by a remark made by Federal Reserve (Fed) President Jerome Powell in the context of the latest interest rate hike in the US. Developments in the US financial system have led to an implicit tightening of financial conditions in the US, in addition to the central bank's rate hikes. It is unclear, however, the extent of this tightening and whether this means that monetary conditions in the US (the Fed's benchmark interest rate is 4.75% to 5.0% after the latest rate hike) are not already so restrictive that their cumulative effect could lead to a noticeable cooling of the US economy. In other words, the recession risk in the US has increased, which can also be seen in the clearly inverted US yield curve. On the interest rate markets, for example, interest rate cuts of 1 % to 1.25 % are currently priced in until the end of the year.

Manuela d'Onofrio

Head of Group Investment Strategy

Philip Gisdakis

CIO UniCredit Bank AG
(HypoVereinsbank) (Germany)

[1] The German banking supervisory authority BaFin recently pointed out that abrupt interest rate rises of significant magnitude can also pose certain risks for banks and that "attentive management of interest rate risks is essential" (Risks in BaFin's Focus 2023, 23 January 2023, link)

In Europe, on the other hand, the interest rate markets are pricing in at least one more rate hike by the end of this year and do not expect any significant rate cuts before 2024. The development on European stock markets also reflects, as mentioned above, a somewhat more robust situation in Europe than in the US: a number of key European country indices, such as the MSCI for Germany (9.5 %) and Italy (9.4 %), rose even more strongly than the European average. However, because of the recent financial market turmoil, uncertainty has increased about the extent to which lending standards will be tightened and/or whether demand for credit could weaken – and what consequences this could have for economic growth and inflation.

Potential risks are currently prominently discussed on the capital markets and influence market sentiment, in particular. But even if there should be a recession in the US, a sharp and pronounced course seems unlikely in view of the robust overall economic situation. Regarding investment strategy, vigilant navigation seems entirely appropriate in view of the continuing choppy waters.

In Focus

The EU's response to the US inflation reduction act: industrial policy course-setting on raw materials & green tech

The EU, which has committed to a more ambitious climate policy as part of the **European Green Deal**[2], is struggling in recent weeks to find a response to the US Inflation Reduction Act (IRA). With the IRA, which was enacted in August 2022, the US will provide a total of USD369 billion over 10 years for investments in energy security and combating climate change – as well as another USD64 billion for additional spending on health care (Affordable Care Act, colloquially "Obamacare"). In addition to the transformation towards green technologies, the US government is also pursuing clear industrial and geopolitical goals with the IRA – and the EU's reaction to it is likely to leave their mark on the capital markets in the medium to long term.

IRA PURSUES INDUSTRIAL AND GEOPOLITICAL GOALS

As one of the largest CO2 emitters in the world, the US has a crucial role to play in achieving the **targets of the 2015 Paris Climate Agreement**[3]. It has made a non-binding commitment to reduce its net greenhouse gas emissions by 50-52% below 2005 levels by 2030. Against this backdrop, the investments in climate protection envisaged in the IRA represent the **largest government involvement in a climate-oriented transformation of the US economy and society in the history of the US. Investments**[4] in the decarbonisation of all economic sectors through innovative, green technologies are being promoted (see also Figure 1). On the one hand, productivity increases are to help curb inflation – hence the name of the pact. However, the dampening effects are not likely to be visible in the short term, but rather in the medium and long term. On the other hand, the IRA aims to promote the **conversion of the economy to climate neutrality**[5], especially with tax breaks that benefit those companies that produce green technologies and critical raw materials in the US, or source them from countries with which free trade agreements exist. Overall, around 60% of all tax breaks contain a so-called local content provision. So far, however, according to the German institute **DIW**[6], around 76% of critical raw materials come from countries without free trade agreements with the US, and more than half of selected green technologies also come from non-free trade countries.

[2] See also European Commission website (Link)

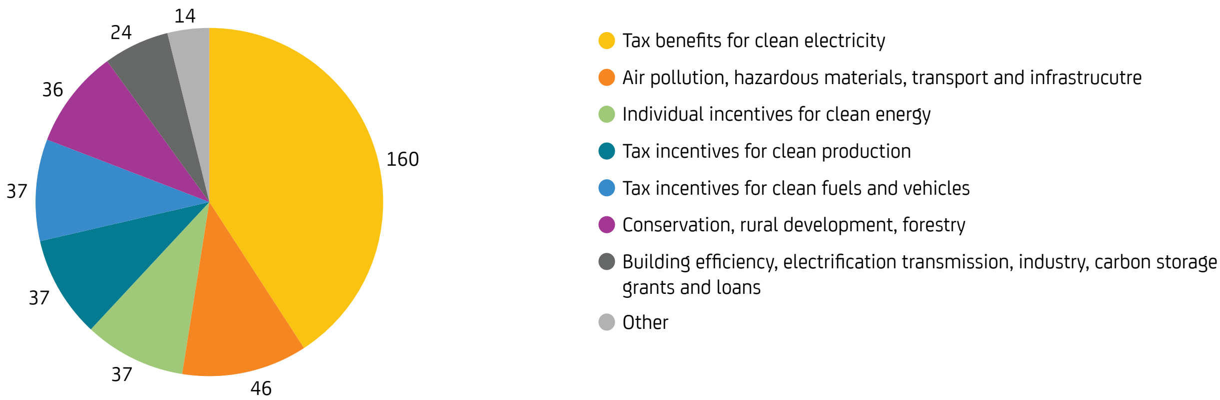
[3] All signatory states have made binding commitments under international law to reduce their greenhouse gas emissions (Link)

[4] The other two major programmes, the Infrastructure Investment and Jobs Act and the Chips & Science Act, are in part larger in terms of total volume, but provide for significantly lower spending on climate protection.

[5] Model calculations show that US GHG emissions would fall by 24% to 35% from 2005 levels under baseline conditions (i.e. without IRA) by 2030, but by 30% to 43% with IRA. This also means, however, that despite considerable efforts, the US would not reach its 2030 emissions target in any of the modelled scenarios.

[6] See also DIW Wochenbericht No. 6/2023: US investment package Inflation Reduction Act requires rapid strategic action by the EU (Link)

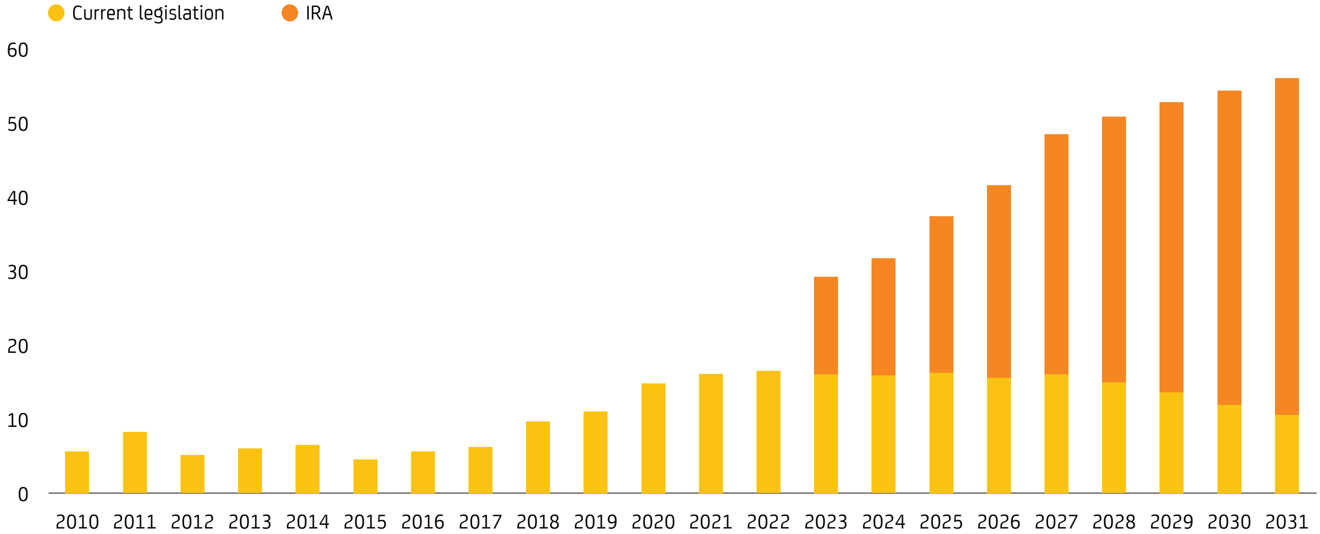
1. MOST SIGNIFICANT INVESTMENT AREAS OF THE IRA (IN USD BN)



Note: The chart shows projections for capital investment based on the Committee for a Responsible Federal Budget's analysis of the potential impact of the bill. The analysis should be considered as a guide and may be updated or refined by subsequent analyses.
Source: IRA Guidebook, CBO Cost Estimate, DIW, UniCredit Group Investment Strategy.

The IRA is estimated to triple the size of the US government's energy tax incentives by 2031 (see chart 2). The IRA will be financed not by new debt, but by a combination of a 15% minimum tax on corporations, increased tax enforcement and prescription drug pricing reform. These measures are expected to flush about USD737 billion into the US budget coffers. The expected revenue surplus of about USD300 billion spread over the next 10 years is also likely to help reduce the US budget deficit.

2. US GOVERNMENT ENERGY TAX INCENTIVES (IN USD BILLION)



Source: US Treasury, Congressional Budget Office, Goldman Sachs Research, UniCredit Group Investment Strategy

EU STRUGGLES TO FIND APPROPRIATE RESPONSE

In the EU, the IRA is the subject of fierce debate. For its part, the Community must find a way to reconcile its climate, energy and industrial policies in order to contribute to global climate goals and energy security while maintaining the global competitiveness of its economy. It has committed to reducing greenhouse gas emissions by at least 55% by 2030, using 1990 – and thus a different base year than the US – as the reference point for the calculation. While EU leaders welcome the planned US investment in clean technologies and the country's contribution to combating climate change, they are concerned that the IRA's provisions may favour US manufacturers and disadvantage European companies. In particular, support for industry and manufacturing has attracted attention on the European side.

With the Green Deal Industrial Plan published at the beginning of February, the EU Commission is trying to provide a response to the IRA. The plan builds on earlier initiatives, whereby the Temporary Crises and Transition Framework (TCTF) is to be further developed into a framework for shaping environmental change. Accordingly, member states are to be given the opportunity to subsidise production capacities for Net Zero technologies. To avoid possible **distortions of competition**[7], the Commission proposes to provide financial support by reallocating existing EU funding pots (RePowerEU, InvestEU and EU Innovation Fund). In the medium term, a new fund (European Sovereignty Fund) is to be established. In addition, the EU wants to launch an education offensive to promote occupational fields for the implementation of the Green Deal and strengthen trade relations via agreements in specific sectors, such as clean tech. In contrast to the US, the focus is not on a protectionist approach, but on setting the course for accelerated implementation of the transformation process with four pillars:

- Simplification of the regulatory framework including the setting of fixed production targets for key future technologies via the Net Zero Industry Act
- Acceleration of investments through at least temporarily less stringent state aid regulations and thus the possibility for member states to set up specific support programmes (e.g. for company relocations)
- Qualification offensive (European year of skills) to enable companies to also implement changes
- Expansion of global cooperation relations and anchoring of the green transformation in free trade agreements as well as the development of a Critical Raw Materials Club to ensure fair access to scarce raw materials on a global level

[7] Within the EU, smaller states such as Ireland, Austria or Finland fear that they will not be able to keep up financially with Germany or France if the rules on state aid are relaxed.

The table below shows a comparison between the IRA and the EU Green Deal Industrial Plan (as far as known and defined).

3. INFLATION REDUCTION ACT VS. THE EU GREEN DEAL INDUSTRIAL PLAN

	US Inflation Reduction Act	EU Green Deal Industrial Plan
Volume	Actual total volume is around 400 billion US dollars, but could ultimately be significantly more than 1 trillion, as support is granted indefinitely until a certain decarbonisation target is reached	Not yet possible to assess conclusively. Decisive is (1) not only the absolute volume, but the question of "time limitation" (will subsidies remain available in the same amount if further projects are developed?), and whether (2) the capital is available in the form of a loan or a grant
Duration	Estimates range from 15 to 20 years	Not yet possible to assess conclusively. Duration is particularly important for a company's decision-making in terms of (1) potential supply chain realignment, (2) greater capital investment for production capacity, and (3) hiring decisions
Form	Almost exclusively cash benefits (instead of loans) in the form of tax credits, in many cases direct cash transfers from the US government	• Cash grants • Tax credits • Reduced-interest and market loans
Competition for subsidies	Subsidies are predominantly "lump sum" payments that any company can receive for a specific technology (e.g. a fixed tax credit for the production of solar panels)	• Feed-in tariffs and fixed, unit-based subsidies • Ongoing calls for projects
Conditions for receiving support	Clear premises with a few significant exceptions, which will be determined by US government guidelines in the coming months	Not yet possible to assess conclusively. Clear conditions for receiving support are crucial for companies considering large investments, supply chain transformations and hiring decisions
Funding	15 per cent minimum tax for companies, stricter tax enforcement and prescription drug pricing reform	Reallocation of existing EU funds (RePowerEU, InvestEU and EU Innovation Fund)

Source: Morgan Stanley Research, UniCredit Group Investment Strategy

While stemming the capital outflows from Europe to the US is expected because the IRA is likely to become essential for the EU, the EU institutions have made it clear that mobilising private capital will be crucial to achieving their ambitious climate change goals. This is because it may be difficult for the EU to mobilise the same financial resources that are being made available by the US government under the IRA. Nevertheless, the Green Deal Industrial Plan should give the EU a boost in greening its energy system and fighting climate change.

INVESTMENT IMPLICATIONS

The International Energy Agency estimates that the global market for clean energy technologies will be worth around €600 billion per year by 2030 – more than triple what it is today. We believe that both the IRA and the European response to it will become a crucial catalyst to accelerate the energy and resource transition in the US and the EU. Both initiatives are likely to have a positive impact on clean energy value chains and expand investment opportunities in this asset class over time. Stocks in several related sectors such as solar energy have outperformed broad equity indices following the initial announcement of the IRA last summer. We see investment opportunities with a view to sustainable investments in the entire clean energy value chain, for example in the areas of photovoltaics, wind turbines, battery storage, hydrogen and energy efficiency. In particular, German-based companies could potentially benefit the most from the EU's Green Deal Industrial Plan, given Germany's fiscal flexibility.

Macro & Markets

Robust macro data, but volatility shakes financial markets

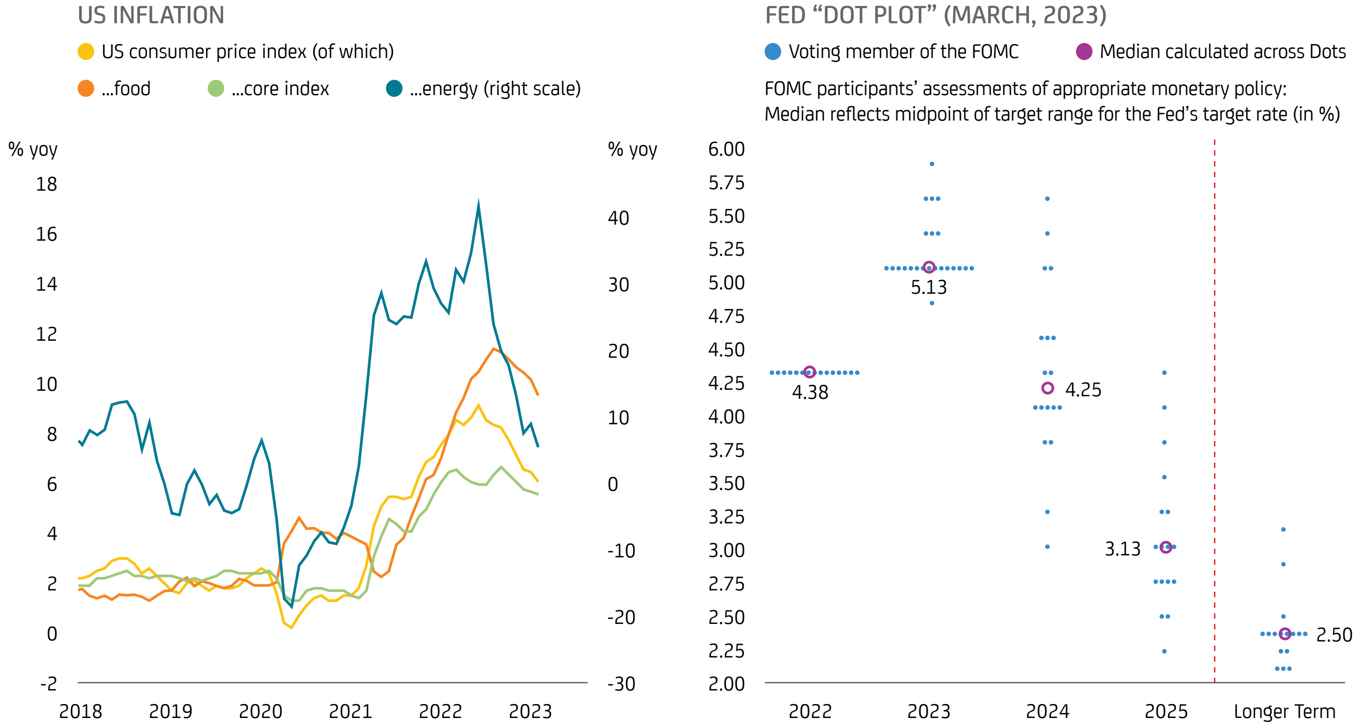
SOLID ECONOMIC DATA ALLOW FED TO STICK TO RESTRICTIVE MONETARY POLICY

Despite signs of a weakening US economy, key economic indicators remain robust. For example, the labour market report for February delivered an unexpectedly strong increase in new jobs of 311,000 (up from 504,000 in the previous month), while the 0.2% month-on-month increase in average hourly wages was slightly below expectations (0.3%). While February's inflation figures (see Chart 4) indicated that headline disinflation continued (6.0% year-on-year versus 6.4% in January) – driven mainly by declines in the volatile components of energy and food – the much-watched core rate remained broadly unchanged at a high level (5.5% year-on-year versus 5.6%). The main factor here was the stubborn inflation in the services sector. The continued solid state of the US economy and the still high inflation rates indicate that the US Federal Reserve (Fed) cannot yet consider its fight against inflation to be over.

The latest macro data led the Fed to raise its key interest rates by a further 25 basis points (bp) at its March meeting. However, the central bank left its interest rate outlook largely unchanged compared with December (**"dot plot"**[8], see also Chart 4), signaling that the interest rate peak is likely to be reached soon. For the end of 2023, the Fed expects a median rate of 5.1% (unchanged), for the end of 2024 a rate of 4.3% (previously 4.1%) and for the end of 2025 a rate of 3.1% (unchanged), with none of the Fed members envisaging rate cuts this year. Regarding the current situation in the U.S. banking sector, Fed Chairman Powell said that the banking system is "sound and resilient," but that the Fed must assume that recent developments will have lasting effects due to a tightening of bank lending standards. Although recent inflation figures have proven more persistent, the expected tightening of lending standards has essentially replaced the rate hikes. We still expect another 25 bp rate hike in May, but this should then also mark the interest rate peak (with a maximum key rate of 5.25%). We do not see interest rate cuts of 100 bp, as priced in by the markets for later this year.

[8] The "dot plot" is a graph in which the individual central bank members give their forecasts for future key interest rates. This is usually done for a forecast period of three years as well as for the longer term. Each dot in this graph represents a central bank member, and the estimates are anonymous so that no conclusions can be drawn about the projections of individual central bank members.

4. US DISINFLATION CONTINUES, CORE RATE REMAINS SLUGGISH – FED RAISES INTEREST RATES, RATE PATH HARDLY CHANGED



Source: BLS, US Federal Reserve, UniCredit Group Investment Strategy

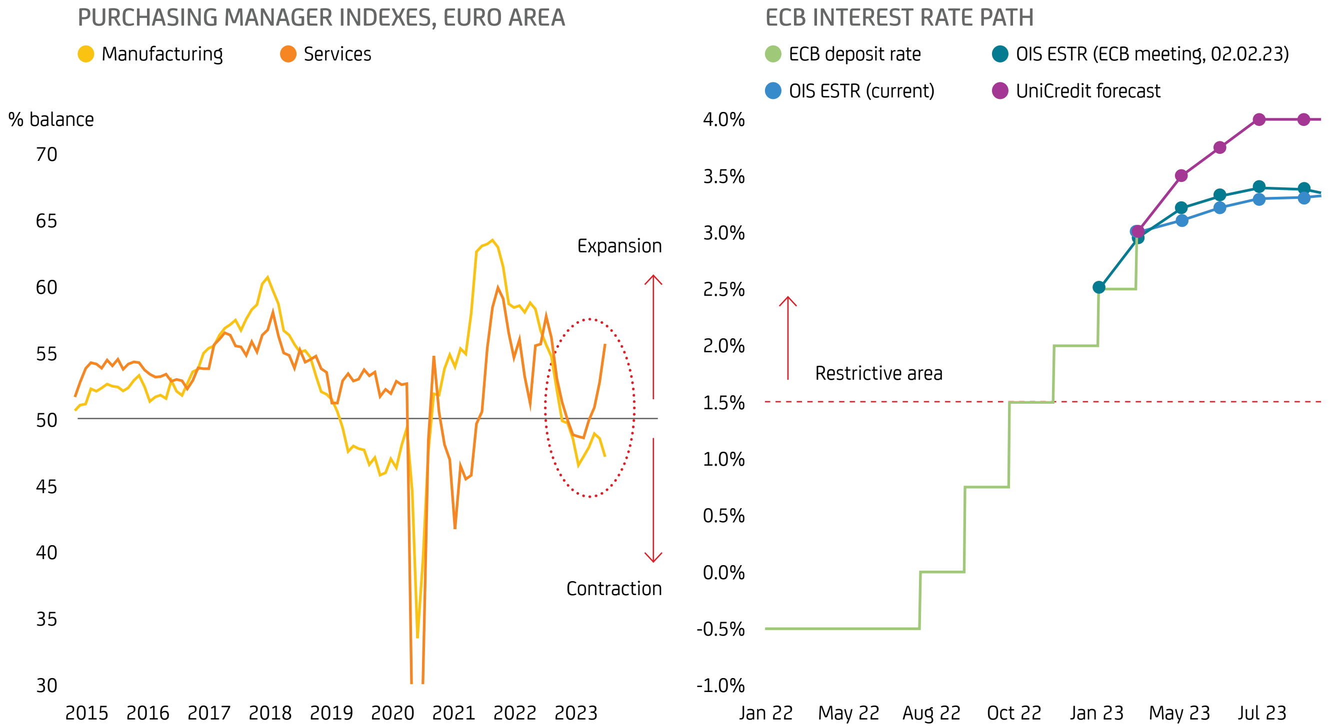
NO RECESSION IN THE EUROZONE, WINTER SLUMP IN THE ECONOMY LIKELY TO BE SHORT-LIVED

According to the latest publications on GDP growth, economic output in the euro area stagnated in the fourth quarter of 2022, which means that it may have escaped a (technical) recession. This is because leading indicators also clearly exceeded market expectations in March (see chart 5). Although the purchasing managers' indices at sector level were mixed, the services sector in particular recorded another strong increase to **56 index points**[9]. This suggests robust growth momentum in the sector. The index for the manufacturing sector declined further to 47 index points compared with January. Although key sub-indices, such as production, new orders and inventories, deteriorated, it was largely another sharp decline in delivery times (which enter the overall manufacturing index with a negative sign) that dampened the March reading. However, the decline in delivery times was primarily due to falling supply bottlenecks (and not, as is usually the case, to falling demand), as a result of which we also take a cautiously positive view of the outlook for the manufacturing sector. Accordingly, economic development in the euro zone is likely to slow further in the first quarter but pick up again in the second quarter and over the rest of the year.

On the monetary policy side, the European Central Bank (ECB) raised its key interest rate by 50 bps in March, as expected, and thus increased its deposit rate to 3%. It is therefore following its previously targeted interest rate path. Nevertheless, the ECB has become more cautious in its assessment of its future monetary policy stance. Due to the current volatility and uncertainty across markets (originally triggered by liquidity problems of some US regional banks), the central bank refrained from giving hints on further interest rate steps at its March meeting. It also reaffirmed its commitment to provide emergency liquidity support if needed. The containment of inflation remains the ECB's primary goal, which is why it continues to adhere to its tendency to tighten monetary policy. Most recently, consumer prices were down only slightly, i.e. 8.5% year-on-year in February (previously 8.6% in January), whereas the core rate continued to rise at 5.6% year-on-year (previously 5.3% in January). Nevertheless, the current situation as well as a possible tightening in bank lending standards in the euro area has made the monetary policy outlook more uncertain, which has also increased the downside risks to our interest rate peak forecast at a deposit rate of 4%. For its part, the market has already largely priced out further interest rate moves in the euro area this year (see Chart 5).

[9] Index values of the Purchasing Managers' Index above the 50 point mark signal an expansion and thus a recovery of economic activity.

5. LEADING INDICATORS HAVE RECENTLY IMPROVED SIGNIFICANTLY – MARKET TURBULENCE, HOWEVER, MAKES ECB INTEREST RATE PATH MORE UNCERTAIN



Source: S&P Global, Bloomberg, UniCredit Research, UniCredit Group Investment Strategy.

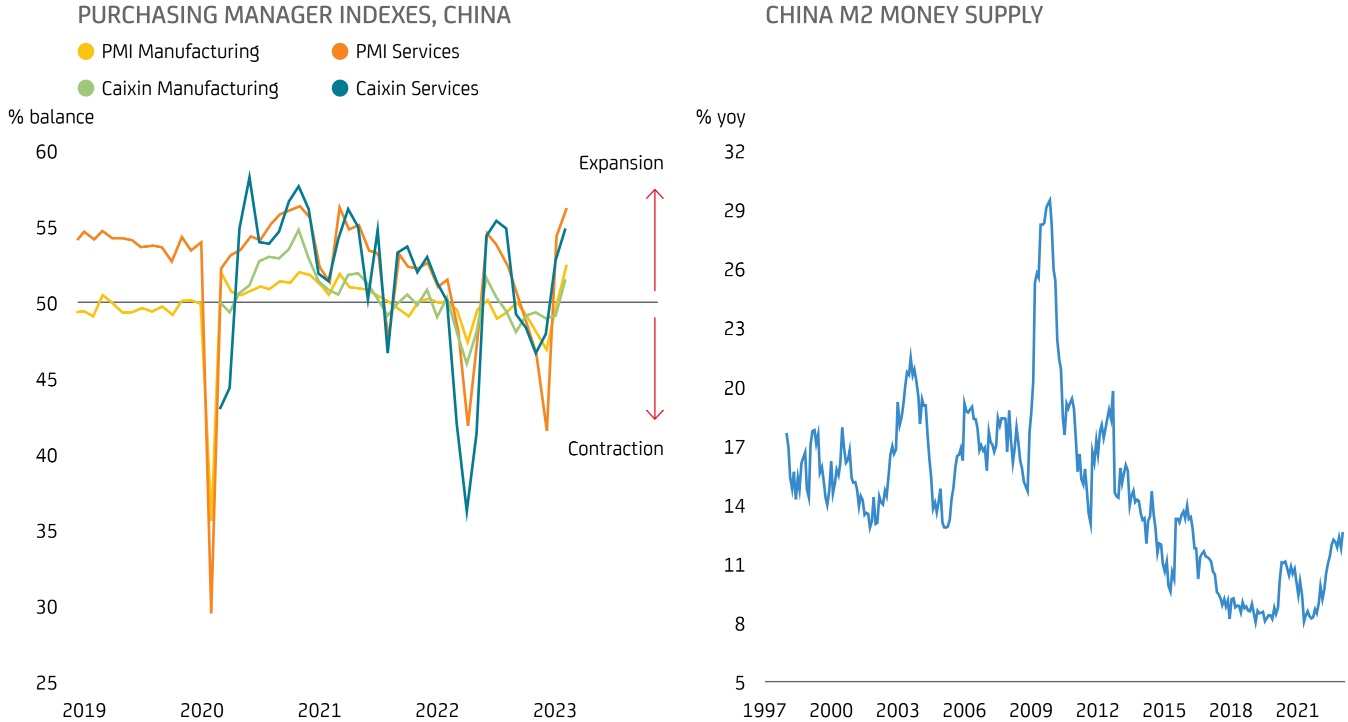
CHINA: REOPENING LEADS TO RECOVERY IN ECONOMIC ACTIVITY

In China, the macroeconomic environment continued to brighten in the first quarter as a result of the end of the zero-Covid policy. Although the National People's Congress had presented a less encouraging than **expected**[10] target of 5% growth in 2023 at the beginning of March, the most recently published data nevertheless show that China's growth upswing is intact. Purchasing managers' indices for both manufacturing and services have improved across the board (see Chart 6), which is also reflected in the "hard" data: industrial production growth registered a year-on-year increase of 2.4% in the period from early January to late February, while retail sales grew at 3.5% year-on-year. In addition, growth in the **M2 money supply**[11] continued to rise (see Chart 6), indicating a credit environment that remains supportive. Accordingly, we continue to expect China's recovery to continue this year.

[10] For 2022, the Chinese government originally set the growth target at 5.5%. In the end, however, only 3% economic growth could be achieved due to the strict zero-Covid policy with lockdowns and forced quarantine.

[11] The M2 money supply comprises cash, demand deposits and time deposits, and is thus a way of measuring the volume of money in an economy. Commercial banks can increase/decrease the money supply by granting/repaying loans (money creation).

6. ECONOMIC ACTIVITY RECOVERS NOTICEABLY AND CREDIT ENVIRONMENT ALSO REMAINS CONSTRUCTIVE



Source: S&P Global, People's Bank of China, UniCredit Group Investment Strategy

MARKETS CAUGHT BETWEEN INTEREST RATE CONCERNS AND MACROPRUDENTIAL INTERVENTION

The significantly more robust inflation and labour market data in the US caused the markets to adjust their assessment of US monetary policy in February. In particular, the prospect of a potential renewed acceleration of the pace of interest rates moved back into the focus of investors: on the bond markets, the yields of 10-year US government and German Bunds increased by around 50 bps and 40 bps, respectively, in February, while at the same time the US stock markets in particular had to absorb significant price losses (S&P 500 index fell more than -3.5%). European stock markets, however, were able to largely escape this downward slide and even posted gains, which was primarily due to the consideration that an energy crisis appears increasingly unlikely in Europe. Due to higher interest rate expectations, especially in the US, the euro weakened in February and depreciated by around 4% against the US dollar. Gold lost more than 6% in the same period.

In the financial markets, the recent events in the US and Swiss banking sectors were the dominant theme. They resulted in significantly more restrictive financing conditions. In the second week of March, in particular, the sharp sell-off in bank stocks following the collapse of two US regional banks, and the news coverage surrounding a major Swiss bank, led to significant price adjustments. The yields of 10-year US government bonds fell noticeably and within a few days completely priced out the February yield increases. For 10-year Bunds, the decline in yields even exceeded the February increases. In both the US and Switzerland, however, the supervisory authorities and central banks reacted quickly, decisively and comprehensively and were initially able to calm investors. Nevertheless, the stock markets, especially in Europe, recorded significant price losses. For example, the EuroStoxx50 and the DAX40 indexes have fallen by more than 3.5% since the beginning of March (as of 20 March 2023). The euro is trading virtually unchanged against the US dollar in the same period, while the troy ounce of gold gained more than 9% due to the increased uncertainty.

Even if the insolvencies of the US regional banks can be understood as a warning signal that the rapid and significant interest rate turnaround of the major Western central banks entails macroprudential risks – i.e. risks that affect the financial system or its stability – we assume that the markets will calm down after a phase of increased volatility and shift their focus back to inflation and growth issues.

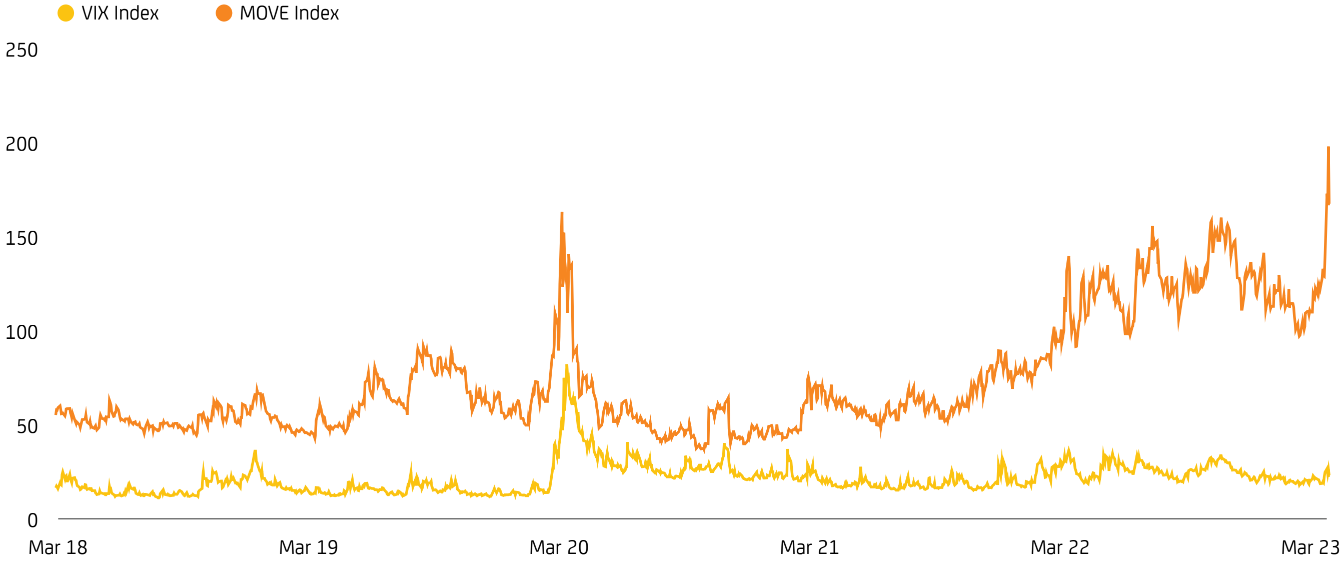
Asset Allocation – How we manage our portfolio mandate

Asset		Investment Universe	Investment View		
			Negative	Neutral	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	○	○	●
	Commodities	Oil	○	●	○
		Gold	○	○	●

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

Earlier on in the first quarter, and before the SVB crisis, data on higher-than-expected growth in the US and Eurozone – in particular, services-led PMIs – and on inflation – in particular, core services inflation – led to a sharp retracement of the bond markets (following the good performance in January), while the equity market held relatively steady. The stickiness of inflation data generated a repricing of both the Fed and ECB's terminal rate and a lengthening of the expected timing for rate cuts. While a stickier core inflation in the US and even in the Eurozone (to a lesser degree) will likely keep the short term volatility elevated in the bond markets (see graph below), we remain constructive on high quality bonds.

7. BOND (MOVE INDEX) AND EQUITY MARKETS (VIX INDEX) VOLATILITY



Source: Bloomberg, UniCredit Group Investment Strategy
Observation period: 15.03.2018-15.03.2023.

The mild winter may partially have supported the stronger economic releases in the US and Eurozone, and it is fair to expect a slowdown of these economies – especially once the higher rates fully spread out their effects and consumers gradually deplete their excess savings made during the pandemic. Against this backdrop, it is no surprise that investors have increased their positioning on high quality bonds such as government and corporate investment grade bonds, considering their competitive yields and their role of macro-hedging versus equities in the case of a slowdown or shallow recession. We remain cautious on high yield corporate bonds, where spreads are not yet fully discounting the economic slowdown. We are also constructive in the long term on EM bonds and believe they should benefit when the Fed announces a policy pivot.

8. INSTITUTIONAL INVESTORS ARE ACCUMULATING "HIGH QUALITY" BONDS

Sources: BofA Global Investment Strategy, EPFR. As of week ending March 1st

Meanwhile, equities are holding up relatively well, discounting a sort of “no landing scenario” i.e., they are not discounting the material risk of an earnings disappointment in the coming months, considering the lagging effect of higher interest rates. Therefore, while we remain constructive in the medium to long term, we are actively managing our regional, industry and style allocation. As for the regional equity allocation, we remain neutral across all the main regions, but we see better macro momentum and valuation metrics in Europe, where consumption is supported by falling natural gas prices, a high savings rate and low unemployment, and in Asia, including Japan, thanks to China’s reopening.

In terms of style and sectors allocation, we maintain our preference for value plays such as energy and consumer staples, but we expect a recovery of the growth sectors once the Fed turns more dovish. More generally, we continue to prefer companies with high pricing power and superior cash flow generation.

As for the US dollar, when the Fed pivots, it is expected to further weaken, trading more in line with fundamentals.

Commodities are affected by the global growth slowdown but partially supported by the pick-up of China’s economic reopening. Gold should benefit from its role as a safe haven amid the uncertainty from the US regional bank crisis, and from expectations of a less restrictive Fed and a weakening USD.

NEUTRAL ON GLOBAL EQUITIES

A resilient macro picture has ignited a rebound in equities but the risk of an earnings deceleration in the coming months is material considering the lagging effect of higher interest rates. Sectors and stocks selectivity is increasingly key.

NEUTRAL EUROPEAN EQUITIES

Restrictive ECB but resilient consumer growth due to falling natural gas prices, a high savings rate and low unemployment. Cheap valuation, the value bias and investors under-positioning support European equities, despite the ongoing high geopolitical risk from the Russia / Ukraine war.

NEUTRAL US EQUITIES

Strong jobs market and earnings resilience, but rising uncertainty due to the regional bank crisis. The rich equities valuation makes the asset class vulnerable in the case of an economic downturn.

NEUTRAL EMERGING MARKET EQUITIES

China's reopening and the cheap valuation support EM equities in the short term. Long term, the increasing strategic confrontation between US and China is a source of concern. Countries and sectors selectivity among EMs is strongly recommended.

NEUTRAL PACIFIC EQUITIES

China's reopening is a positive, but there is more uncertainty in the medium to long term as the Bank of Japan, under the new leadership of Kazuo Ueda, could be forced to abandon the yield curve control policy and raise interest rates in the case of an overheating economy – leading to a stronger Japanese yen and affecting equity markets, particularly the exporters.

NEUTRAL GLOBAL BONDS

Competitive yields and major central banks expected to become gradually less hawkish, although core inflation is showing stickiness.

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

Their spreads do not yet fully discount the possible slowdown of the economy due to more restrictive lending conditions. Also, they are not enough liquid.

NEUTRAL (FROM NEGATIVE) EMU GOVERNMENT BONDS

Despite the high inflation, we expect the ECB not to be insensitive to financial stability and credit crunch concerns.

NEUTRAL (FROM POSITIVE) NON-EMU GOVERNMENT BONDS

Very competitive yields in the 1-2-year bucket of the yield curve and the Fed is not far from reaching the terminal rate, despite stickier core services inflation.

OVERWEIGHT EMERGING MARKET BONDS

Supported by expectations of a gradually less restrictive Fed and a weakening USD. We remain defensive and selective, avoiding countries with high external debt and a current account deficit.

NEUTRAL MONEY MARKETS

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

NEUTRAL ALTERNATIVES

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

NEUTRAL COMMODITIES

Penalised by fears of a global slowdown but partially supported by China's economic reopening.

POSITIVE GOLD

Hedging for rising uncertainty.

CURRENCIES

The USD is expected to weaken due to a less restrictive Fed and the weakening of the US economy.

How to invest

Investment ideas in the current scenario

CURRENT SCENARIO

MONETARY POLICY

Recent financial market volatility and a tightening of financial conditions has further complicated the central banks' job. On 22 March the Fed announced a rate hike by 25 bps and the ECB is also likely to adopt the same wait-and-see strategy.

INFLATION

Despite the monetary policy tightening delivered globally in 2022, inflation continues to remain at levels that are too high for central banks to say that price stability has been achieved. The recent tightening in financial conditions triggered by the US regional bank crisis should translate into a more modest economic activity in the US, therefore allowing for a more significant decline in inflation.

ECONOMIC GROWTH

In the US, despite the robustness of the labour market, there are clear signs that economic activity might switch to a lower gear in the second half of the year. According to the latest publications on GDP growth, economic output in the euro area stagnated in the fourth quarter of 2022, which means that it may have escaped a (technical) recession.

HOW TO INVEST

BOND INVESTMENTS

The corporate bond asset class shows appealing yields, but given the relatively tight spreads, we recommend increasing the allocation to high quality bonds – especially in the case of a sharp weakening of the macro picture (Corporate Investment Grade bonds).

OUR IDEA: INFLATION-LINKED BONDS

Inflation-linked bonds can be an interesting investment opportunity to be included within the portfolio, as their remuneration grows with the rising cost of living. An increase in inflation expectations corresponds to an increase in the price of bonds and vice versa. In short, the price of inflation-linked bonds is a function of expectations regarding inflation that will occur throughout the life of the bond.

Inflation-linked bonds are useful tools for portfolio diversification, due to their low correlation with other asset classes, primarily equity, as well as to their ability to improve the risk-return profile.

In the current volatile and uncertain environment, inflation-linked bonds represent a safe haven in the event of financial tensions, thanks to the high credit rating as they are issued by sovereign states.

EQUITY INVESTMENTS

Equities are holding up relatively well, discounting a sort of “no landing scenario”. We remain constructive in the medium to long term. As for the regional equity allocation, we remain neutral across all the main regions. However, we see better macro momentum and valuation metrics in Europe, where consumers are supported by falling natural gas prices, a high savings rate and low unemployment, as well as in Asia including Japan, thanks to China’s economic reopening.

OUR IDEA: ELECTRIC VEHICLES

In our view, European and US automakers are best positioned to capture market share through an increasing portfolio of battery electric vehicles (EV) models allowing them to appeal to different buyers. Their ability to generate positive cash flows through their operations enables them to be more solid than Chinese competitors, which continue to operate at a zero margin or even at a loss. They are also likely to face serious financial and regulatory challenges if ever willing to enter developed markets.

Given the magnitude of changes in the global economy, legacy automakers can start to capitalise on the investments made over the past years on the EV technology. They also have an opportunity to drive the evolution of the EV market, approaching future investments more cost-effectively to protect their margins.

REGIONAL INVESTMENTS

Since the pandemic year of 2020, China has shown a comparatively volatile development among the major world regions. In 2020, the MSCI China outperformed the four regional components of the MSCI ACWI, while in 2021 and 2022, it was weaker than all four regional indices. The weak price performance of the MSCI China was accompanied by an equally weak performance of the corresponding earnings expectations of Chinese companies.

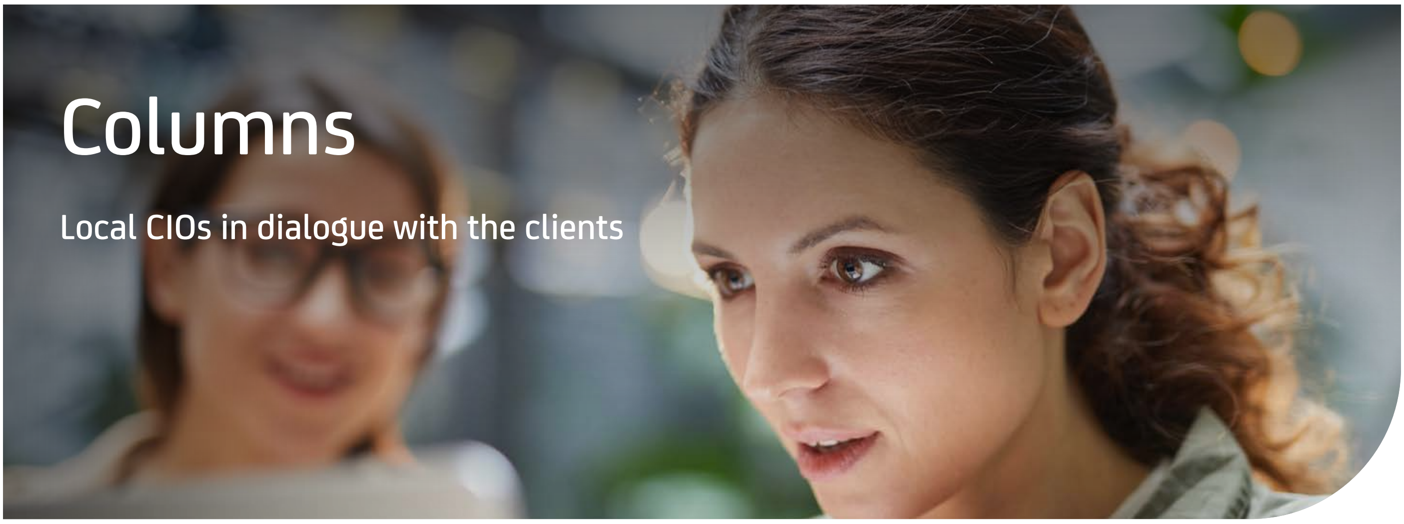
After the surprising end of the zero-Covid policy in China, the country is once again the focus of investor interest. Although investors are likely to face a China characterised by lower economic growth than in the past and a greater focus on national security issues in the medium to long term, the country’s economic recovery could gain significant momentum in the coming months.

OUR IDEA: EMERGING MARKETS – CHINA

For risk-adverse investors who want to profit from a possible renewed recovery rally in Chinese and/or Asian assets, the question is how to concretely invest a corresponding positioning. In principle, different investment strategies are available for China and Asia.

- Direct investments in shares of companies from the region can be done either via corresponding individual stocks or via portfolio products such as funds or ETFs, since direct access to the Chinese stock market, i.e., via individual stocks, is not always easy for foreign investors.
- An investment strategy aiming at indirect investments can be implemented by picking some large European companies which generate a significant part of their global sales in Asian or Chinese markets, in sectors such as the luxury goods industry, the premium segment of European car manufacturers, and also the semiconductor industry. The advantage of such an indirect strategy is that one invests in well-known companies that are subject to European law. Risks such as exchange rate fluctuations can be managed by the companies themselves.

Against the backdrop of the current geopolitical situation, we currently tend to advise caution in direct investments in China, but in principle we do see diversification potential for a broadly diversified portfolio. In the short term, risk-averse investors can focus on opportunities on the equity side, especially as part of an indirect investment strategy.



Columns

Local CIOs in dialogue with the clients

Answers from Italy

WHY ARE BOND PRICES RISING EVEN AS CENTRAL BANKS CONTINUE TO HIKE RATES?

Since the beginning of the year, central banks have continued on their path to increase short-term interest rates, which began in 2022 to combat inflation. In this first quarter, the ECB raised the rate on deposits to 3.0% from 2.0% and the Fed hiked rates to 5.0% from 4.5%.

However, despite this backdrop, many bond markets are posting positive year-to-date returns. The reasons for this apparently opposite movement are manifold. Firstly, we must consider that these hikes were already "priced in" and therefore did not constitute a negative surprise for investors, i.e. they were already incorporated in the price level of the bonds. This point is especially true for shorter bonds, typically up to two years of maturity, whose yields effectively represent investors' expectations of central banks' next moves.

Another element is represented by the starting yield of the bonds. In 2022, many bonds started with very low yields to maturity, some even around zero or negative. Today, the yield to maturity is a good indicator of potential return for 2023, if central banks get to their interest rate targets and maintain them for the rest of the year. It is true that some yield curves are downward sloping: therefore, 10-year bonds yield less than two-year bonds, as in the case of the US or German government bond curve. But many others, for example Italian government bonds or corporate bond issuers, have a positive slope and therefore the buffer represented by the yield is even more important.

Further, the recent turbulence on the stock markets, caused by the events of some Californian banks and by the rescue intervention of Credit Suisse, had a double effect. On the one hand, it generated buying flows in search of safety, which gave further support to the prices of quality bonds, represented by high-rated government bonds and investment grade corporate bonds. On the other hand, it has provided evidence of additional elements of risk and potential economic slowdown that central banks need to take into account in their future actions. And in fact, both the ECB and the Fed in their statements from the March meetings introduced the additional element of attention to the stability of the financial system.

In this context, therefore, bonds are once again playing their natural role: the production of nominal returns and protection for phases of more marked volatility.

Alessandro Caviglia

CIO Italy, UniCredit SpA (Italy)

Answers from Austria

Oliver Prinz

Co-CIO Bank Austria and Schoellerbank (Austria)

HOW WAS THE CHANGE FROM "TINA" TO "TAPAs"?

Until a year ago, many asset managers spoke of "TINA" (There Is No Alternative). What they meant was that there was no alternative to equity investments. Interest rates were at rock bottom, many bonds were yielding zero or even negative, and other asset classes such as real estate or precious metals offered only modest profit prospects.

Then came the pandemic, and the rise in energy prices, which were further fuelled by the war in Ukraine – and inflation shot up to unimagined heights. Central banks reacted quickly and strongly, first with the Fed and, with the usual slight delay, the ECB. They raised key interest rates at a speed that could not have been anticipated from the experience of past cycles.

Similar to money market rates, yields at the long-end of the yield curve also moved upwards. In the face of even double-digit inflation, investors no longer accepted zero yields, and demand for bonds in various segments collapsed. This caused prices to plummet and, conversely, yields to rise. Many bonds showed yield increases of 300 bps (100 bps is one percentage point) and more.

Now, markets have returned from the worst of all bond worlds to an excellent bond starting position in a very short time. Many market participants today speak of "TAPAs" (There Are Plenty of Alternatives or also There Are Powerful Alternatives). So today – depending on the diction – there are even "many" or "powerful" alternatives to equity investments.

In summary, equities have proven to be great investment instruments in the past and will remain so in the future. Nevertheless, the investment world is now a different one than it was in the last 10 years. No one could have expected the developments of the past year, especially the speed and intensity of the rise in yields. Asset managers who, like us, were very cautious, quality-oriented, broadly diversified, and positioned away from common benchmarks were well advised.

The starting situation for the future is much more interesting today than it was in the last decade. For conservative investors, equities are no longer unconditionally recommended for asset preservation. Within bond investments, there are many low-risk alternatives that nevertheless offer exciting returns. Investors should quickly adapt to the new situation.

Answers from Germany

Philip Gisdakis

CIO UniCredit Bank AG (HypoVereinsbank) (Germany)

WHY IS INDIA IMPORTANT FOR THE EU?

For a long time, India has been overshadowed by China. But gradually, India has become at least equal to China in many areas – and in some instances, even overtaken it. Before the end of this year, India is forecast to replace China as the world's most populous country. The country's economic outlook is comparatively good: with an average annual growth rate of 6-7%, India currently has one of the **fastest growing economies in the world**[12]. According to International Monetary Fund forecasts, the country could pass Germany as early as 2025 or 2026 and be the world's second largest economy by 2050. This is primarily due to the country's "demographic dividend" – around two-thirds of its population, some 900 million people, are of working age between 15 and 64, and this group is expected to grow further in the coming years. This represents a great opportunity for India's economy and thus also for the living conditions of large parts of its population.

India's sheer size makes it an attractive economic partner for the export-oriented EU economy and for companies based here. Moreover, there is a growing realisation in EU capitals that it needs to rebalance its economic relations in the global economy. While the rise of India – as a counterweight to China – is in Europe's interest, India's future course is likely to be a deciding factor in whether the EU succeeds in achieving its global economic and (climate) policy goals. As a result, Western interest in the South Asian country is growing, although it remains a challenging partner for the EU. This is because India occupies a geopolitical position "between the blocs", and Russian-Indian ties are close despite Russia's war of aggression on Ukraine. India abstained from the recent vote on the Ukraine war in the UN General Assembly. It is heavily dependent on Russia for **military**[13] and energy, and it has expanded its imports of relatively cheap Russian oil and gas over the past year. Planned talks on a free trade agreement between India and the EU could be a catalyst in bilateral (economic) relations, but they seem to be delayed again.

[12] However, at least for a short time, economic growth in Vietnam and Indonesia has been stronger recently.

[13] The US think tank "Stimson Center" estimates that about 85% of India's weapons systems are of Russian (or still Soviet) origin.

DEVELOPMENT OF SELECTED FINANCIAL MARKET INDICES

From	**17.03.22**	17.03.18	15.03.19	17.03.20	17.03.21	17.03.22	17.03.18	**01.01.23**
To	**17.03.23**	17.03.19	17.03.20	17.03.21	17.03.22	17.03.23	17.03.23	**31.01.23**
Stock market indices (total return, in %)								
MSCI World (in USD)	**-8.9**	1.4	-14.2	62.7	7.4	-8.9	39.0	**2.5**
MSCI Emerging Markets (in USD)	**-12.3**	-10.6	-20.4	66.6	-14.4	-12.3	-9.8	**-0.2**
MSCI US (in USD)	**-10.4**	4.8	-9.4	63.8	10.7	-10.4	54.6	**2.6**
MSCI Europe (in EUR)	**0.7**	5.1	-21.6	48.1	9.9	0.7	35.0	**3.4**
MSCI AC Asia Pacific (in USD)	**-8.9**	-8.5	-16.2	63.5	-12.5	-8.9	1.1	**1.5**
STOXX Europe 600 (in EUR)	**-0.1**	4.7	-21.1	49.7	9.0	-0.1	34.7	**3.2**
DAX 40 (Germany in EUR)	**2.6**	-5.4	-23.3	63.3	-1.4	2.6	19.2	**6.1**
MSCI Italy (in EUR)	**10.2**	-3.6	-26.2	56.9	1.5	10.2	25.2	**5.9**
ATX (Austria, in EUR)	**-2.7**	-8.6	-40.2	82.5	9.3	-2.7	6.4	**0.0**
SMI (Switzerland, in CHF)	**-9.4**	10.3	-8.1	33.2	14.2	-9.4	39.9	**0.2**
S&P 500 (USA, in USD)	**-9.7**	4.8	-8.9	59.9	12.6	-9.7	55.4	**2.4**
Nikkei (Japan, in JPY)	**4.9**	0.4	-19.5	79.2	-9.4	4.9	39.3	**4.8**
CSI 300 (China, in Yuan)	**-4.4**	-6.5	-1.5	40.4	-15.5	-4.4	8.5	**2.3**
Bond market indices (total return, in %)								
US Government Bonds 10Y (in USD)	**-7.6**	4.8	18.7	-3.6	-2.6	-7.6	8.0	**4.6**
US Government Bonds (ICE BofA, in USD)	**-5.3**	3.5	13.0	-2.9	-3.0	-5.3	4.5	**3.3**
US Corporate Bonds (ICE BofA A-BBB, in USD)	**-5.8**	3.6	5.3	9.9	-4.3	-5.8	8.3	**2.4**
German Bunds 10Y (in EUR)	**-12.7**	6.3	5.4	-1.0	-5.7	-12.7	-8.7	**4.7**
EUR Government Bonds 1Y-10Y (iBOXX, in EUR)	**-11.7**	2.1	3.4	3.8	-5.3	-11.7	-8.2	**3.6**
EUR Corporate Bonds 1Y-10Y (iBOXX, in EUR)	**-7.9**	1.5	-1.1	6.7	-5.5	-7.9	-6.6	**1.6**
Bond yields (change in basis points = 0.01 percentage points)								
US Government Bonds 10Y (in USD)	**124**	-23	-161	65	55	124	58	**-40**
US Government Bonds (ICE BofA, in USD)	**158**	-4	-170	11	120	158	114	**-42**
US Corporate Bonds (ICE BofA A-BBB, in USD)	**178**	9	-17	-142	132	178	158	**-12**
German Bunds 10Y (in EUR)	**178**	-49	-51	10	68	178	156	**-43**
EUR Government Bonds 1Y-10Y (iBOXX, in EUR)	**190**	-10	-32	-37	69	190	179	**-39**
EUR Corporate Bonds 1Y-10Y (iBOXX, in EUR)	**240**	4	41	-106	123	240	299	**-16**
Spreads on government bonds (credit spreads, change in basis points)								
US Corporate Bonds (BofAML US Corporate Master)	**23**	16	146	-170	37	23	52	**24**
US Corporate Bonds (BofAML US High Yield)	**136**	33	446	-476	16	136	157	**38**
Euro Corporate bonds (BofAML Euro Corporate AAA-A)	**37**	20	80	-98	49	37	86	**27**
Euro Corporate Bonds (BofAML Euro High Yield)	**78**	101	371	-443	132	78	233	**28**
Money market rates (change in basis points)								
Libor (USD, 3 months)	**407**	45	-158	-86	74	407	280	**23**
Euribor (EUR, 3 months)	**324**	2	-10	-14	5	324	308	**62**
Euro exchange rates (change in %)								
US Dollar (EUR-USD)	**-3.9**	-8.4	-3.2	8.4	-7.2	-3.9	-13.6	**-0.4**
British Pound (EUR-GBP)	**3.8**	-3.5	6.0	-5.7	-1.6	3.8	-0.9	**-1.4**
Swiss Franc (EUR-SFR)	**-5.1**	-2.8	-7.0	4.6	-6.0	-5.1	-15.8	**0.1**
Japanese Yen (EUR-JPY)	**7.1**	-3.6	-7.1	10.7	1.0	7.1	8.0	**-0.1**
Commodities (change in %)								
Commodity Index (GSCI, in USD)	**1.0**	-1.8	16.3	9.9	11.9	1.0	42.3	**8.1**
Industrial metals (GSCI, in USD)	**-26.5**	-9.0	-18.6	52.4	38.6	-26.5	15.6	**-4.0**
Gold (in USD per fine ounce)	**0.9**	-1.1	18.0	12.2	12.5	0.9	49.2	**8.0**
Crude oil (Brent, in USD per barrel)	**-32.2**	2.8	-56.0	129.9	57.0	-32.2	10.0	**-14.5**

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 31.01.2023.

Disclaimer

This publication of UniCredit S.p.A., UniCredit Bank Austria AG, Schoellerbank AG and UniCreditBank AG (hereinafter jointly referred to as the "UniCredit Group") is addressed to the general public and is provided free of charge for information only. It does not constitute investment recommendation or consultancyactivity by the UniCredit Group or, even less, an offer to the public of any kind nor an invitation to buy or sell securities.

UniCredit Group, including all its group companiesand the other companies of the UniCredit Group may have a specific interest in relation to the issuers, financial instruments or transactions detailed herein. Please refer to https://www.unicreditresearch.eu/index.php?id=disclaimer. Any estimates and/or assessments contained in this publication represent the independent opinion of the UniCredit Group and, like all the information contained therein, are given in good faith on the basis of the data available at the date of publication, taken from reliable sources, but having a purely indicative value and subject to change at any time after publication, on the completeness, correctness and truthfulness of which the UniCredit Group makes no guarantees and assumes no responsibility. Interested parties must therefore carry out their own investment assessments in a completely autonomous and independent manner, relying exclusively on their own considerations of the market conditions and the information available overall, also in line with their risk profile and economic situation.

It should also be noted that:

1. Information relating to the past performance of a financial instrument, index or investment service is not indicative of future results.
2. If the investment is denominated in a currency other than the investor's currency, the value of the investment can fluctuate strongly according to changes in exchange rates and have an undesirable effect on the profitability of the investment.
3. Investments that offer high returns can undergo significant price fluctuations following any downgrading of creditworthiness. In the event of bankruptcy of the issuer, the investor may lose the entire capital.
4. High volatility investments can be subject to sudden and significant decreases in value, being able to generate significant losses at the time of sale up to the entire capital invested.
5. In the presence of extraordinary events, it may be difficult for the investor to sell or liquidate certain investments or obtain reliable information on their value.
6. If the information refers to a specific tax treatment, it should be noted that the tax treatment depends on the individual situation of the customer and may be subject to change in the future.
7. If the information refers to future results, it should be noted that they do not constitute a reliable indicator of these results.

The UniCredit Group cannot in any way be held responsible for facts and/or damages that may arise to anyone from the use of this document, including, but not limited to, damages due to losses, lost earnings or unrealized savings.

UniCredit Spa
Client Solutions

Address
Piazza Gae Aulenti, 3
20124 Milano

Online
unicreditgroup.eu/clientsolutions