The clock is ticking

Group Investment Strategy

Monthly Outlook

June 2023

UniCredit

Index

Summary

The clock is ticking

MACROECONOMIC UPDATE

In the US the political debate concerning the increase in the legally permissible ceiling for the federal debt is intensifying. US Treasury Secretary Janet Yellen repeated in May her warnings from the beginning of the year that the US government could face a default as early as the beginning of June. Despite the political stalemate, we consider it very unlikely that a failure to raise or suspend the debt limit will lead to a default on US government bonds. However, a last-minute compromise is likely to weigh on sentiment and create great volatility in the financial markets in the short term.

In the euro area, a recession was avoided over the winter months. Nevertheless, the economy grew only weakly in the first quarter, with real GDP growth of 0.1% compared to the previous quarter. Growth rates of between 0.5% and 1% are expected for Europe and the US for the current year, and these should accelerate to 1-2% in the coming years. On a quarterly basis, the consensus sees a slight contraction for the US in the second half of 2023, but its extent should not be significant. Chinese GDP growth had recovered significantly at the start of the year. Although we expect growth to be around 5 % this year, there are still some negative factors that need to be monitored more closely. China's fundamental real estate sector stands out, as it accounts for about just under one third of the country's gross domestic product, but it continues to be in a difficult situation.

INFLATION AND MONETARY POLICY

In April the US economy posted a robust gain of new jobs and recorded an increase in average hourly wages. These data suggest that the Fed is likely to maintain its monetary tightening stance into the second half of the year. This is also supported by the still sluggish consumer price inflation. As expected, the US Federal Reserve raised the key interest rate by 25 basis points to 5.25% (at the upper end) at its last meeting. In addition, it signalled that it does not intend to tighten monetary policy further in June unless incoming data significantly contradict this.

In the euro area, inflation rose slightly to 7.0 % in April, mainly due to higher energy prices. However, these effects are likely to reverse from May onwards, due to slower growth of energy costs and food prices. The weaker inflation momentum in the core rate allowed the ECB to slow the pace of rate steps to 25 bps at its May meeting, raising the deposit rate to 3.25%. Nevertheless, the central bank has signalled that more rate hikes are still to come, even if the outlook for such rate hikes appears quite vague. We continue to assume that there will be two more rate hikes of 25 bp each, in June and July respectively.

FINANCIAL MARKETS

Capital markets have shown themselves to be surprisingly robust in recent weeks: European equities (measured by the MSCI Europe) recently reached a new high for the year – and the all-time high reached in early 2022 is also within reach.

Nevertheless, the risk factors create a certain vulnerability of risky investments, especially for higher valued shares, such as in the US market. European equities show less vulnerability in terms of valuations, but the earnings growth opportunities of US companies seem higher. In the overall view of all factors, a cautious investment strategy with a neutral equity ratio currently appears most suitable, in our view. Due to the increased yields, however, investments in bonds are also quite interesting.

The current discussions among market participants are characterised by a number of risks. These include the necessary raising of the debt ceiling in the US, possibility of recession due to the sharp rise in interest rates (for the US, in particular, the probability of recession is considered substantial), persistently high inflation, as well as geopolitical factors.

Despite these risk factors, capital markets have shown themselves to be surprisingly robust in recent weeks: European equities (measured by the MSCI Europe) recently reached a new high for the year – and the all-time high reached in early 2022 is also within reach. How can the strength in the capital markets be classified despite the presence of a number of risk factors? Are markets neglecting the substantial risks here?

The concerns cannot simply be dismissed out of hand. If one analyses individual market segments that react very specifically to certain risk factors, one can certainly recognise a reflection of the risks. For example, let's take a look at the distortions resulting from the US debt ceiling debate on the US dollar money market. US Treasury Secretary Janet Yellen recently warned that the extraordinary measures used since the beginning of the year to keep the government solvent could be exhausted as early as 1 June. US Treasury Bills, i.e. money market securities issued by the US federal government, that mature by 30 May show significantly lower yields than those that mature two days later, i.e. on 1 June. This significant jump in yields represents a premium for the risk of payment delays or disruptions around this potentially important day. However, the yield curve also shows that the issue of raising the US debt ceiling is likely to be a temporary problem, because with longer maturities the yields of the corresponding securities decrease again.

This suggests that markets are well aware of the risks, but they are obviously looking through possible temporary distortions. A look at the consensus estimates for economic and corporate earnings growth shows why this is the case.

While no dynamic recovery is expected for European and US economic growth either for the current year or for the next two years, a substantial cooling of the economy is not on the agenda either. Growth rates of between 0.5% and 1% are expected for Europe and the US for the current year, and these should accelerate to 1-2% in the coming years. On a quarterly basis, the consensus sees a slight contraction for the US in the second half of 2023, but its extent should not be significant.

Earnings expectations on the stock markets reflect this view. Earnings of companies in the major European and US stock indices are expected to move sideways, but thus also remain at the relatively high level of the past year. In the next two years, earnings growth should then pick up again, by 6-7% in Europe and by 9-10% in the US. Moreover, the phase of negative profit revisions (i.e. the reduction of current profit forecasts by analysts) seems to be over. In some cases, positive revisions are already visible again.

Other important factors for the assessment on the markets is the development of inflation and central bank monetary policy. Inflation dynamics are cooling, but not as quickly as hoped a few months ago. However, the Federal Reserve (Fed) and the European Central Bank (ECB) are likely to reach their inflation target levels of 2% on a one to two year horizon. The Fed seems to have already reached the peak of the rate hike cycle and the ECB is close to it. One or two more rate hikes of 0.25% each will likely be forthcoming in the euro area, in June and possibly also in July. After (soon) reaching the peak in the interest rate hike cycle, the question of when the central banks will (have to) lower interest rates again is increasingly becoming the focus of interest on the financial markets.

Our expectation: not as quickly as the market hopes. One could even say, hopefully the Fed and the ECB will not have to lower their interest rates so soon, because in view of the declining but still too high inflation, interest rate cuts are only likely to occur in the case of rather noticeably unfavourable economic developments (i.e., recession).

Nevertheless, the risk factors create a certain vulnerability of risky investments, especially for higher-valued shares, such as in the US market. On the one hand, high valuations reduce the short-term price appreciation potential, as a contribution to rising prices is less likely due to an increase in valuation. On the other hand, they increase the risk of a setback in the event of a crisis. European equities show less vulnerability in terms of valuations, but the earnings growth opportunities of US companies seem higher. In the overall view of all factors, a cautious investment strategy with a neutral equity ratio currently appears most suitable, in our view. Due to the increased yields, however, investments in bonds are also quite interesting. For investments in the US dollar bond market, the short-end of the curve appears attractive due to the massive inversion of the yield curve (short yields are significantly higher than long yields).

All in all, despite a somewhat more cautious investment strategy in the short term, there is no need to worry too much. Setbacks in investments with an attractive profile can certainly be used for additional purchases. However, tactical investing should also be designed to be path-dependent. Thus, strong short-term price movements, especially in the context of the US debt showdown, can offer the opportunity for tactical manoeuvres, such as profit-taking.

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In Focus

US debt ceiling debate intensifies

Despite the turbulence at some US regional banks, rising interest rates, and the economic slowdown on both sides of the Atlantic, the signs on the global financial markets so far in 2023 are pointing to a recovery. While the mood, particularly in Europe, has brightened considerably, the increase in the legally permissible **ceiling for the federal debt of the US**[1] is increasingly coming into focus as a market risk. Should a timely agreement between the Republicans and the Democrats fail to materialise, this would not only cause turbulence on the financial markets but it may also have tangible economic consequences for the US and the rest of the world.

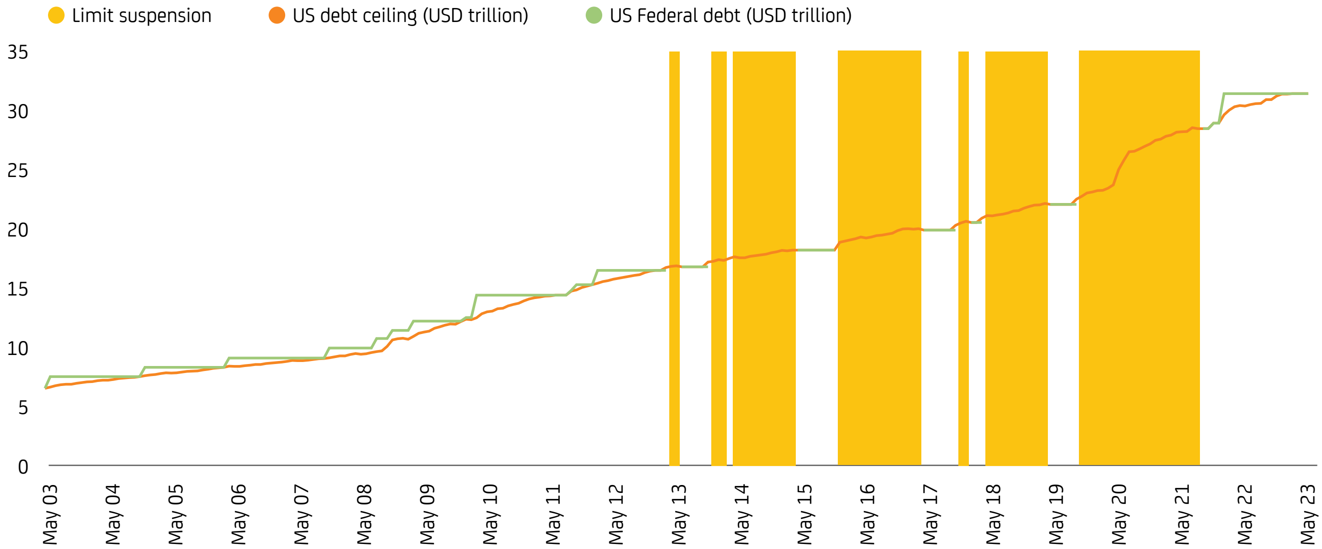
[1]The debt limit applies to US gross debt, i.e., the sum of net debt and domestic borrowing.

NO (NEGOTIATED) SOLUTION IN SIGHT SO FAR

US Treasury Secretary Janet Yellen repeated in May her warnings from the beginning of the year that the US government could face a default as early as the beginning of June (after examining the latest tax revenues, this is the best available estimate), as soon as the **“extraordinary measures”**[2] taken by the US Treasury to maintain funding for government activities are exhausted. This is because the limit, which currently stands at around $31.382 trillion since its last increase in December 2021, was formally reached on 19 January (see chart 1).

[2]With these measures, the US government can delay the day when it actually becomes insolvent by a few months. Primarily, these are fiscal instruments that restrict certain government investments or expenditures (such as the temporary suspension of payments into pension funds for civil servants).

1. DEBT CEILING FORMALLY REACHED ALREADY SINCE JANUARY



Observation period: 12.05.2003-12.05.2023
Source: Bloomberg, UniCredit Group Investment Strategy

Since its introduction in 1917, raising the debt ceiling has mostly been a formality. As a rule, Congress raises (or suspends) the limit before it is reached – in total, this has happened more than 80 times. More recently, however, it is becoming apparent that consensus between the political camps is becoming increasingly difficult, and that the debate on raising it is becoming increasingly heated. In the House of Representatives, opposition Republicans passed a bill at the end of April to raise the debt ceiling by USD1.5 billion and postpone the risk of default until next year. They are trying to use such an increase as leverage for tangible spending cuts and the dissolution of Covid-19 support funds (if the funds have not yet been spent). However, the initiative has no chance of passing the Democrat-controlled Congress. US President Joe Biden, pointing out that previous governments were responsible for the debt, is demanding an unconditional increase in the debt ceiling so that the government does not have to cut **government spending**[3] before next year's elections.

[3]Mandatory programmes such as Social Security, Medicaid, and Medicare account for almost half of the total US annual budget. Expenditures for the military account for about 12%.

IN 2011, AS A RESULT OF THE DEBT DISPUTE, THE US LOST ITS AAA RATING FROM S&P

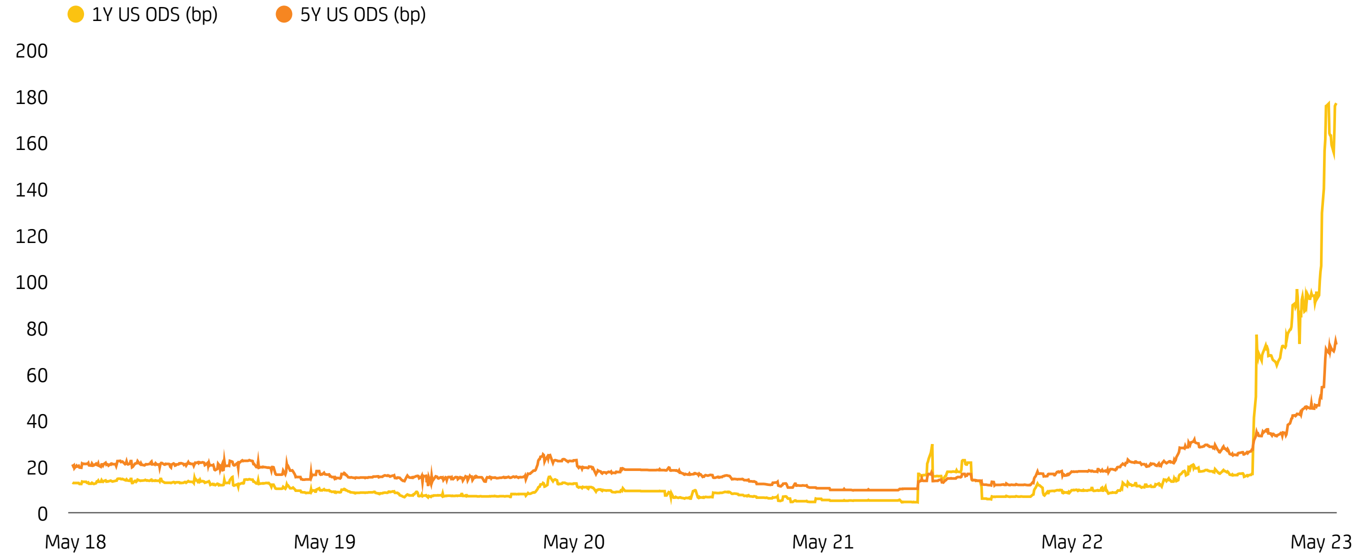
A large-scale US default was simply unthinkable in the past, and **there has been no such event so far**[4]. Should a default actually occur (which we do not expect this time either), this would call into question the position of the US as a "risk-free borrower" on the global credit markets. Moody's Analytics, a subsidiary of the well-known rating agency, estimates that it would not only result in rising interest rates, but could jeopardise up to six million jobs in the US and cause a 4% decline in the country's economic output.

[4]In fact, the US was briefly insolvent in 1979, which the Treasury Department attributed to an inadvertent cheque-processing problem.

The financial markets still do not expect a US default either. However, concerns are growing that the world's largest economy might not be able to meet its financial obligations. While the stock markets have so far shown little sign of being impressed, 1-year US **credit default swaps (CDS)**[5] are currently trading at 177 basis points (bps) (as of 12 May 2023), according to Bloomberg – a value that is significantly above the level of 2011 (see chart 2). Although an agreement was reached at the last minute between the Republicans and the Democrats on raising the limit, Standard & Poor's (S&P), one of the three major rating agencies, downgraded the country's credit rating from AAA to AA+ for the first time ever, leaving a clear mark on US stock markets and also exacerbating the sovereign debt crisis in the euro area. The recent rise in CDSs indicates that inves-tors are trying to hedge against a default. Nevertheless, it should be noted that the market for 1-year swaps in particular is rather small and illiquid – and therefore has only limited significance as an indicator of market expectations regarding a potential US default. But the fact that yields on T-bills maturing in early June have risen significantly in recent weeks also indicates that investor nervousness is rising. In addition, demand for hedges against a sharp rise in volatility in the options market in May was the strongest in five years, Bloomberg reported, indicating that traders are not entirely ruling out a rare "black swan" event.

[5]CDS are derivatives with which a buyer of corporate or government bonds attempts to exclude potential losses from the issuer's default. This is achieved by the issuer insuring the buyer's potential losses as part of the agreement.

2. CONCERNS ABOUT A POTENTIAL US DEFAULT INCREASE



Note: The CDS contracts shown are denominated in euros. Past performance, simulations and forecasts are not reliable indicators of future performance. The contracts 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 because of currency fluctuations.
Observation period: 12.05.2018-12.05.2023
Source: Bloomberg, UniCredit Group Investment Strategy

IMPLICATIONS FOR INVESTMENT

Despite the political stalemate in Washington over the debt ceiling, we consider it very unlikely that a failure to raise or suspend the debt limit will lead to a **default on US government bonds**[6]. While a short-term extension of the debt ceiling by Congress (presumably either until the end of July or until the end of September, i.e., until the end of the fiscal year) remains on the table as a fallback option, it is to be feared that a compromise between Republicans and Democrats could only **be reached after tough, intensive negotiations**[7]. As a result, the country's creditworthiness and the confidence of businesses, consumers, and investors (in the US dollar, among other things) could suffer. A protracted political stalemate over the debt ceiling issue would also presumably drive up short-term borrowing costs for taxpayers (i.e., consumers and businesses) and weigh on US economic growth.

The talks between Republicans and Democrats have not yet brought a breakthrough. A last-minute deal that includes a small increase in the debt ceiling and smaller, easy-to-implement spending cuts nevertheless remains a realistic scenario. But even if the unlikely worst case of a US default fails to materialise (which we assume it will), a last-minute compromise – like 2011, when the broad US equity market plunged by double digits – is likely to weigh on sentiment and create significant volatility in the financial markets in the short term. Against this backdrop, it is important to keep a close eye on the developments of negotiations in Washington.

[6]Corporations, insurance companies, pension funds and foreign governments together hold about 60% of US debt securities.

[7]In this case, the US Treasury could prioritise principal and interest payments on government bonds and defer other appropriations.

Macro & Markets

Inflation and credit developments allow central banks to act less aggressively

US FEDERAL RESERVE SIGNALS INTEREST RATE PAUSE, CREDIT SITUATION TIGHTENS

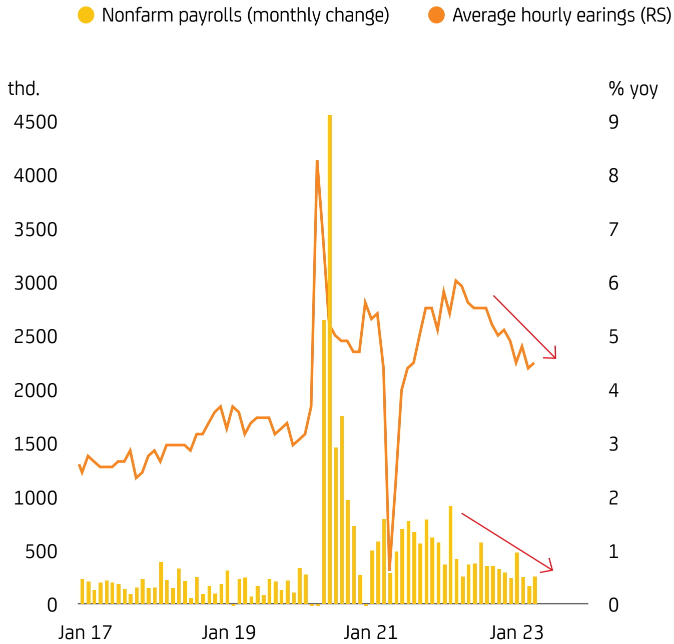
The US economy posted a robust gain of about 250,000 new jobs in April, following a downwardly revised 165,000 in the previous month (see Chart 3). This was a larger-than-expected gain in April, despite large downward revisions for February and March (149,000 jobs). In addition, average hourly wages rose 4.4% year-on-year (a slight increase from March), keeping earnings above the 3% to 3.5% range that the Fed sees as consistent with its 2% inflation target. In our view, the numbers from this labour market report will not prompt the Fed to raise interest rates in June. However, as the labour market remains tight and wage growth remains too high, the Fed is likely to maintain its monetary tightening stance into the second half of the year. This is also supported by the still sluggish consumer price inflation. In April, the headline rate declined only slightly year-on-year (to 4.9% from 5.0% in March), although the core rate weakened further (to 5.5% from 5.6%). Nevertheless, the latter inflation figures make us optimistic that the peak in the core rate has now been reached and passed, or that the disinflation trend will continue over the next few months.

As expected, the US Federal Reserve raised the key interest rate by 25 basis points (bp) to 5.25% (at the upper end) at its last meeting (see Chart 3). In addition, it signalled that it does not intend to tighten monetary policy further in June unless incoming data significantly contradict this. In other words, the Fed does not expect any more rate hikes. Of course, the Fed has not completely closed the door to further rate hikes either. Accordingly, it wants to decide at its next meetings to what extent the previous monetary tightening has worked and whether additional tightening might be appropriate. The latter increasingly also depends on how much credit conditions will tighten in the coming months and how much demand for credit will decline. The **latest survey data among US banks**[8] show that both the supply of credit tightened further and the demand for credit weakened significantly in the first quarter of 2023. Accordingly, economic conditions in the US are likely to cool further. Nevertheless, the Federal Open Market Committee expects that it will still take some time before inflation will fall more significantly and in particular towards the Fed's inflation target of 2%. Therefore, Fed Chair Powell does not expect any rate cuts this year, contradicting the market's priced-in rate cut expectations for 2023. Nevertheless, as in March, he did not really firmly oppose these market expectations this time, but pointed out that the markets expect inflation to fall faster, which he could not rule out per se. There were no changes regarding the reduction of the US Federal Reserve balance sheet, so that the current pace of a reduction of 95 billion US dollars per month will remain unchanged.

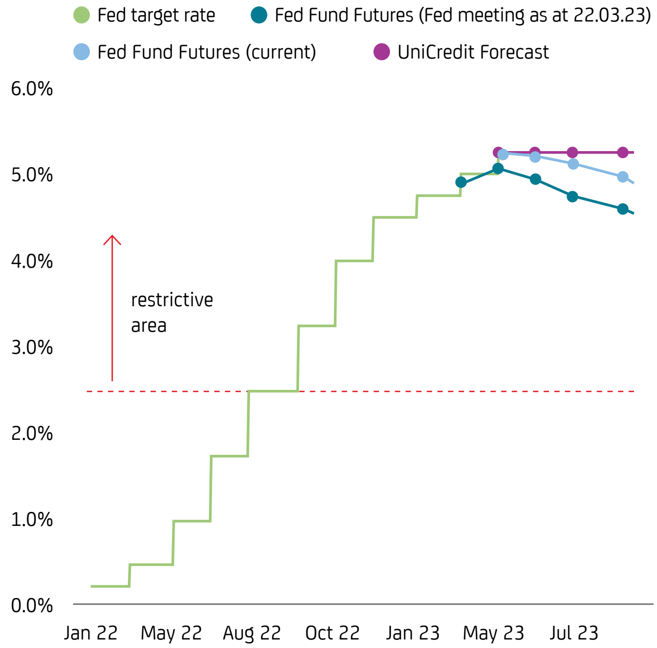
[8] See online: https://www.federalreserve.gov/data/sloos/sloos-202304.htm (as of 15.05.2023)

3. DOWNWARD TREND ON THE LABOUR MARKET REMAINS INTACT – FED REACHES INTEREST RATE PEAK, MARKETS EXPECT CUTS SOON

US LABOUR MARKET



FED'S INTEREST RATE PATH



Source: BLS, Bloomberg, UniCredit Research, UniCredit Group Investment Strategy (as of 08.05.2023)

EURO AREA: WEAKER CORE INFLATION LEADS ECB TO REDUCE KEY INTEREST RATES

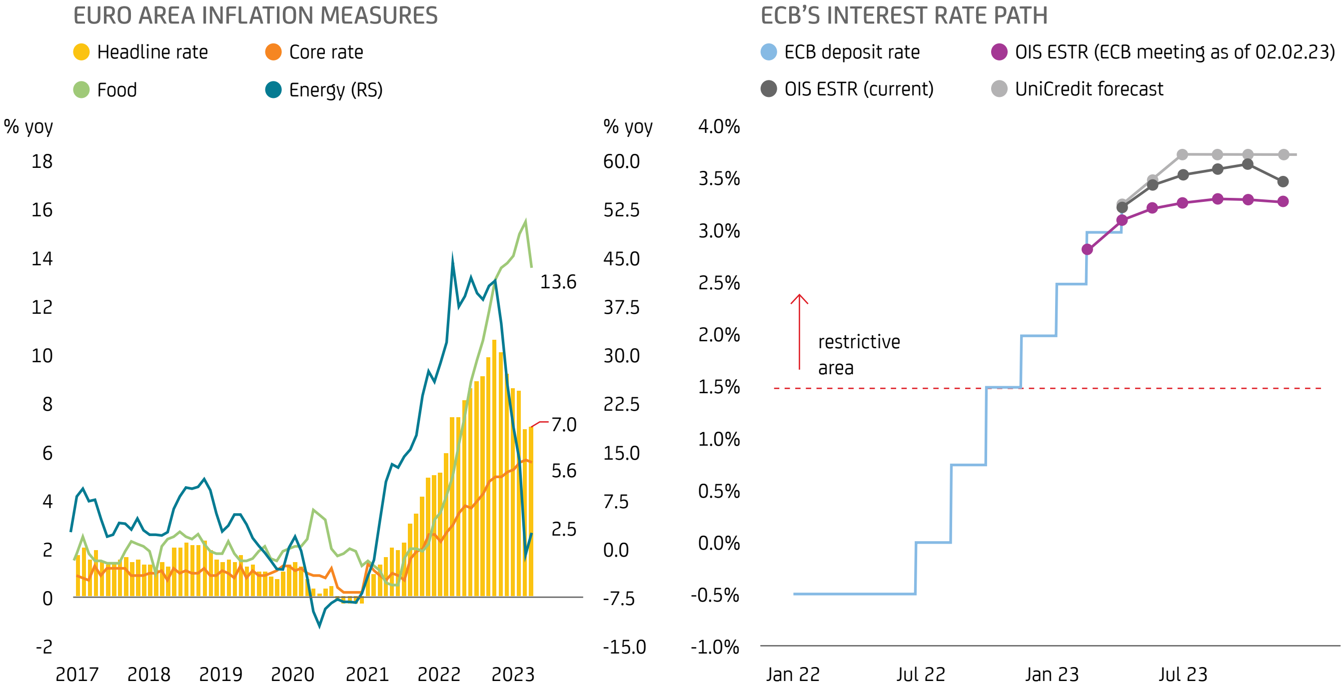
In the euro area, a recession was avoided over the winter months. Nevertheless, the economy grew only weakly in the first quarter, with real GDP growth of 0.1% compared to the previous quarter (in the fourth quarter of 2022: -0.1%). Inflation rose slightly to 7.0 % in April (from 6.9 % in March), mainly due to higher energy prices in the month under review (see Chart 4). However, these effects are likely to reverse from May onwards, as contributions from energy costs are then likely to have a dampening effect due to base effects. Food price increases are also likely to decrease then. Core inflation, on the other hand, has fallen slightly to 5.6% (March: 5.7%). There is now some evidence that the core rate has peaked, although continued high wage growth should ensure that services inflation (a key component of the core rate) remains strong and keep headline price increases high for a while yet.

The weaker inflation momentum in the core rate allowed the ECB to slow the pace of rate steps to 25 bps at its May meeting (from 50 bps previously at the March meeting), raising the deposit rate to 3.25% (see Chart 4). Nevertheless, the central bank has signalled that more rate hikes are still to come, even if the outlook for such rate hikes appears quite vague. Given the continuing high level of uncertainty, this is certainly intentional in order to maintain a high degree of flexibility. We continue to assume that there will be two more rate hikes of 25 bp each, in June and July respectively. A major factor of uncertainty is how lending conditions or demand for credit will develop in the coming months. Similar to the US, the recent **survey of euro area banks**[9] has shown that monetary tightening has so far caused a greater decline in loan demand than in the tightening of lending conditions. However, the full extent of monetary tightening is not yet visible in the data, making it more difficult to make predictions about economic developments and the targeted interest rate path at this stage. The guidelines for the ECB's balance sheet reduction, on the other hand, were clearly communicated. The ECB expects to stop reinvestments in the **APP**[10] in July, which means a significant acceleration of the run-off rhythm from currently €15 billion to €25 billion per month. Overall, we continue to expect the deposit rate to peak at 3.75% in July this year. We expect interest rate cuts (of 75 bp cumulatively) from mid-2024.

[9]See online: https://www.ecb.europa.eu/stats/ecb_surveys/bank_lending_survey/html/ecb.blssurvey2023q1~22c176b442.en.html (as of 15.05.2023)

[10]The APP (Asset Purchase Programme) is an expanded asset purchase programme introduced by the ECB in 2015, which provides for additional purchases of bonds issued by central governments based in the euro area as well as issuers with a promotional mandate and European institutions. The aim of the APP at the time was to ensure price stability in the euro area over the medium term by lowering long-term interest rates and providing additional liquidity.

4. CORE INFLATION WEAKENS, ECB RAISES THE KEY INTEREST RATE AND HOLDS OUT PROSPECT OF FURTHER STEPS



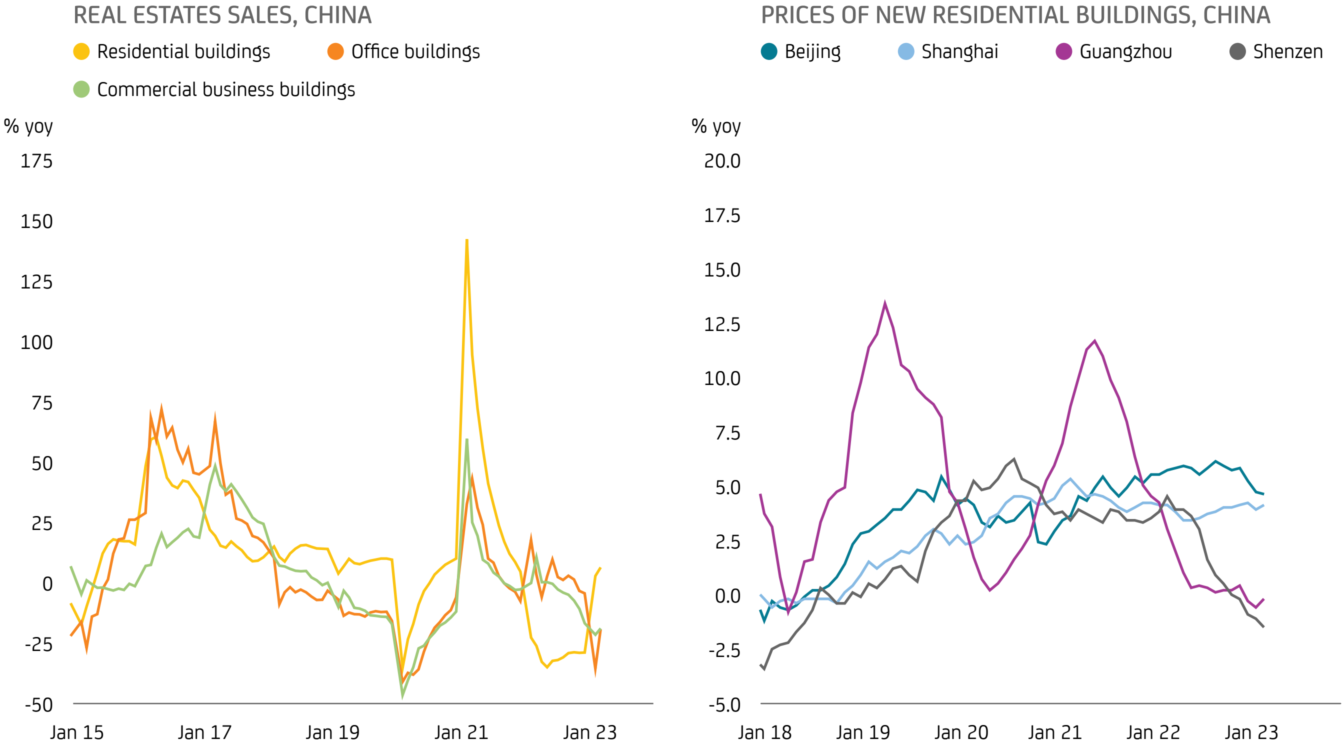
Note: OIS stands for Overnight Index Swap and is an interest rate swap that allows financial institutions to swap the interest rates they pay without having to refinance or change the terms of the loans they take out with other financial institutions. Source: Eurostat, Bloomberg, UniCredit Research, UniCredit Group Investment Strategy

CHINA: RISKS REMAIN DESPITE EXPECTED RECOVERY

Chinese GDP growth had recovered significantly at the start of the year (first quarter: 2.2% quarter-on-quarter, up from 0.6% in Q4 2022). Although we expect growth to be around 5 % this year, there are still some negative factors that need to be monitored more closely. China's fragile real estate sector stands out. In particular, property sales and prices have not yet recovered (see chart 5). Although sales of residential buildings rose again in the first quarter of 2023, they continued to decline for office and commercial buildings. Furthermore, the price development of new residential buildings indicates an imbalance between supply and demand. For example, prices of residential buildings in China's largest metropolitan region, the cities of Guangzhou and Shenzhen, have not only weakened further since the beginning of the year compared to the previous year, but have even fallen again. The regions of Beijing and Shanghai, on the other hand, seem to have largely stabilised, even if the price trend in Beijing has recently weakened more significantly. These developments show that the Chinese real estate market continues to be in a difficult situation to watch - and this despite the fact that the Chinese government has taken a number of measures to support the market, ranging from interest rate cuts for housing loans to the easing of financing regulations for construction companies. We still expect the government measures to work and support China's growth this year. Nevertheless, we will continue to closely monitor China's real estate sector, which is central to the country's growth prospects: including related industries, it accounts for about just under one **third**[11] of the country's gross domestic product.

[11] Rogoff, Kenneth and Yuanchen Yang (2021), "Has China's Housing Production Peaked?", China and the World Economy 21 (1), pp. 1-31.

5. CHINA'S REAL ESTATE MARKET STILL IN A WEAK PHASE



Source: NBS of China, Bloomberg, UniCredit Group Investment Strategy

COOLING OF THE ECONOMY FUELS MARKET PROSPECT OF INTEREST RATE CUTS IN THE USA IN THE NEAR FUTURE

The financial markets were largely unchanged in April, with slightly rising stock and bond markets. The situation has been similar so far in the month of May (as of 14.05.2023). The latest interest rate decisions by the two central banks, the Fed and the ECB, were in line with market expectations and did not release any significant impulses. The political dispute over raising the debt ceiling for the US federal debt (see In Focus section), on the other hand, could bring some volatility in the short term. The yields on 10-year US and German government bonds fell by about 10 bp from the beginning of May to mid-month. The latter thus reflect the market's increasing expectations that a weakening US economy and weaker inflation figures could prompt the US Federal Reserve to cut interest rates soon. In line with swap rates, market participants expect US policy rates to fall by around 70bp by the end of 2023 (as at 14.05.2023). We do not share these expectations but see rate cuts of 150 bp in the coming year. While the EUR-USD exchange rate was still able to appreciate by almost 1% in April, it has had to give up around 0.50% so far in May and fell below the 1.10 mark. This decline is probably less related to yield expectations than to the increased uncertainty about global economic development and the resulting flight of investors into safe investments such as the US dollar. The latter has appreciated by around 0.5% since the beginning of May. On the commodity markets, the price of Brent oil fell by more than 3 % to below 75 US dollars per barrel by mid-May and the gold price also fell by more than 1 %. Investors tend to invest more in gold in times of higher uncertainty, although a stronger US dollar weighs on dollar-denominated gold prices.

Asset Allocation – How we manage our portfolio mandate

Asset		Investment Universe	Investment View: Negative	Investment View: Neutral	Investment View: Positive
Main Asset Classes		Global Equities	○	●	○
		Global Bonds	○	●	○
		Money Markets	○	●	○
		Alternatives	○	●	○
Main Asset Classes in Detail	Equities	US	○	●	○
		Europe	○	●	○
		Pacific (DM[1])	○	●	○
		Emerging Markets	○	●	○
	Bonds	EMU Government Bonds	○	●	○
		Non-EMU Government Bonds	○	●	○
		EUR IG Corporate Bonds	○	○	●
		HY Corporate Bonds	●	○	○
		Emerging Market Bonds	○	○	●
	Commodities	Oil	○	●	○
		Gold	○	○	●

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

UniCredit Group Investment Strategy – Asset Allocation Stances

NEUTRAL ON GLOBAL EQUITIES

Equities resilience due to expectations of the Fed's pivot and a decent Q2 earnings season, but risk of 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

Support from China's economic recovery is fading while the ECB is expected to raise interest rate until July. However, risks of recession are less evident than in the US and the valuation is cheaper.

NEUTRAL US EQUITIES

Robust – although a weakening – job market and earnings resilience, but rising uncertainty due to fears of credit crunch / recession. The Fed is likely to pause at the June meeting. The rich equities valuation makes the asset class vulnerable in the case of an economic downturn.

NEUTRAL EMERGING MARKET EQUITIES

China's economic recovery is losing steam while tensions between US and China remains a major source of concern. Overall, valuations are cheap for EM equities. Countries and sectors selectivity among the Ems is strongly recommended.

NEUTRAL PACIFIC EQUITIES

Solid earnings and cheap valuations but more uncertainty in the medium to long term as the Bank of Japan, under the leadership of Kazuo Ueda, could be forced to abandon the yield curve control policy and raise interest rates in case of overheating of the economy. This will lead to a stronger yen and affect equity markets, particularly the exporters.

NEUTRAL GLOBAL BONDS

Competitive yields and major central banks likely to pause tightening (Fed), or are close to the end of the hiking cycle (ECB), although core inflation is showing some 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 sharp weakening of the macro picture.

NEGATIVE HIGH YIELD CORPORATE BONDS

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

NEUTRAL EMU GOVERNMENT BONDS

High core inflation and ECB expected to hike rates until July but a concerning Bank Lending Survey and first signs of an economic slowdown make us increasingly constructive on this asset class.

NEUTRAL NON-EMU GOVERNMENT BONDS

Competitive yields and expectations of a Fed pivot. Encouraging moderation in April of the US super-core inflation index.

OVERWEIGHT EMERGING MARKET BONDS

Supported by the Fed's possible pivot and a weak USD. We stay defensive and selective, avoiding countries with high external debt and current account deficit.

NEUTRAL MONEY MARKETS

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

POSITIVE GOLD

Supported by expectations of falling US rates, a weak USD and rising uncertainty.

CURRENCIES

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

How to invest

Investment ideas in the current scenario

BOND INVESTMENTS

OUR IDEA: HIGH QUALITY SENIOR FINANCIALS BONDS

After the failure of Silicon Valley Bank (SVB) in March, followed by the take-over of Credit Suisse by UBS, spreads on financial issuers' bonds widened significantly in relation to non-financial bonds, not only in the US market, but also across major European banks' bonds. In our view, this is unjustified given the differences in the two banking systems. We believe this creates an attractive opportunity in the European senior financial bonds space.

While both SVB and Credit Suisse are idiosyncratic events, the regional banking sector in the US remains vulnerable. In particular, the take-over of First Republic Bank on May 1 by J.P. Morgan may not be the last one. As this takeover was widely expected, the market reaction was limited. After the great financial crisis in 2008, a stricter regulation for banks with more than USD50 billion in assets was introduced, known as the "Dodd-Frank Act". Under the Trump administration in 2018, this law was changed, so that it only applies to institutions with more than USD250 billion in assets, giving smaller and medium-sized banks in the US more opportunities to take on risks.

The picture is completely different for major European Banks. In contrast to the US, deposits are holding up well in Europe and are broadly diversified. In fact, three quarters are stable household deposits, and 60% of all deposits are safeguarded by protection schemes. Euro area banks with assets above EUR30 billion are supervised by the ECB, and regulations are very strict. Banks are also subject to regular stress tests and close liquidity monitoring, including simulations of deposit run-offs. In addition, interest rate risks in European bank portfolios are hedged to a significant extent. As a result, a situation like SVB's, with long unhedged bond investments, financed by unstable deposits, is unlikely to materialise in the Euro area. Furthermore, European banks still have EUR4200 billion of excess liquidity.

Overall, the banking sector is expected to continue to benefit from the rising interest rate environment, driven by a slower repricing of deposits compared to new loans. The outlook for 2023 and 2024 remains bright and reported Q1 results have been very strong.

The senior bonds of major European financial institutions are trading at historic wide levels relative to non-financials issuers and are offering an attractive pick-up to government bonds and a compelling yield of around 4%, combined with strong fundamentals. Given that rate hikes are expected to pause and the economy is softening, we believe this sector offers an attractive risk-reward profile and should be considered as a buying opportunity for long-term investors.

EQUITY INVESTMENTS

OUR IDEA: HEALTHCARE INNOVATION

The demands of an ageing and increasingly health-conscious world population are pushing the healthcare sector towards innovation. Technology and the availability of funding are key enablers of the new "more for less" approach: better outcomes, greater convenience and access to lower costs, and less complexity and time. Big data is set to enhance advanced diagnostics, to power the shift from treatment to prevention, and to enable personalised and targeted therapies while cloud computing and AI can potentially accelerate the pace of progress. The sector's run for innovation is largely supported by private and public research efforts, and favourable regulation such as tax credits for R&D, market exclusivity and fast-tracked approvals.

The interest of governments on healthcare advances comes with a growing need to boost longevity and simultaneously manage the demographic pressure on budgets. Global healthcare spending already represents about 11% of global GDP, and with life expectancy continuing to increase, national health systems are likely to face a major challenge. By 2030 the share of the population aged 60 years and over is set to increase to 1.4 billion, or one in six people in the world, and by 2050 it is set to reach 2.1 billion, thus making the discovery and improvement of more efficient treatments a priority at a global scale.

Particularly exciting advancements have already been delivered in several areas such as:

- Smart Chemotherapy: A new class of drugs called Antibody Drug Conjugates (ADCs) that can kill cancer cells while sparing healthy tissues and significantly increasing survival rates. Replacing the traditional treatment with its smart version is expected to unlock a market worth over USD140 billion over the next 15 years.
- Obesity Treatment: Obesity is the upstream cause of more than 200 complications, and it is responsible for approximately 5% of global deaths. The market potential for obesity drugs is comparable to other breakthroughs like cholesterol-lowering, anti-hypertensive, and diabetes chronic treatments, with a revenue opportunity of more than USD50 billion in the US alone in 10-15 years.
- Chronic obstructive pulmonary disease (COPD): This is the third cause of death globally. The positive results in the Phase 3 trial of Dupixent, Sanofi-Regeneron's drug, open up a multi-billion dollar opportunity in annual sales as it possibly becomes the first biologic treatment for this complex disorder.
- Precision medicine: the use of a patient's full medical profile like genetic data, medical history, environmental factors, and even lifestyle to create a customized, unique treatment and prevention protocol for that individual. A relevant development in this field is the use of therapeutic mRNA vaccines to treat cancer.
- Wearable healthcare technology: Activity trackers and devices focused on specific health concerns (such as glucose monitoring) to allow consumers and doctors to easily monitor health. It will also help build and feed the available health dataset, further accelerating innovation.

DEVELOPMENT OF SELECTED FINANCIAL MARKET INDICES

From	**13.05.22**	15.05.18	15.05.19	15.05.20	15.05.21	15.05.22	15.05.18	**01.01.23**
To	**15.05.23**	15.05.19	15.05.20	15.05.21	15.05.22	15.05.23	15.05.23	**15.05.23**
Stock market indices (total return, in %)								
MSCI World (in USD)	**6.7**	2.1	-3.3	49.8	-4.8	6.7	47.3	**9.4**
MSCI Emerging Markets (in USD)	**0.7**	-9.2	-8.1	48.7	-20.3	0.7	-3.6	**3.0**
MSCI US (in USD)	**4.3**	7.3	2.0	50.1	-2.3	4.3	64.4	**8.5**
MSCI Europe (in EUR)	**11.9**	-0.1	-12.6	38.1	3.3	11.9	39.0	**12.3**
MSCI AC Asia Pacific (in USD)	**4.2**	-8.6	-3.6	42.1	-17.2	4.2	4.8	**4.8**
STOXX Europe 600 (in EUR)	**11.2**	-0.2	-11.7	39.1	2.1	11.2	38.8	**12.0**
DAX 40 (Germany in EUR)	**13.5**	-6.7	-15.0	49.1	-7.7	13.5	22.7	**14.3**
MSCI Italy (in EUR)	**20.7**	-11.0	-20.5	49.6	1.0	20.7	29.8	**16.9**
ATX (Austria, in EUR)	**6.8**	-11.2	-28.6	66.5	-4.1	6.8	7.2	**3.4**
SMI (Switzerland, in CHF)	**2.5**	8.8	1.6	21.4	8.6	2.5	50.0	**11.1**
S&P 500 (USA, in USD)	**4.6**	7.3	1.5	48.7	-0.8	4.6	65.4	**8.4**
Nikkei (Japan, in JPY)	**14.7**	-5.2	-2.7	43.3	-1.9	14.7	43.3	**14.7**
CSI 300 (China, in Yuan)	**2.6**	-2.9	7.0	32.9	-18.7	2.6	13.7	**3.4**
Bond market indices (total return, in %)								
US Government Bonds 10Y (in USD)	**-0.7**	8.8	21.2	-6.9	-9.9	-0.7	8.9	**4.5**
US Government Bonds (ICE BofA, in USD)	**-1.1**	6.4	14.0	-5.0	-7.4	-1.1	4.8	**3.3**
US Corporate Bonds (ICE BofA A-BBB, in USD)	**0.7**	7.8	8.1	6.2	-10.8	0.7	10.0	**3.3**
German Bunds 10Y (in EUR)	**-9.2**	8.8	4.5	-3.6	-8.9	-9.2	-9.5	**3.5**
EUR Government Bonds 1Y-10Y (iBOXX, in EUR)	**-8.3**	3.3	3.9	0.3	-8.2	-8.3	-9.3	**2.4**
EUR Corporate Bonds 1Y-10Y (iBOXX, in EUR)	**-3.9**	3.2	-1.4	5.5	-8.5	-3.9	-5.6	**2.5**
Bond yields (change in basis points = 0.01 percentage points)								
US Government Bonds 10Y (in USD)	**56**	-71	-178	102	128	56	50	**-33**
US Government Bonds (ICE BofA, in USD)	**94**	-55	-183	48	186	94	101	**-38**
US Corporate Bonds (ICE BofA A-BBB, in USD)	**92**	-46	-80	-65	217	92	129	**-20**
German Bunds 10Y (in EUR)	**136**	-74	-43	41	107	136	169	**-26**
EUR Government Bonds 1Y-10Y (iBOXX, in EUR)	**151**	-25	-39	3	110	151	200	**-16**
EUR Corporate Bonds 1Y-10Y (iBOXX, in EUR)	**161**	-30	44	-81	189	161	285	**-19**
Spreads on government bonds (credit spreads, change in basis points)								
US Corporate Bonds (ICE BofA US Corporate Master)	**2**	10	96	-129	54	2	35	**11**
US Corporate Bonds (ICE BofA US High Yield)	**14**	81	372	-442	126	14	140	**-2**
Euro Corporate bonds (ICE BofA Euro Corporate AAA-A)	**5**	17	64	-86	64	5	64	**7**
Euro Corporate Bonds (ICE BofA Euro High Yield)	**-20**	110	255	-352	192	-20	181	**-13**
Money market rates (change in basis points)								
Libor (USD, 3 months)	**389**	20	-214	-23	129	389	300	**56**
Euribor (EUR, 3 months)	**376**	2	5	-29	14	376	368	**123**
Euro exchange rates (change in %)								
US Dollar (EUR-USD)	**4.7**	-5.9	-3.6	12.3	-14.0	4.7	-9.3	**2.0**
British Pound (EUR-GBP)	**2.1**	-1.2	1.5	-2.7	-1.1	2.1	-1.5	**-2.0**
Swiss Franc (EUR-SFR)	**-6.1**	-5.3	-7.0	4.2	-5.2	-6.1	-18.5	**-1.0**
Japanese Yen (EUR-JPY)	**10.6**	-6.5	-5.9	14.7	1.2	10.6	12.9	**5.3**
Commodities (change in %)								
Commodity Index (GSCI, in USD)	**11.4**	0.0	35.4	2.6	-1.5	11.4	45.4	**10.8**
Industrial metals (GSCI, in USD)	**-15.3**	-16.0	-17.6	74.5	4.3	-15.3	7.6	**-7.4**
Gold (in USD per fine ounce)	**11.0**	0.2	35.5	6.2	-0.4	11.0	52.7	**11.0**
Crude oil (Brent, in USD per barrel)	**-32.6**	-8.4	-55.5	120.1	66.5	-32.6	-3.4	**-11.4**

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 15.05.2023.

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