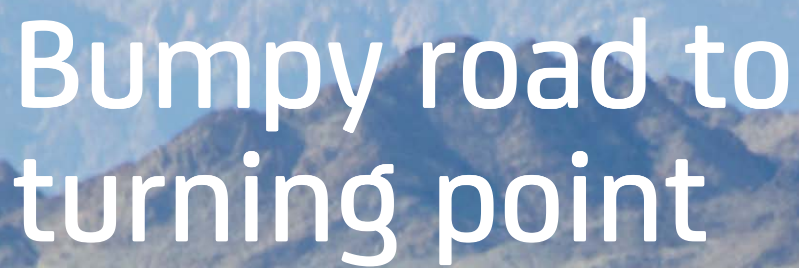

Bumpy road to turning point

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CIO's Letter

Bumpy road to turning point

Since the end of the third quarter, which marked this year's performance low for equity markets in Europe and the US – while bond indices reached their recent lows a few weeks later – performance across capital markets has been somewhat friendlier. The MSCI Europe gained around 14% (in EUR) and the MSCI North America 12% (in USD) in the fourth quarter to 24 November. Over the same period, the 10-year yield in Europe (measured by the 10-year EUR swap rate) fell from almost 3.1% to around 2.5%, while the corresponding 10-year USD swap rate was roughly unchanged.

The entire second half of 2022, for capital markets, has been characterised by the inflation-fighting mode of the big Western central banks, which have raised interest rates noticeably in recent months – and will likely continue to do so in the coming ones. For the Eurozone, the markets expect the European Central Bank (ECB) to raise the monetary policy interest rate to a peak of up to 3%, while the US Federal Reserve (Fed) is expected to raise the so-called Fed Funds Target Rate to a peak of 5%. These interest rates are far above the respective so-called neutral interest rates. For the ECB, the latter should be between 1-2% and for the Fed between 2-3%. Interest rates in the restrictive range slow down inflation, but also economic momentum. The capital market attests to the Fed that this monetary policy will push the inflation rate close to the inflation target of 2% within a year. For the ECB, reaching the inflation target is likely to take a little longer. In the coming year, inflation rates are expected to be around 5%, and in two years they will likely be close to the target value of 2% again. In Europe, inflation is likely to be more stubborn, as price dynamics are driven more by energy prices, which are not so easily controlled by traditional central bank measures. Economists refer to this as cost-push inflation. In the US, the inflation trend tends to reflect strong demand, driven by a robust labour market with high wage increases – also called demand-pull inflation.

The low EUR-USD exchange rate is also likely to play a major role for the ECB. A look at the oil price dynamics of the last few years helps to put things in perspective. Oil prices of around USD100 per barrel or above have occurred from time to time in recent years. The last time the oil price was above this level was in 2014, before the current energy crisis. During this time, the EUR-USD exchange rate was much firmer. In 2014, it was almost 1.40. In the past, phases of high oil prices were often accompanied by strong EUR-USD. This is now different, also because the energy crisis is weakening the European economy and weighing on the euro. We believe that the ECB does not want to allow the common currency to weaken further against the US dollar because of inflationary pressures. However, this also means that the difference in interest rates between the US and the euro area should not become too large. At the same time, the European economy is currently in a weaker position than the US economy. And the high interest rates are not helpful.

This connection also explains why the European markets have recently reacted very euphorically to encouraging inflation data from the US. The core inflation rate (i.e., excluding the volatile components food and energy) has fallen to a monthly rate of price increase of 0.3 %. In September, this value was still 0.6 %. A core inflation rate of 0.3% per month corresponds to an annualised inflation rate of around 3.6 %, i.e., it is moving towards the Fed's target value of 2 %. If the slowdown in inflation momentum in the US is indeed confirmed in the coming months, this would take pressure off the US central bank to raise interest rates even further than previously expected. Consequently, this would also ease the pressure on the ECB to follow the US guidance in order to counteract the devaluation pressure on the euro. In other words, the ECB would also not have to raise interest rates more than previously expected, which would be quite welcome in view of the current economic weakness in Europe.

Manuela d'Onofrio

Head of Group Investment Strategy

Philip Gisdakis

CIO UniCredit Bank AG (HypoVereinsbank) (Germany)

The growth risks on both sides of the Atlantic are likely to be reflected to some extent in companies' earnings expectations. After strong earnings growth this year, which was initially driven by delayed catch-up effects in the post-pandemic phase, European equities are currently expected to post unchanged earnings in 2023. Profit growth should then pick up again in 2024. An analogous dynamic is also expected for the US. It cannot be ruled out that a sideways development of the earnings level in the coming year could prove to be too optimistic. However, if the earnings level of companies is not fundamentally burdened and a return to positive profit growth is confirmed as the basic assumption for 2024, no substantial setbacks should be expected on the stock markets even in the event of a somewhat stronger than currently expected economic slowdown at the beginning of next year. Especially since the current low price-earnings ratios reflect a certain risk premium for such a development.

Nevertheless, the stock markets are likely to initially develop in a broad sideways movement in the new year. However, should the expected economic recovery become apparent in the course of the year, the stock markets should also rise. When such a trend reversal will occur can hardly be estimated at present in view of the widespread uncertainty. While investment strategies for a volatile sideways movement appear attractive against this background in the first half of the year, investors should prepare in good time for a possible recovery over the year.

Fixed income securities are also likely to bottom out in the coming months, likely even gaining slightly, especially also in the US. However, a possible recovery, especially compared to the equity markets, may be limited. A return to interest rate levels like before the crisis currently seem very unlikely and also not desirable. In an environment in which the central banks are reaching the peak of the interest rate hike cycle and could possibly lower the interest rate level slightly as a result, the US dollar should trend weaker. Due to the economic and geopolitical challenges, however, the currency will probably not completely give up the strength it gained in the current year, in the year ahead. On balance, we therefore consider a balanced risk appetite in the investment strategy to be appropriate for the beginning of 2023.

In terms of our long-term investment strategy, at a time of great upheaval and tension, we are essentially sticking to the seven global megatrends we outlined a year ago – but we have made more fundamental adjustments to two of them. Since we believe that these trends have enormous growth potential, they should play an increasingly important role in our portfolios.

Macro & Markets

Economic environment remains challenging in 2023

The year 2022 is drawing to a close. The Russian war of aggression on Ukraine has triggered a massive energy price shock that has caused inflation, especially in Europe, to rise to levels not seen in decades. Globally, inflation is also proving to be higher and more stubborn than expected. Hampered by the tighter monetary policy of the major Western central banks and real losses of purchasing power on the part of households, economic activity has cooled across the board over the course of the year. And the global economy will continue to face numerous challenges in 2023. In addition to continued monetary tightening by major Western central banks and high inflation rates, these include geopolitical uncertainties due to tensions between the West, Russia and China.

In this environment, global growth is expected to increase by less than **2.0%**[1], which is de facto equivalent to a recession. GDP growth in the euro area and the US is likely to be characterised by a **technical recession**[2] around the turn of the year and in the first half of 2023, respectively, followed by a recovery in the second half of 2023. The latter, however, will likely only come up with growth rates below long-term trend growth, as the lagged effect of monetary policy on the economy is likely to slow down the recovery in the US and the euro area. Nevertheless, we think the macroeconomic environment should prove quite constructive for financial markets. China's economy is also likely to re-accelerate, although the road looks to remain bumpy as the country struggles to overcome the pandemic and the downturn in the real estate sector. Nevertheless, the outlook for 2023 is quite constructive here as well.

[1]For detailed information on our assumptions and forecasts, see The UniCredit Macro & Markets 2023-24 Outlook, "Go for carry as central banks approach peak rates", 17 November 2022.

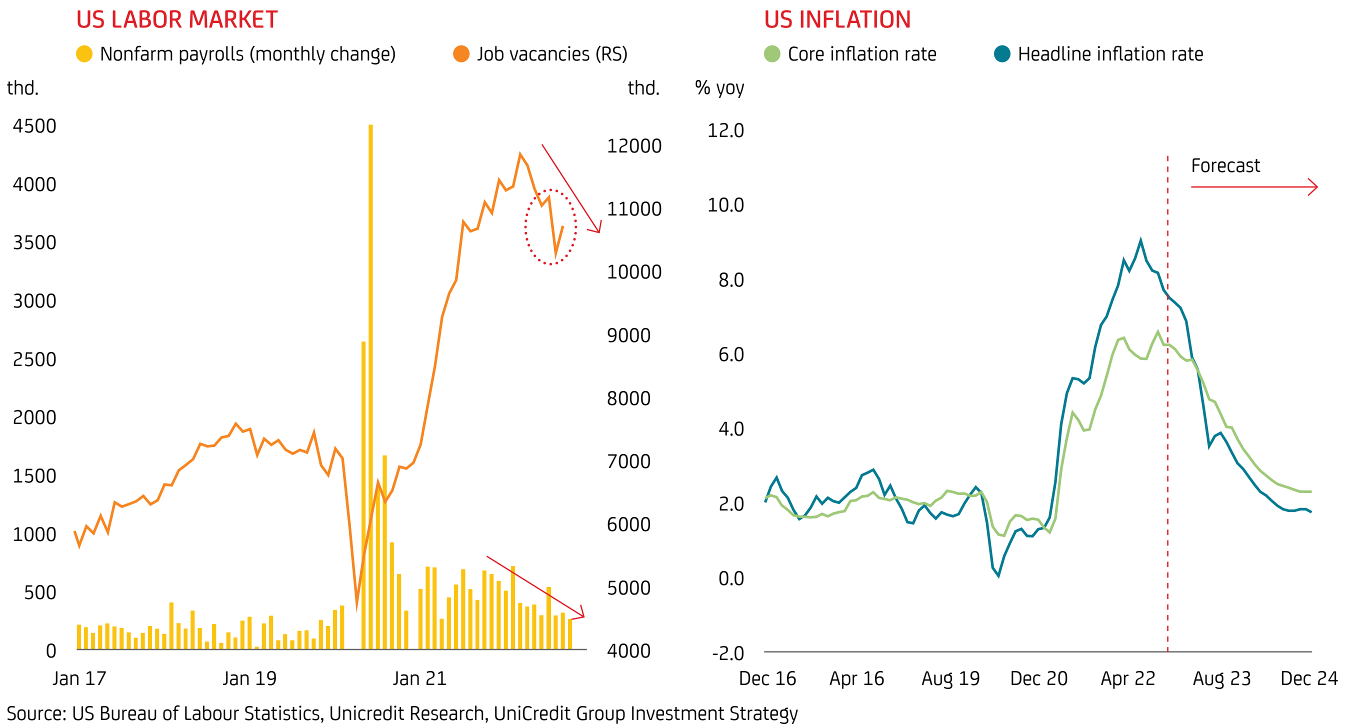
[2]A technical recession is defined as two consecutive quarters of negative growth.

END OF THE US RATE HIKE CYCLE IN SPRING 2023

The US economy is likely to stagnate for the most part next year and only show a more pronounced recovery in 2024 (around 1%). In the short term, we expect zero growth in the fourth quarter of 2022, followed by a mild (technical) recession in the first two quarters of 2023. Growth should then recover in the second half of 2023. The slowdown in economic activity has already been noticeable in many areas for some time. The tightening of monetary policy by the Fed and real incomes weighed down by high inflation have slowed output growth. Excluding the impact of volatile components (such as net exports and inventories), the US economy grew very weakly in the third quarter of 2022, by around 0.1% compared to around 0.2% in the first half of 2022 and around 0.5% in the second half of 2021. The tightening of **financial conditions**[3] is particularly noticeable in interest rate-sensitive areas of the economy, such as housing. For example, 30-year mortgage rates have risen from just under 3% at the end of 2021 to around 7% recently. As a result, mortgage applications, sales and construction starts have plummeted, and house prices are also starting to weaken significantly. However, given the time lag with which monetary policy affects the real economy, the full effects of monetary tightening will probably not become visible until 2023.

[3]Financial conditions include the wealth effect of a variety of asset classes (such as in the money, bond, equity and foreign exchange markets) as well as access to financial resources through the banking system.

The slowdown is also reflected in the labour market (see chart 1). Consequently, demand for labour has weakened significantly and wage growth has also slowed down recently. So far, there is no danger of a wage-price spiral, especially because nominal wage growth has lagged well behind current inflation. The cooling of the labour market should also ensure a normalisation of wage growth. In terms of inflation, we expect a significant decline, with an average rate of around 4.5% for 2023 and around 2% for 2024. Core inflation should also ease further. The recently visible slowdown in the rate of inflation is likely to continue, led by further declines in the prices of used cars and clothing. The decline in service prices is likely to last a little longer due to the tight labour market. Rental prices, in particular, could take a while before weakening noticeably.



Due to persistently high inflation, the Fed has aggressively tightened its monetary policy in recent months, raising the target range for the federal funds rate by a whopping 375 bps in just nine months. As a result of weakening inflation trends and the lagged effects of monetary tightening, we expect the Fed to slow the pace of rate hikes to 50 bps in December. This is likely to be followed by a final two hikes of 25 bps each at its next two meetings in February and March 2023. The Fed is likely to keep raising rates until core inflation shows clear signs of falling to a level consistent with the 2% target. We interpret the inflation figures for the month of October 2022 as the first real sign that inflationary pressures are easing. However, a series of further lower inflation rates will be necessary for an end to interest rate hikes. We do not expect interest rate cuts until the first quarter of 2024. For 2024 as a whole, however, we assume that the Fed will lower key interest rates by a total of 150 bps.

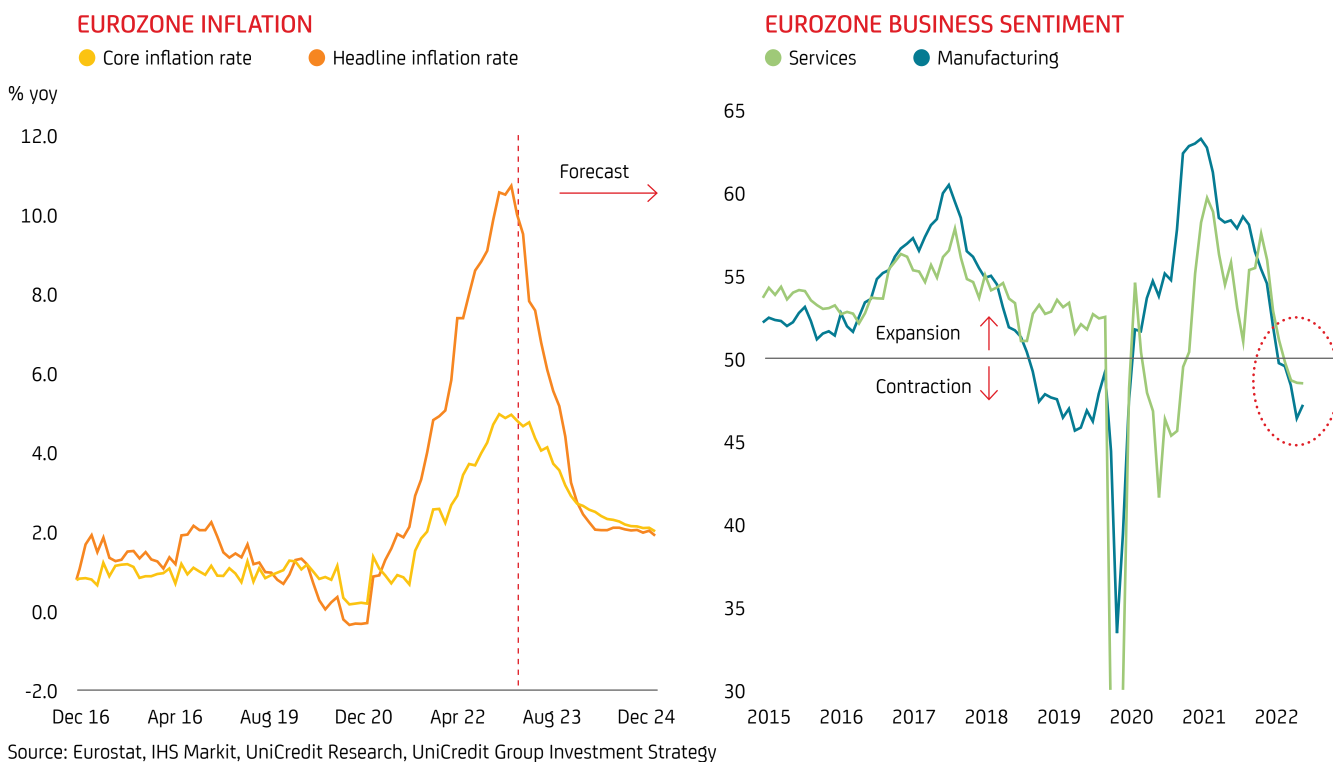
ECONOMIC WEAKNESS IN THE EURO AREA SHOULD FAVOUR A DECLINE IN INFLATION

After growth of over 3% this year, GDP in the euro area will probably stagnate in 2023. The sharp declines in leading indicators suggest that a technical recession is very likely at the turn of the year. The reasons for the downturn are notable pressures on household real incomes, high corporate energy costs in the wake of the ongoing distortions caused by the Ukraine conflict with Russia (despite more significant declines in gas prices recently), and slower global growth. The effects of the tighter ECB monetary policy, on the other hand, are not yet being felt for the most part. Looking at individual sectors, a deterioration in new orders as well as rising inventories in the industrial sector point to a considerable decline in production, even if the most recently published purchasing managers' indices indicate the first signs of a stabilisation of the situation. In the services sector, there is also a downward trend as the recovery impulses after the pandemic (i.e., due to the reopening of the economy) continue to weaken, although here, too, the first tendencies of a bottoming out can be seen. Based on the sharp declines in indicators, we expect a cumulative decline in GDP of 0.7% between the beginning of the fourth quarter of 2022 and the end of the first quarter of 2023. Supporting factors should come from expansionary fiscal policy, easing supply bottlenecks, healthy private sector balance sheets and a fairly solid labour market, preventing a sharper slump. We expect a recovery in the first half of 2023, although the pace of expansion should remain below potential growth into 2024. In 2024, GDP growth in the euro area is therefore likely to be only 1%.

On the inflation side, monthly rates are likely to remain above 10% until the end of 2022, before easing significantly to around 2.5% at the end of 2023 (see chart 2). On an annual basis, inflation is then expected to decelerate from around 8.5% this year to around 6% in 2023, and then to around 2% in 2024. Base effects, a broad stabilisation of commodity prices, a decline in demand

and a further easing of bottlenecks in global supply chains are likely to be the main factors behind the slowdown. With much of the inflation coming from supply-side factors (such as supply chain bottlenecks and higher energy prices) that are gradually easing, coupled with a simultaneous weakening in aggregate demand, core inflation is also expected to eventually decline noticeably. The first signs of an easing of inflationary pressures can already be seen, albeit from a very high level. Now, a slowdown is emerging, especially in the industrial sector, which is directly affected by the weakening global demand for manufactured goods and the falling prices for industrial metals. Accelerating wage growth should keep inflation in the services sector in check, at least in the near term. Nevertheless, core inflation is likely to peak soon at a current level of 5%. We expect core inflation to moderate to around 3% by the end of 2023 and then to approach 2% again by the end of 2024.

2. INFLATION PEAK PROBABLY REACHED SOON – COOLING OF THE ECONOMY SHOULD FAVOUR DISINFLATION



Source: Eurostat, IHS Markit, UniCredit Research, UniCredit Group Investment Strategy

On the monetary policy front, we expect the ECB to continue tightening its policy rates into the first quarter of 2023 as it seeks to bring inflation under control as quickly as possible. Given its determination to fight inflation despite a likely recession, we see the deposit rate peaking at 2.75% with rate hikes of 50 bps each in December and February and a final hike of 25 bps in March. This would take policy rates even more clearly into the restrictive range, with the accumulated tightening in this cycle then ultimately comprising 325 bps. The return of inflation to 2% should allow the ECB to start cutting rates for the first time in mid-2024. We expect three rate cuts of 25 bps each in the second half of 2024, which should bring the deposit rate back to 2 %. As for the reduction of the central bank's balance sheet, the ECB is expected to set out its "principles" of quantitative tightening in December and then start the actual reduction in the second quarter of 2023. Presumably, the tightening will initially involve a reduction in the **APP holdings**[4], while the **PEPP bonds**[5] will continue to be fully reinvested. The latter should ensure that the negative effects of the balance sheet reduction on a fragmentation of funding costs in the euro area are mitigated.

CHINA: GROWTH RECOVERY IN 2023, BUT ROAD AHEAD REMAINS BUMPY

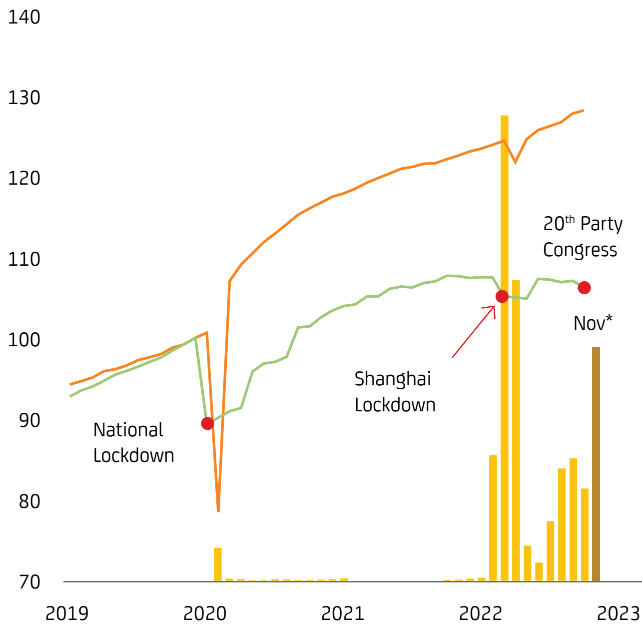
After a much weaker 2022 with GDP growth expected to be only slightly above 3% (China's own target is 5.5%), we expect growth to accelerate to around 4% in 2023 and 2024. Currently, however, China's macroeconomic environment is fragile as recent leading indicators have again fallen into contractionary territory due to weak domestic and external demand. In particular, the sharp Covid-19 outbreaks in major metropolitan areas as well as the strict lockdown measures in the wake of the government-imposed zero Covid policy continue to weigh on private consumption (see chart 3). At the same time, the slowdown in global demand is taking its toll in the form

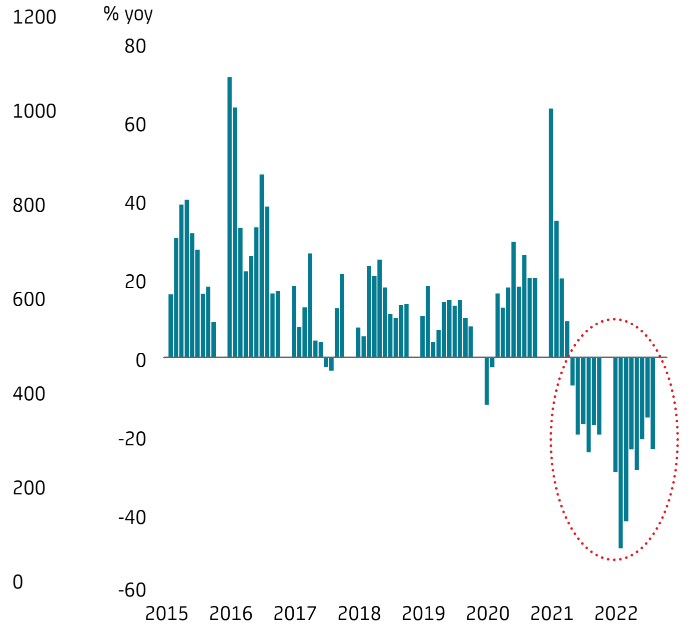
[4] These holdings relate to the Asset Purchase Programme (APP) launched by the Governing Council in 2015. With the help of this purchase programme, the ECB attempts to ensure medium-term price stability by lowering long-term interest rates and providing additional liquidity.

[5] The Pandemic Emergency Purchase Programme (PEPP) launched in 2020 is a temporary purchase programme for bonds of public and private debtors, as already purchased under the APP. It serves to maintain favourable financing conditions during the pandemic. Since the end of March 2022, the net purchases of the PEPP have been discontinued. However, reinvestment of the redemption amounts due from the PEPP holdings is to continue until at least the end of 2024.

of falling exports, removing an important driver of China's growth. Nevertheless, we expect the recently announced zero Covid easing, an acceleration in vaccinations, and fiscal stimulus to support growth next year. The recovery is likely to be sluggish in the first half of 2023 before strengthening in the second half of the year.

3. ZERO COVID POLICY AND REAL ESTATE SECTOR WEIGH ON ECONOMIC OUTLOOK





Note: *Preliminary November value (as of 24/11/2022), indices (industrial production, retail sales) based on Dec 2019 = 100
Source: National Bureau of Statistics of China, Bloomberg, UniCredit Group Investment Strategy

A persistent drag on China's economic development and our long-term growth prospects in the region is the weakening real estate sector. Most recently, Covid-related restrictions have led to property transactions being frozen or delayed in several cities. In addition, households have become more cautious about making large down payments for fear that financially strapped developers will not complete their housing projects. But the supply side also continues to adjust as fewer houses are built. Chinese developers' lack of appetite for new projects is also due to a slowing urbanisation process and unfavourable demographic trends, which are likely to continue to affect demand in the Chinese property market. Government support has already been injected via additional monetary easing, which includes interest rate cuts for short-dated loans as well as interest rate cuts for property loans. We expect the largest support in 2023 to be in the area of infrastructure investment at the local level. After months of hesitation, Beijing has recently shown increased willingness to support the real estate sector with measures ranging from improving developer liquidity to easing down payment requirements for property buyers.

Geopolitically, there are also some challenges to China's longer-term growth prospects. The re-election of President Xi Jinping for a third term is likely to ensure that the political orientation will be one of a more inward-looking, state-led and self-confident China. While the 20th Communist Party Congress emphasised a return to the country's economic development, there is nevertheless a risk that too much focus on national security in the form of economic self-reliance will be seen as taking precedence over growth issues. We see another challenge in the partial technological decoupling from the US. For example, the US government recently banned the export of high-performance microchips to China in the hope of gaining control over advanced computer and semiconductor technologies that are central to a modern military and economy. This poses risks not only to China's long-term economic development, but also to the future of Taiwan, where 90% of the microchips needed are manufactured.

Megatrend Focus

What we expect for the future

In a period marked by major upheavals and tensions, most notably the Russian war against Ukraine, we are essentially sticking to the **megatrends we outlined a year ago[6]**, but we have made more fundamental adjustments to two of the seven trends. For example, we see the phase of low inflation, low interest rates and low volatility of the so-called "lower for longer" scenario transitioning into a new "higher for longer" scenario, which suggests structurally higher interest rates and inflation than in the 2010-2020 decade, combined with potentially more expansionary fiscal policy and higher volatility in financial markets. Against this backdrop, 2023 is likely to be the year of a return to investing in bonds. And following the Russian invasion of Ukraine, the second megatrend (geopolitics) focuses on the transition from a multipolar to a new bipolar world order. The geopolitical balance of power is re-sorting, and the world appears increasingly fragmented economically.

[6]Megatrends describe fundamental social, economic and political change processes that significantly determine many areas of life over a long period of time.

Furthermore, we observe that the importance of technological innovations as a catalyst for change in the world is increasing, and that questions of sustainability in all its facets, especially the fight against climate change, are penetrating every area of the economy and society. Moreover, the trend towards more diversity, equality and inclusion is continuing. The last two megatrends, in particular, are closely related to the "Healthy Lifestyle" megatrend. The last megatrend "Infrastructure 2.0" represents a mix of digital, green and traditional infrastructure that can boost public and private investment by enabling smart cities and new ways of living, moving and working.

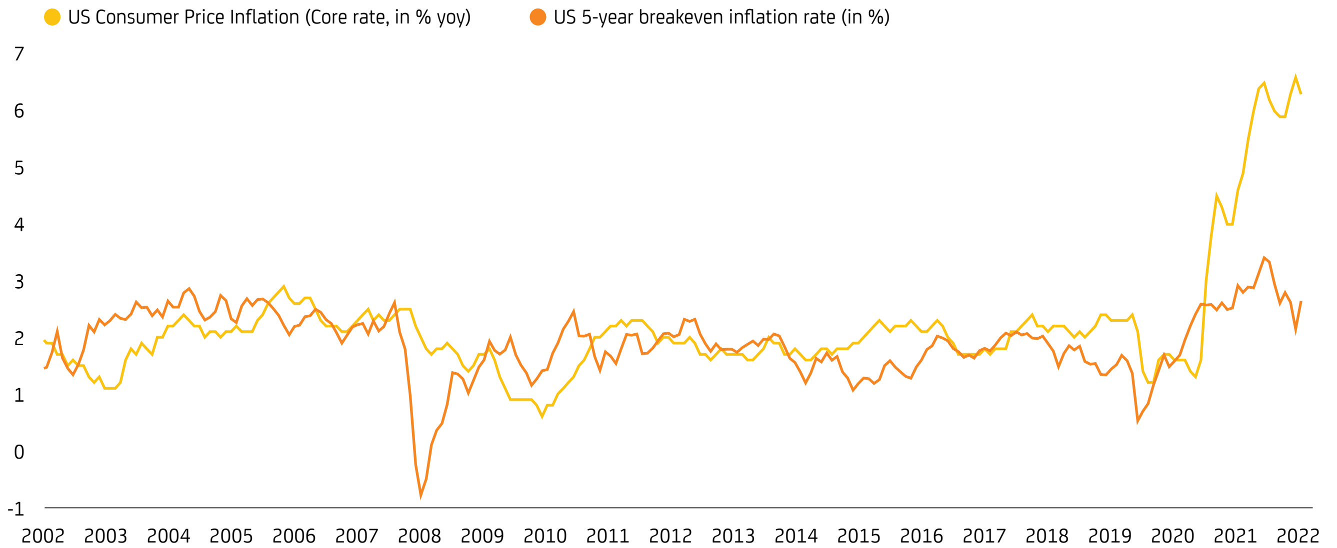
For our investment strategy, these seven megatrends, which are closely linked and interdependent, have a special significance. Their implications are far-reaching and diverse. They offer both enormous opportunities that need to be exploited and risks that need to be properly assessed and mitigated. The complexity of the challenges arising from these megatrends requires solutions for the entire economy and society. We believe that there is enormous growth potential inherent in them. Therefore, we successively align traditional portfolios with these megatrends, as we believe that they should play an increasingly important role in our portfolios.

I. FROM "LOWER FOR LONGER" TO "HIGHER FOR LONGER"

We see the phase of low inflation, low interest rates and low volatility in financial markets of the so-called "lower for longer" scenario transitioning into a new "higher for longer" scenario, which suggests structurally higher interest rates and inflation than in the 2010-2020 decade, more expansionary fiscal policy and higher market volatility. Having raised the target range for the federal funds rate by a whopping 375 basis points (bps) in just nine months, the Fed is likely to continue raising rates until monthly core inflation shows clear signs of falling to levels consistent with its 2% target. Factors such as higher supply constraints, labour shortages, fiscal stimulus, as well as the green transition and emerging deglobalisation are likely to contribute to inflation settling at higher levels over the next few years than in the past. The **breakeven inflation rate[7]** shows that this is also the assessment of the financial markets (see chart 4).

[7]The breakeven inflation rate is an important indicator of the financial markets' real-time expectations of future inflation developments. Its value lies in its ability to signal general changes in inflation trends. The break-even inflation rate is the difference in yield between nominal and inflation-indexed government bonds and can be calculated for different maturities.

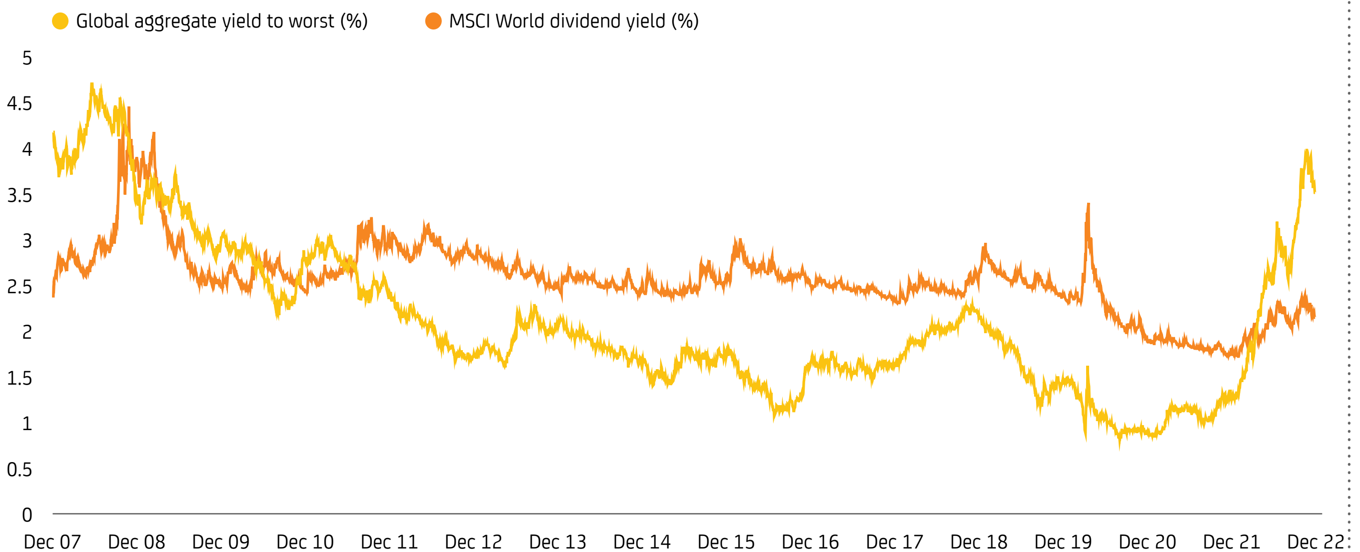
4. FINANCIAL MARKETS PRICE IN HIGHER US INFLATION FOR THE NEXT FEW YEARS



Source: Bloomberg, UniCredit Group Investment Strategy. Period shown: 31.10.2002-31.10.2022

Since the global financial crisis, TINA ("There Is No Alternative") has been an important support for equities – the major Western central banks kept the key interest rate at an extremely low level for years, which, with low inflation, meant that yields in the overall bond market were also extremely low by historical standards. Equities, on the other hand, were more attractive (especially compared to fixed income) for a long time, and investors accordingly had little choice but to turn to the equity market in search of yield. With inflation on the rise, the Fed, first and foremost, has been raising interest rates at a record pace and investors are faced with TARA ("There Are Reasonable Alternatives"). Bonds look increasingly attractive thanks to the unprecedented series of rate hikes and the sharp rise in bond yields (see chart 5).

5. FROM TINA (THERE IS NO ALTERNATIVE) TO TARA (THERE ARE REASONABLE ALTERNATIVES)



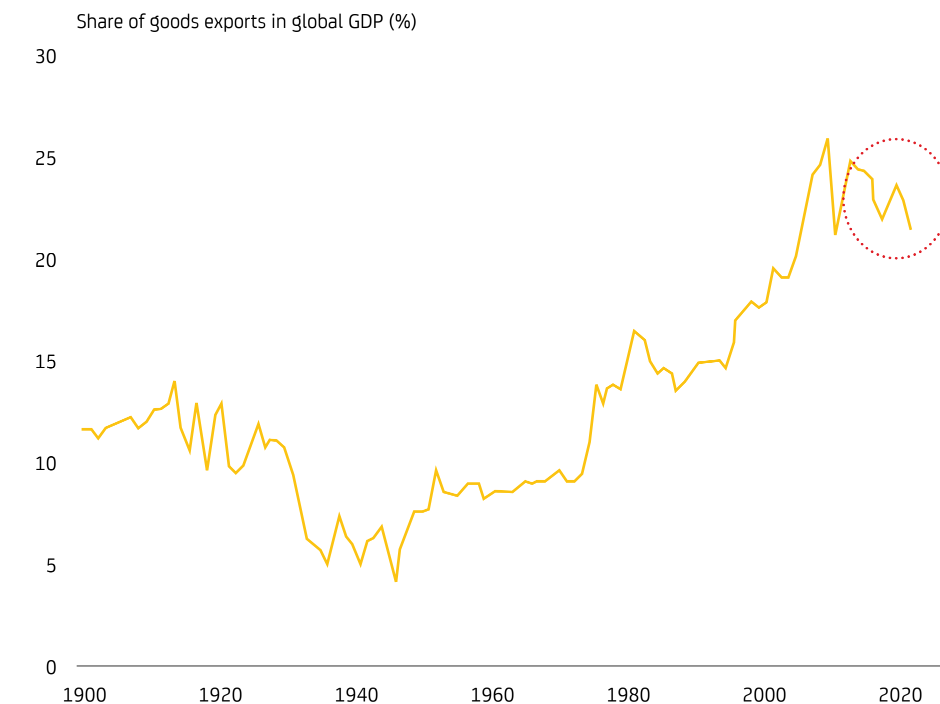
Note: Past performance, simulations and forecasts are not a reliable indicator of future performance. The indices cannot be purchased and therefore do not include costs. When investing in securities, costs are incurred which reduce the performance. In the case of an investment in foreign currency, the return may also rise or fall as a result of currency fluctuations. The performance comparison shown does not take into account the different risk profiles of the asset classes.
Source: Bloomberg, UniCredit Group Investment Strategy. Period shown: 25.11.2007-25.11.2022

Against this backdrop, 2023 should be the year of a return to bond investing as yields become competitive again. The first six to nine months of next year should see the greatest investment opporunities in bond markets, especially government bonds – both in the US and Europe.

II. GEOPOLITICS: A MORE FRAGMENTED WORLD

Following the Russian invasion of Ukraine, the second megatrend (geopolitics) focuses on the transition from a multipolar to a new bipolar world order. The geopolitical balance of power is re-sorting, and the world appears increasingly fragmented economically. This has implications for global economic interdependencies. While China's President Xi Jinping has recently consolidated his power and secured a third term in office, China's attitude towards Russia, the Taiwan-conflict or the human rights situation in China are causing concern in Europe and the US and are straining Western relations with the country that there is no way around economically. China's share of the global economy is increasing, while the economic importance of Europe, in particular, is declining. Not least due to the rise of China, global trade has grown remarkably in the last two centuries and has fundamentally changed the world economy. Today, about a quarter of total world production is exported. However, this growth trend seems to have ended for the time being (see chart 6).

6. SHARE OF TRADE IN WORLD PRODUCTION MUCH HIGHER THAN IN THE 1930S, BUT TREND DECLINING



Source: World Bank, OECD, Our World in Data, UniCredit Group Investment Strategy

The tensions between the US and China, the Covid-19 pandemic, and the Ukraine war have exposed key weaknesses in the principles of the international division of labour and have disrupted global supply chains. With a view to increase the security of supply, **re-shoring or near-shoring[8]** is increasingly coming into focus – and many companies now want to bring production back from Asia. The reasons are manifold, such as lower wage differentials, a higher weight of transport costs, the increasing importance of domestic production for strategically relevant goods or the goal of more sustainable production with shorter transport distances. Within six months of taking office, US President Joe Biden's administration completed a comprehensive review of supply chains for four critical products, identified solutions to secure them against a wide range of risks and established the Supply Chain Disruptions Task Force (SCDTF).

[8]Reshoring or nearshoring is the relocation of operational activities back to home countries or their relocation to nearby regions.

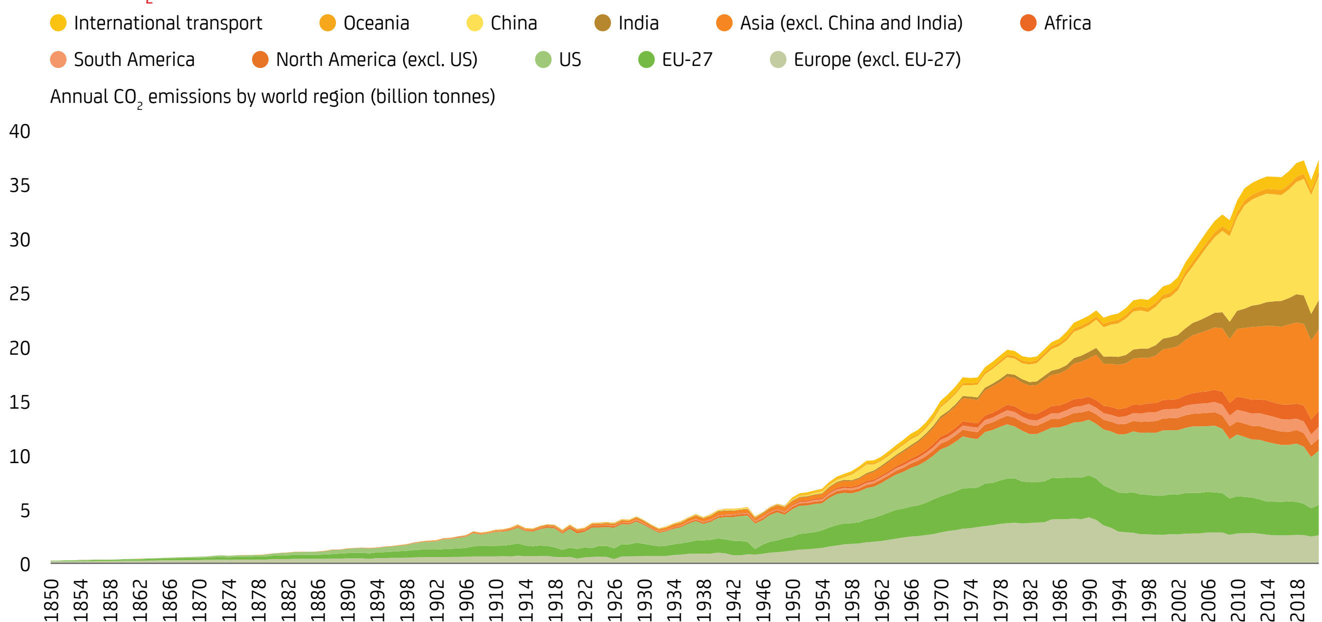
Greater global economic fragmentation is likely to bring slower global growth and higher inflation, which in turn should lead to higher interest rates compared to the post-GFC decade in developed countries (see also Megatrend I: From Lower for Longer to Higher for Longer) – and a stronger US dollar, to the detriment of emerging markets. However, even though China's outlook has become more uncertain because of rising international pressure on human rights compliance, the ongoing restrictive Covid-19 pandemic and growth losses from its transformation to a service-based economy, we still see great long-term growth potential in the Asian region.

III. SUSTAINABILITY AND THE FIGHT AGAINST CLIMATE CHANGE

The next trend concerns the state of existential commons, which is deteriorating at an accelerating pace. **Climate change**[9], dwindling biodiversity, polluted oceans and the spread of infectious diseases are an increasing threat to the foundations of human life worldwide. Global warming and a damaged biosphere pose enormous challenges to major economies. The fight for more sustainability and thus against man-made climate change has become the central task for the future.

As the latest report of the United Nations Intergovernmental Panel on Climate Change (UN IPCC) makes clear, time is ticking ever more towards global warming of over 1.5°C (compared to **1850**[10]). The next few years are crucial: to still reach the 1.5°C target, global **greenhouse gas emissions**[11] must peak by 2025 at the latest, according to the Paris Climate Agreement, and be reduced by 43% by the end of 2030. Despite all climate pledges, however, emissions – after the pandemic-related dip in 2020 – are still rising according to the IPCC (see chart 7). According to a current study by the **"Global Carbon Project"**[12], global fossil CO_2 emissions in 2022 will probably be slightly higher than in 2019 and 2021 at 36.6 billion tonnes, thus reaching a new peak.

7. GLOBAL CO_2 EMISSIONS CONTINUE TO RISE DESPITE CLIMATE PLEDGES



Note: Emissions from fossil fuels and industry (land use change not included).
Source: Our World in Data, UniCredit Group Investment Strategy

Reversing this trend will require transformative changes on both the demand and supply side. Regarding energy supply, policy makers, especially in Europe, face the challenge of striking a balance between decarbonisation, security of supply and affordability. The war in Ukraine has made this balancing act even more difficult. As the substitution of coal for missing gas makes clear, the unpleasant short-term reality is that decarbonisation has inevitably taken a (temporary) back seat at the expense of energy security given the developments of the past few months. But this also means that efforts to ensure the long-term transition to a low-carbon energy future need to be significantly scaled up once again.

A significant part of the European response to the Russian war of aggression in Ukraine has been to accelerate targets for new renewable energy installations (REPowerEU). The latter are seen as a way to address each element of the so-called energy trilemma: security of supply (by reducing dependency on Russian gas), affordability (renewables for power generation are becoming cheaper) and decarbonisation. REPowerEU foresees an increase in the EU's renewable energy target for 2030 to 45% (from the current 40%), bringing their total capacity in the EU to more than 1,200 Gigawatts by 2030. Globally, the share of renewables in energy production is expected to double to two-thirds by 2050. In principle, companies that enable innovative, technological solutions for the economic-ecological transformation (see also Megatrend IV: Technological Innovations) should benefit particularly from climate policy initiatives worldwide. They therefore also hold great potential in terms of investment strategy and the corresponding portfolio composition.

[9] The list of climate changes is long. At the same time, not all regions are equally affected by the changes. There will be significantly more heat waves and droughts, but also more heavy rainfall events. In general, areas that have had to struggle with such weather extremes in the past will be even more affected in the future.

[10] The time marker 1850 comes from the fact that industrialisation began around this time.

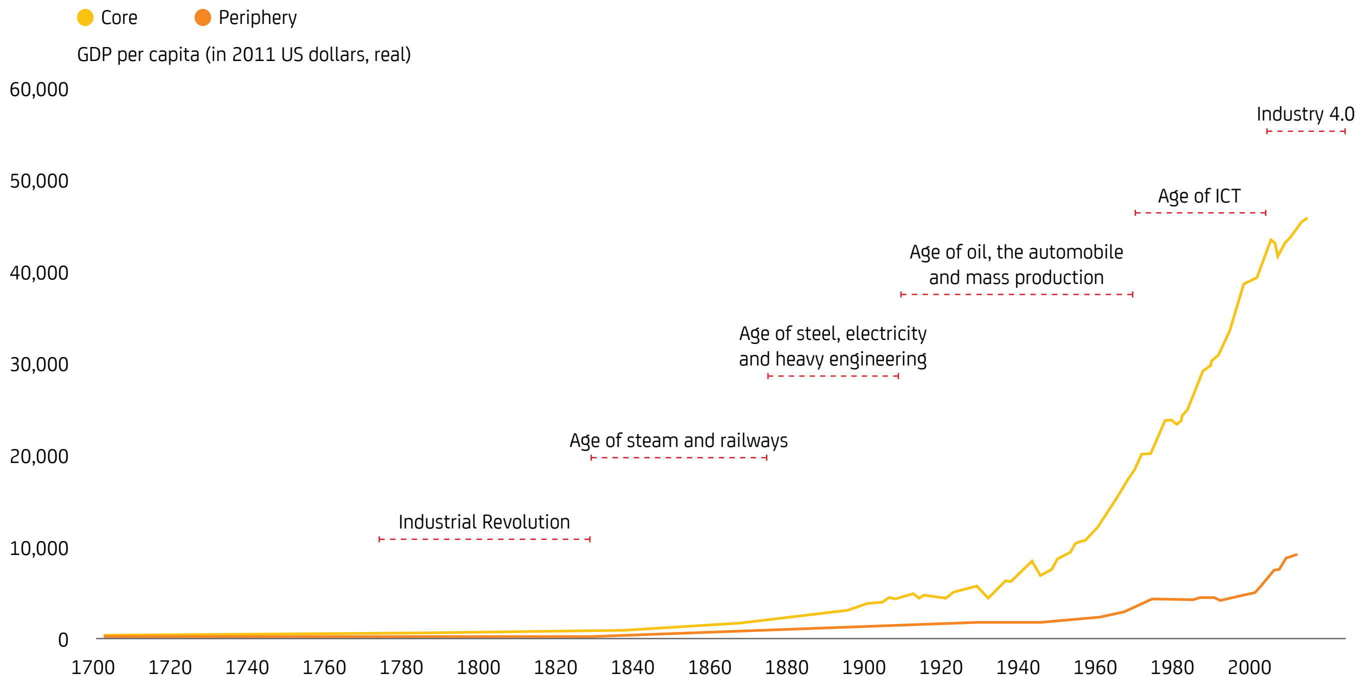
[11] The most important greenhouse gases are carbon dioxide (CO_2), methane and nitrous oxide.

[12] Global Carbon Project, Global Carbon Budget, November 2022 (Link). The Global Carbon Project is a worldwide association of scientists who monitor the carbon cycle globally.

IV. TECHNOLOGICAL INNOVATIONS

Technological innovations are fundamentally changing the way we live and work. For millennia, progress was linear, and the world changed slowly over generations. With the industrial revolution and subsequent waves of technological change, today's industrialised nations began to generate rapid and sustained economic growth (see chart 8). Their high investments in key technologies are likely to make it difficult for emerging economies to catch up quickly.

8. TECHNOLOGICAL CHANGE SINCE 1700 OVER TIME



Note: The "core countries" include Western Europe and its offshoot (i.e. Australia, Canada, New Zealand, USA) and Japan. The "periphery" corresponds to the world without the "core countries".
Source: UNCTAD, based on data from the Maddison Project Database (2018 version), UniCredit Group Investment Strategy

In the meantime, technological innovations are developing exponentially, and the surge in digital transformation seen during the pandemic shows no signs of slowing down. In this context, technological **convergence**[13], in particular, makes possible what used to seem unthinkable in the past. This development is massively accelerated by artificial intelligence (AI). It increasingly competes with human intelligence and leads to machines being able to take over tasks that only humans could do in the past.

New technologies such as Cloud, **Edge Computing**[14], Machine Learning, **Metaverse**[15], **Web 3.0**[16], **Non-fungible Token**[17] (NFTs), Robotics, **Internet of Things**[18] (IoT), and 5G are finding their way into all areas of life and are increasingly spreading into the economy. Production processes and organisations are changing, new products, services and business models are emerging. The new technologies are also having a significant impact on the labour markets, and digitalisation in particular is bringing about significant shifts in qualification requirements.

While rapid progress can also have disadvantages – namely when it exceeds the adaptive capacity of society – technological innovations hold enormous potential for sustainable(re) development. They can improve the lives of many people enormously. The positive examples of their successful mobilisation, for example in agriculture, health, education and energy, are numerous. However, the pandemic has made clear that they also risk potentially exacerbating inequalities (see also Megatrend V: Diversity, Equality and Inclusion) by widening the digital divide between those who have innovative technologies and those who do not.

[13] Convergence is the combination of two or more technologies that have previously developed separately from each other. When they are combined, new starting points for products and business models emerge.

[14] In computing, the term "edge" refers to the outermost edge of a technical information network, where the virtual world of a computer network meets the real world. In most cases, the term "edge" implies that the network is the internet.

[15] The broad term Metaverse refers to a virtual space in which people can interact with each other as avatars using virtual reality technologies. In doing so, the metaverse creates a convergence between physical reality and virtual space in the context of networked digital space. The difference to traditional websites and social networking lies in the immersive experience that the Metaverse offers.

[16] Web 3.0 is the third generation of internet services for websites and web applications that focus on the use of machine-based data to create a data-driven and semantic web.

V. DIVERSITY, EQUALITY AND INCLUSION

During the last few decades, it is not only the industrialised nations that have experienced growing prosperity. Economic growth in emerging economies has fuelled the rise of a global middle class, and people are living longer and healthier lives on average (see also Megatrend VI: Healthy Lifestyles). However, poverty and inequality still exist. Wealth is highly concentrated and disparities in income opportunities, education and health standards are still large. Inequality often correlates with the level of income. In the last 10 to 15 years, global income inequality has decreased, mainly because the large developing countries have grown faster and have partly caught up.

In business, a new wave of sustainability that focuses on diversity, equality and inclusion is becoming increasingly important, and **stakeholders**[19] are placing ever higher demands on these "soft" factors. There are several good reasons for this. It is now undisputed that companies that do not strive for equality and diversity lose crucial competitive advantages – especially because in times of increasing skills shortages, they risk losing the battle for talent and being left behind by the market. In other words, inequality and lack of diversity pose a financial risk for companies that is likely to increase.

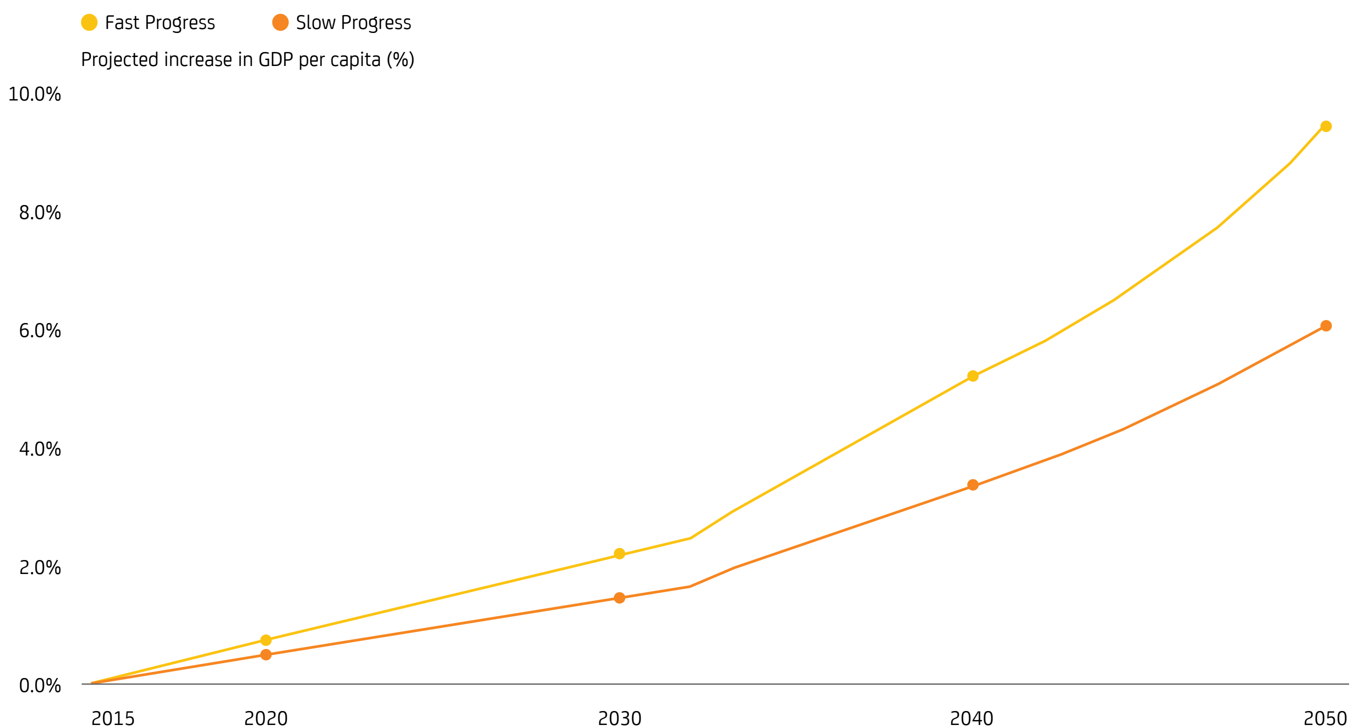
The UN 2030 Agenda for Sustainable Development aims to achieve gender equality, gender equity and empowerment for all women and girls (Sustainable Development Goal 5, SDG 5). There is broad consensus among experts that economies are more resilient and productive when they reduce gender inequalities and support women's equal participation in all spheres of life. Gender parity has a positive impact on GDP per capita in the EU, according to the European Institute for Gender Equality (EIGE). By 2050, improving gender equality would increase GDP per capita in the EU by 6.1% to 9.6% (see graph 9), equivalent to EUR1.95-3.15 billion. It would also create up to 10.5 million additional jobs.

[17]Non-fungible means not replaceable or exchangeable. And a token is a unit of value. The term first appeared in the field of cryptocurrencies. A "non-fungible token" is a digital good that represents real-world objects such as art, music, in-game items and videos.

[18]The Internet of Things (IoT) is a collective term for technologies of a global infrastructure of information societies, which makes it possible to network physical and virtual objects with each other and to let them work together through information and communication technologies.

[19]Stakeholders are all persons, groups or institutions that are directly or indirectly affected by the activities of a company or that have an interest in these activities.

9. MORE GENDER EQUALITY WOULD HAVE A POSITIVE IMPACT ON GDP DEVELOPMENT PER CAPITA IN THE EU



Fast progress: reduce the gender gap in computer science by 5-14%, reduce the gender gap in engineering by 9-12%, reduce the gender gap in participation rates by 0-20% by 2030, reduce the gender wage gap by 0-14% by 2030 and increase the fertility rate by 0-8% by 2030.
Slow progress: Reduce gender gap in computer science by 2-14%, reduce gender gap in engineering by 4-12%, reduce gender gap in labour force participation rates by 0-13% by 2030, reduce gender wage gap by 0-5% by 2030 and increase fertility rate by 0-5% by 2030.
Source: EIGE, UniCredit Group Investment Strategy

In recent decades more women have entered the labour force and increasingly also leadership positions in the economy. However, in addition to the UN and the EIGE, the World Economic Forum criticised in its latest **report**[20] that progress towards gender parity has stalled – not least due to the implications of the pandemic – because there are still numerous barriers to educational and career opportunities.

[20]WEF, " Global Gender Gap Report", July 2022 (Link)

VI. HEALTHY LIFESTYLE

The world's population has grown rapidly in the last century. In fact, in 1900, less than two billion people lived on earth, today there are more than eight billion. The **world population**[21] will continue to grow, albeit with very different regional population growth rates. In addition, life expectancy is rising worldwide and birth rates are declining with increasing material prosperity. This changes the age structure in all regions of the world.

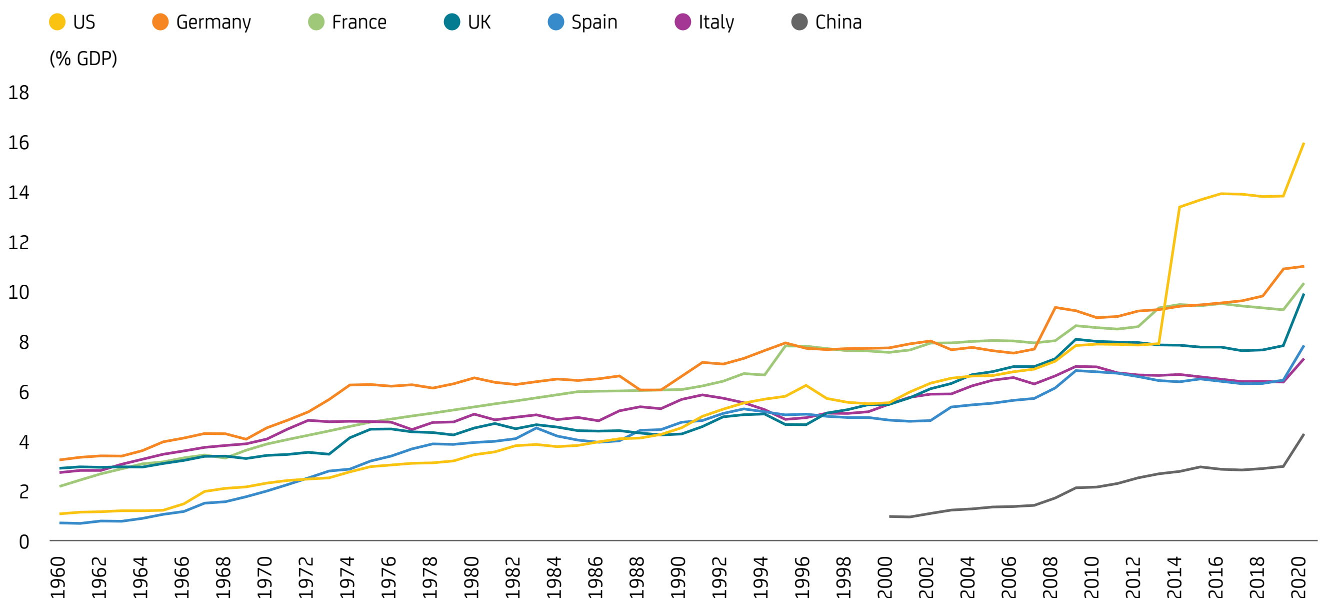
[21]The UN predicts that world population growth will slow significantly over the course of the 21st century, almost peaking at 10.9 billion people in 2100.

Especially in the western industrialised nations, the "healthy lifestyle" megatrend permeates many areas of everyday life. Ensuring a healthy life for all people of all ages and promoting their well-being is one of the goals (SDG 3) of the UN Agenda 2030. Not least since the experience with the pandemic, the importance of physical integrity has become a key resource. According to the latest **Eurostat evaluation of April 2022**[22], the increase in life expectancy is due to a number of factors, including lower infant mortality (down by about half in the EU since 2000), higher living standards, healthier lifestyles and better education, and advances in health care and medicine.

[22]Eurostat, Mortality and life expectancy statistics, April 2022 (Link).

In 2016, global health spending already accounted for 8.6% of global GDP, or about USD8 trillion, according to the Lancet. And it is expected to continue to rise, both in absolute per capita expenditure and as a proportion of economic output. In Germany, the share of health expenditure in GDP was around 11% in 2020 (see chart 10), a high value in international comparison. Only in the US was it significantly higher at just under 16%.

10. SHARE OF HEALTH EXPENDITURE IN ECONOMIC OUTPUT GROWS WORLDWIDE



Source: Our World in Data, UniCredit Group Investment Strategy

In the highly developed industrial nations whose populations are ageing and shrinking in the process (for instance, Germany and Japan) or which dampen the ageing process primarily through migration (such as the US), demographic change has a significant impact on the relative scarcity of production factors. In the long term, the associated global demographic trends will lead to a redistribution of global wealth – according to a **study by the Bertelsmann Foundation**[23]. The latter expects, at least as a tendency, that wages and per capita GDP will each converge towards a global average.

[23]Bertelsmann Stiftung, "Megatrend Report #01: The Bigger Picture – How Globalisation, Digitalisation and Demographic Change Challenge Us", September 2019 (Link).

Many developments in the context of a healthy lifestyle do not originate in the health sector or are driven by it, but are socio-cultural developments that emerge from society, have an impact on many areas of life and work and in some cases fundamentally change them. It can thus also be the basis for strategic decisions by companies – and thus investment decisions.

VII. INFRASTRUCTURE 2.0

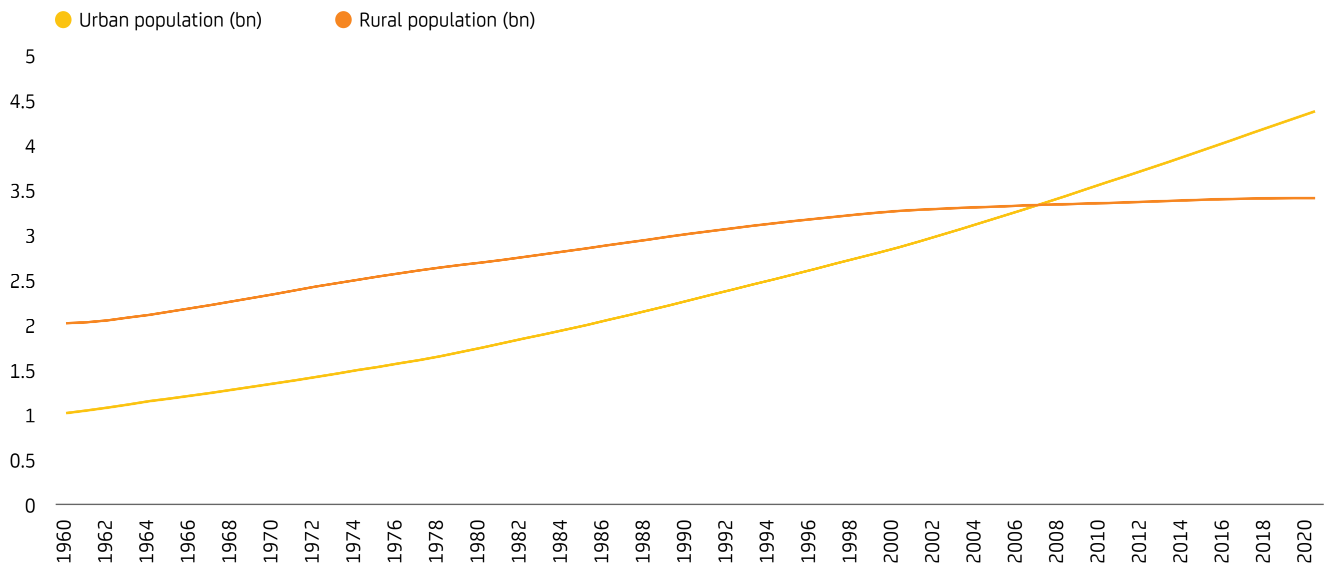
The pandemic painfully exposed the urgent need for high quality, reliable, sustainable and resilient **infrastructure**[24], which is one of the goals (SDG 9) of the UN 2030 Agenda to build. Economies with a diversified industrial sector and strong infrastructure (e.g., transport, internet connectivity and utility services) were less affected by the pandemic and recovered faster from its consequences, according to the **UN**[25].

Today, over 60% of the world's population lives in cities (more than half since 2007, see chart 11), which continue to grow at an unprecedented pace. In many cases, however, the expansion of urban infrastructure is lagging this growth. Innovative solutions are needed to make living together in conurbations, but also in rural areas, more efficient. We subsume these under our latest trend, "Infrastructure 2.0", i.e., the integration of intelligent technology into public infrastructure. It combines several elements of the aforementioned megatrends and describes the embedding of sensor, computer and communication functions in traditional urban and rural physical infrastructures such as roads, buildings and bridges in order to improve the quality of life for all, conserve resources and increase competitiveness.

[24]Infrastructure includes all state and private facilities that are considered necessary for sufficient services of general interest and economic development. Infrastructure is usually subdivided into technical infrastructure (e.g. facilities for transport and communication, energy and water supply, waste disposal) and social infrastructure (e.g. schools, hospitals, sports and leisure facilities, shopping facilities, cultural facilities).

[25]UN, The Sustainable Development Goals Report 2022, July 2022 (Link).

11. SINCE 2007, MORE THAN HALF OF THE WORLD'S POPULATION LIVES IN CITIES – AND THE TREND IS STILL RISING



Source: Our World In Data, UniCredit Group Investment Strategy

The smart city is a vision of urban space where connected devices and sensors increase efficiency, resilience and safety based on data analysis and intelligent control. Thanks to an exponentially growing IoT, powerful mobile and broadband networks and advances in machine learning or AI (see also Megatrend IV: Technological Innovation). In this context, for example, the integration of control devices, intersection controls and sensors along roads creates new possibilities for controlling traffic signals and optimising traffic flow. The development of smart grids offers the opportunity to increase the efficiency of power generation and transmission, improve resilience to disruptions and improve the integration of new energy sources such as wind power. These are all examples of how smart infrastructures are changing the way we plan and design our living spaces.

Rapid urbanisation will not only bring opportunities and challenges for the economy and society, but also a variety of investment opportunities. **The US government, for example, is providing USD1.2 trillion**[26] by 2029 to renew the infrastructure of the US, including roads, bridges, ports, airports, mass transit and railways. It also wants to expand high-speed internet, the electricity grid and the water supply. Climate protection, which President Biden has declared a priority, is also to benefit. It is the most extensive investment package of its kind in the US since the 1950s.

[26]In August 2021, the US Congress passed the corresponding infrastructure bill.

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)

NEUTRAL ON GLOBAL EQUITIES

Lower global growth and negative earnings revision. Medium- to long-term investment opportunities due to cheaper valuations.

NEUTRAL EUROPEAN EQUITIES

Restrictive ECB and likely technical recession. However, cheap valuations and investors' huge under-positioning may favour a sharp rebound of European equities when the conjuncture will start improving.

NEUTRAL US EQUITIES

Strong job market, earnings resilience, hawkish Fed. Defensive choice as the asset class outperforms when global growth slows.

NEUTRAL EMERGING MARKET EQUITIES

Lower global growth, falling liquidity due to the Fed's restrictive policy, and the strengthening of the US dollar penalises EM equities, but cheaper valuations will favour a recovery when the Fed will announce the pivot becoming less restrictive. Countries and sectors selectivity among EMs is strongly recommended.

NEUTRAL PACIFIC EQUITIES

Exports are supported by the weak Japanese yen but affected by lower global growth.

NEUTRAL GLOBAL BONDS

We have upgraded the asset class to neutral from negative, considering the competitive yields and on the assumption that inflation has likely peaked, making major central banks gradually less hawkish.

OVERWEIGHT EURO INVESTMENT GRADE CORPORATE BONDS

Appealing yields but we are increasing our high quality, selective and defensive tilt due to the weakening macro picture.

NEGATIVE HIGH YIELD CORPORATE BONDS

We have downgraded the asset class to negative from neutral, as the spreads do not yet fully discount the recession scenario, and also considering their lower liquidity.

UNDERWEIGHT EMU GOVERNMENT BONDS

Vulnerable to the ECB tightening but we are reducing the underweight and gradually increasing the duration of the government bonds portfolio.

POSITIVE NON-EMU GOVERNMENT BONDS

We have upgraded the asset class to positive from neutral, given the competitive yields and the expectation of peaking inflation.

OVERWEIGHT EMERGING MARKET BONDS

The search for yield supports our positive stance, but we stay defensive and selective, avoiding countries with high external debt and current account deficits. The asset class is set to benefit when the Fed will announce the pivot.

NEUTRAL MONEY MARKETS

We reduced our stance on Money Markets to neutral from positive, as we now prefer to invest in higher yielding fixed income asset classes such as non-Euro Government bonds, Euro corporate investment grade and Emerging Market bonds.

NEUTRAL ALTERNATIVES

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

NEUTRAL COMMODITIES

Penalised by fears of recession but supported by supply constraints and geopolitical tensions.

POSITIVE GOLD

Hedging for uncertainty.

CURRENCIES

The US dollar is set to further loosen its grip on the expectation of the Fed's pivot, but its strength is unlikely to be fully reversed, given the higher resilience of the US economy and the ongoing geopolitical tensions.

DEVELOPMENT OF SELECTED FINANCIAL MARKET INDICES

From	**30.11.21**	30.11.17	30.11.18	30.11.19	30.11.20	30.11.21	30.11.17	**01.01.22**
To	**30.11.22**	30.11.18	30.11.19	30.11.20	30.11.21	30.11.22	30.11.22	**30.11.22**
Stock market indices (total return, in %)								
MSCI World (in USD)	**-10.4**	0.7	15.6	15.1	22.3	-10.4	47.1	**-14.1**
MSCI Emerging Markets (in USD)	**-17.1**	-8.8	7.3	18.8	3.0	-17.1	-2.0	**-18.6**
MSCI US (in USD)	**-11.0**	6.1	17.3	20.0	27.2	-11.0	69.0	**-14.4**
MSCI Europe (in EUR)	**-0.4**	-4.0	17.3	-3.1	22.1	-0.4	32.4	**-5.6**
MSCI AC Asia Pacific (in USD)	**-15.1**	-7.4	9.7	18.5	2.6	-15.1	4.0	**-16.7**
STOXX Europe 600 (in EUR)	**-2.0**	-4.4	18.0	-1.9	22.2	-2.0	32.3	**-7.0**
DAX 40 (Germany. in EUR)	**-4.7**	-13.6	17.2	0.4	13.6	-4.7	10.2	**-9.4**
MSCI Italy (in EUR)	**1.6**	-10.8	24.5	-6.4	19.2	1.6	25.5	**-4.4**
ATX (Austria, in EUR)	**-8.4**	-5.5	6.3	-16.8	48.3	-8.4	13.7	**-13.1**
SMI (Switzerland, in CHF)	**-5.9**	0.3	20.3	3.3	19.4	-5.9	40.0	**-11.1**
S&P 500 (USA, in USD)	**-9.2**	6.3	17.1	17.5	27.9	-9.2	69.8	**-13.1**
Nikkei (Japan, in JPY)	**2.8**	0.3	6.9	15.7	7.0	2.8	36.7	**-0.8**
CSI 300 (China, in Yuan)	**-18.6**	-19.0	24.8	32.3	-0.9	-18.6	5.5	**-20.3**
Bond market indices (total return, in %)								
US Government Bonds 10Y (in USD)	**-16.5**	-3.2	14.7	12.0	-2.9	-16.5	0.3	**-16.4**
US Government Bonds (ICE BofA , in USD)	**-12.9**	-1.0	10.1	7.9	-2.1	-12.9	0.0	**-12.4**
US Corporate Bonds (ICE BofA A-BBB, in USD)	**-15.3**	-3.0	15.8	9.6	-0.2	-15.3	3.9	**-15.2**
German Bunds 10Y (in EUR)	**-17.8**	2.1	7.5	2.3	-1.7	-17.8	-9.2	**-16.5**
EUR Government Bonds 1Y-10Y (iBOXX, in EUR)	**-15.9**	-0.8	8.9	3.9	-1.7	-15.9	-7.2	**-14.5**
EUR Corporate Bonds 1Y-10Y (iBOXX, in EUR)	**-12.7**	-1.7	6.5	2.5	-0.8	-12.7	-7.1	**-12.6**
Bond yields (change in basis points = 0.01 percentage points)								
US Government Bonds 10Y (in USD)	**228**	60	-124	-96	59	228	133	**221**
US Government Bonds (ICE BofA , in USD)	**293**	78	-117	-118	54	293	194	**281**
US Corporate Bonds (ICE BofA A-BBB, in USD)	**311**	114	-148	-107	44	311	215	**306**
German Bunds 10Y (in EUR)	**228**	-6	-67	-22	23	228	156	**212**
EUR Government Bonds 1Y-10Y (iBOXX, in EUR)	**234**	30	-87	-38	25	234	161	**215**
EUR Corporate Bonds 1Y-10Y (iBOXX, in EUR)	**317**	64	-93	-29	32	317	289	**313**
Spreads on government bonds (credit spreads, change in basis points)								
US Corporate Bonds (BofAML US Corporate Master)	**39**	42	-31	1	-9	39	39	**44**
US Corporate Bonds (BofAML US High Yield)	**88**	68	-21	32	-66	88	91	**145**
Euro Corporate bonds (BofAML Euro Corporate AAA-A)	**51**	38	-31	-7	20	51	72	**62**
Euro Corporate Bonds (BofAML Euro High Yield)	**135**	207	-131	28	2	135	243	**175**
Money market rates (change in basis points)								
Libor (USD, 3 months)	**459**	125	-83	-168	-5	459	328	**455**
Euribor (EUR, 3 months)	**255**	1	-9	-13	-5	255	230	**255**
Euro exchange rates (change in %)								
US Dollar (EUR-USD)	**-8.7**	-4.1	-3.6	9.1	-5.2	-8.7	-12.3	**-8.4**
British Pound (EUR-GBP)	**1.5**	1.2	-4.4	5.4	-5.2	1.5	-2.0	**2.9**
Swiss Franc (EUR-SFR)	**-5.5**	-3.1	-2.9	-1.4	-3.8	-5.5	-15.5	**-4.6**
Japanese Yen (EUR-JPY)	**12.5**	-3.1	-6.6	3.6	2.7	12.5	9.1	**10.7**
Commodities (change in %)								
Commodity Index (GSCI, in USD)	**-1.9**	-4.7	18.9	17.7	-1.0	-1.9	29.0	**-4.7**
Industrial metals (GSCI, in USD)	**-5.7**	-8.6	-4.8	21.6	24.3	-5.7	22.6	**-10.2**
Gold (in USD per fine ounce)	**-1.6**	-4.7	19.1	21.4	0.3	-1.6	36.4	**-3.9**
Crude oil (Brent, in USD per barrel)	**21.3**	-7.9	5.0	-23.8	47.5	21.3	34.8	**8.9**

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.

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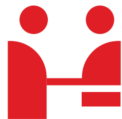

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