Big in Japan

Group Investment Strategy

Monthly Outlook

July 2023

UniCredit

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Summary

Big in Japan

MACROECONOMIC UPDATE

In the US the economy continues to be robust, even if private consumption and the household savings surplus are shrinking. In May the labour market recorded a 4-month high in the number of new jobs, together with a strong upward revision of employment figures in March and April. Wage growth is still above the Federal Reserve's (Fed) target of 3% to 3.5%, which is in line with its inflation target of 2%.

The euro area economy slipped into a technical recession during the winter months: revised gross domestic product (GDP) data show a decline in growth of 0.1% in both the fourth quarter of 2022 and the first quarter of 2023. Employment growth, in turn, accelerated from 0.3% in Q4 2022 to 0.6% in Q1 2023, outpacing GDP growth for the second quarter in a row. After plunging in March, industrial production (excluding construction) rose by 1.0% month-on-month in April (slightly above the consensus estimate).

Economic activity in China continued to lose momentum in May. Industrial production slowed, fixed asset investment growth declined, along with retail sales.

INFLATION AND MONETARY POLICY

The US headline inflation rate weakened significantly, falling to the lowest level since March 2021 (4.0% year-on-year). The decline was largely due to a significant drop in energy prices, while food prices rose slightly. Important drivers of disinflation in the coming months are likely to be rents and producer prices, which both slowed considerably in May. The Fed left the target range for the key interest rate unchanged at 5.00-5.25% at its last meeting, as generally expected. In our view, while another rate hike in July is likely, another 25 bps move later in the year is more doubtful, especially as we expect economic growth and inflation to be weaker than the Fed expects.

Inflation in the euro area fell significantly in May, underlining that the European Central Bank's (ECB) monetary tightening policy is starting to take effect. Energy fell by 1.7% year-on-year, while food and groceries rose by 12.5% in May. So while price inflation in Europe continues, confidence is growing that the inflation rate may have peaked as well. The ECB continues to show its determination to move inflation down to the medium-term target of 2% in a timely manner and raised its key interest rates again by 25 bps in mid-June, thus bringing the deposit rate to 3.50%. There is also little in ECB President Christine Lagarde's rhetoric to suggest that the ECB will end its rate hike cycle in July. Accordingly, we are raising our forecast for the deposit rate to peak at 4.00% from 3.75%.

FINANCIAL MARKETS

The stock markets were well supported in June. The S&P 500 ended the second week of June more than 20% above its closing low of October 2022, thus fulfilling the purely technical criterion for the start of a bull market. The Stoxx Europe 600 rose more than 3% between early and mid-June. In addition to the settlement of the debt dispute in the US, a key driver of the good performance was the markets' focus on artificial intelligence, a theme that gained momentum. However, due to the many uncertainties in inflation, economic development and monetary policy stance, we see the risk of potential setbacks by the end of the year. Developments in the Japanese stock market were particularly remarkable. The Japanese benchmark index, Nikkei 225, even outperformed the AI-driven S&P 500 and recently reached its highest level since 1990. Japanese equities are in demand again and optimism is spreading, as the land of the rising sun seems to have finally overcome decades of stagnation and deflation.

CIO’s Letter

Big in Japan

After a 2022 marked by several crises, the first half of 2023 brought rising equity prices, further interest rate hikes by major Western central banks, a weakening economy in Europe (with a technical but not a severe recession), and several headline-grabbing developments. The latter were caused, in particular, by a number of US regional banks with home-made problems (as a result of rising yields and apparently inadequate interest rate risk management) and the takeover of Credit Suisse by UBS in Switzerland, while the banking sector in Europe was basically one of the winners in this first half of the year. The now settled debt dispute in the US (which caused some volatility on US stock markets in the meantime) also kept investors on their toes for several weeks. The hype around artificial intelligence (AI), which is gaining momentum, in turn supported a rally of a very special kind on the US stock markets, which was carried for large parts of the first half of the year by a handful of individual stocks (first and foremost the **“Magnificent Seven”[1]**) that were and are associated with the successful AI development. We view this development, which is based on very few titles, with a certain degree of scepticism. While we agree that advances in AI research are likely to bring about significant disruptive and transformational changes in the economy and society, the short-term implications for business and society are not yet clear. However, the short-term implications for companies and the economy are probably overestimated by the markets, while the long-term effects are underestimated.

[1]The “Magnificent Seven” include Apple, Microsoft, Nvidia, Amazon, Meta, Tesla and Alphabet.

The Japanese benchmark index, Nikkei 225, even outperformed the AI-driven S&P 500 in the past three months and recently reached its highest level since 1990. Japanese equities are in demand again and optimism is spreading, as the land of the rising sun seems to have finally overcome decades of stagnation and deflation. Against this background, we have raised Japanese equities from “neutral” to “overweight”.

Meanwhile, the economy in both the US and Europe appears surprisingly robust despite the massive interest rate hikes of the past quarters. Economic output and corporate profits have been moving sideways so far in 2023, but given last year’s solid figures (in Europe, corporate profits in the MSCI Europe grew by almost 20% last year), this development seems more like a consolidation than a crisis. Especially since corporate profits are expected to rise again next year, and the economy is expected to grow. Although economic growth in Europe is likely to remain rather subdued, earnings revisions, i.e., changes in earnings estimates for the current calendar year, have turned from a negative trend (i.e., declining earnings expectations) at the beginning of the year to a positive development (growing earnings).

The latest decisions by the major central banks, the Federal Reserve (Fed) and the European Central Bank (ECB), which led to the markets pricing in further interest rate hikes, have not yet left a lasting negative impression on the market. The outlook for the economy and the markets depends strongly on inflation dynamics. Should the latter – contrary to expectations, including ours – not cool down, the central banks could consider further interest rate hikes, which are currently not priced in, to be unavoidable. As a result, it cannot be ruled out that the economy will cool down more than hoped, even to the point of a noticeable recession. Such a development (which, however, is not our base scenario) is currently not reflected in market prices and is likely to result in significant markdowns in equity indices. On the other hand, there are signs that inflation dynamics are indeed weakening, albeit not as fast as desired. So, if it becomes apparent that no additional interest rate hikes, beyond the currently expected level, are necessary, and if at the same time the economy proves to be stable and resilient, this would be a good basis for the development of stock markets in the coming year.

In the context of portfolio management, two questions must be weighed against each other: the potential returns of equities compared to bonds, and the risk of significant price markdowns. After the extraordinary year 2022, which brought massive price losses for bonds, in particular, longer-dated government bonds are once again showing reasonable yields. For example, yields on 10-year German Bunds are currently around 2.5% and those on 10-year US Treasury bonds are at 3.75%. Yields on shorter-dated government bonds are even somewhat higher. Moreover, the risk of further massive price declines of such government bonds seems rather limited given the fact that central banks are likely to be close to the peak of the rate hike cycle. Should interest rates fall again in the coming quarters (we do not expect noticeable rate cuts this year, however), price gains could be expected in addition to interest income on bonds. The resulting performance potential must be weighed against the return and risk potential of equities. In the long term, investments in broadly diversified equity portfolios are likely to perform better than bond investments, but the price fluctuation risk of equities is also significantly higher than that of bonds. Due to the significant increase in yields over the past year, the expected yield difference between equities and bonds is currently significantly lower than before the inflation crisis – when a yield environment with partly negative yields prevailed. Especially since the risk of an economic slowdown has increased significantly due to the marked rise in financing costs for companies and private as well as government households. As already mentioned, such a slowdown could lead to price losses for equities and price increases for bonds.

In our view, a neutral weighting of equities and bonds (i.e., a weighting close to the targeted long-term average of both asset classes) makes sense in the current economic environment. Should a so-called "soft landing" scenario materialise regarding inflation dynamics (i.e., a cooling of inflation dynamics towards central banks' target levels, without the necessary interest rate hikes plunging the economy into recession), an increase in the equity quota to an overweight compared to bonds would definitely make sense. Such a situation could occur in perspective towards the end of the year. In the short term, however, potential further significant price rises in equities despite persistent inflation could provide opportunities for a tactical reduction of the equity allocation in favour of bonds. Meanwhile, we are keeping a close eye on inflation dynamics, further central bank action and the economic environment. In the medium to long term, a higher equity allocation than currently implemented appears sensible, from a fundamental standpoint.

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In Focus

Transformation of the energy system: key for the EU as an industrial location

2022 was a challenging year for many European companies, even if the clearly noticeable economic slump predicted by many experts failed to materialise at the turn of the year. Although growth has been weak recently and the Eurozone slipped into a technical recession – according to (revised) official data from Eurostat for the fourth quarter of 2022 and first quarter of 2023 – the European economy is proving resilient in a difficult global environment. And with the warmer season, confidence has also increased across capital markets.

ENERGY PRICES REMAIN A SIGNIFICANT LOCATION FACTOR

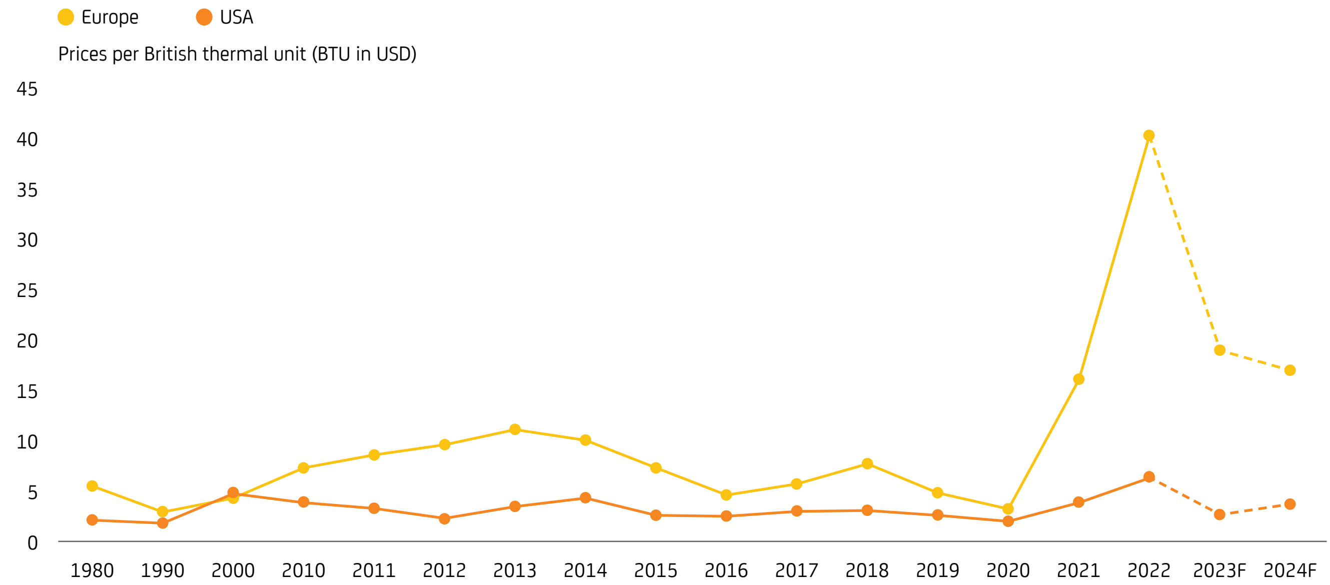
After the EU's shift away from its dependence on Russian supplies caused the price of gas to skyrocket last year and energy prices in the EU to reach record levels, the European economy has apparently managed to contain the negative effects of the Russian war of aggression against Ukraine and overcome the energy crisis. This was primarily due to the mild winter, but certainly also to the fact that it was able to diversify its energy supply surprisingly quickly and significantly reduce gas consumption. The noticeable drop in energy prices this year not only gives companies breathing space in production costs, it also has a positive effect on consumers.

Nevertheless, the extreme volatility of energy prices over the past year highlights the structural challenges the EU faces in transforming its energy system away from fossil fuels. Shifting gas supplies from historically cheap Russian pipeline gas supplies to imports of the more expensive liquefied natural gas (LNG) may provide temporary relief. However, with a view to ensuring competitiveness, policy makers, especially in the EU, face the challenge of striking a fundamental balance between decarbonisation, and security of supply and affordability – especially because energy prices remain a relevant factor in assessing the competitiveness of the industrial location. In particular, they play a decisive role in the location choices of companies, especially energy-intensive companies.

Fossil fuel prices have historically been higher in the EU than in other parts of the world, such as the US. This divergence has been exacerbated by Russia's war of aggression against Ukraine last year, especially for natural gas (see **World Bank data**[2] in chart 1), and it is expected to remain so for the time being.

[2] The World Bank's Commodity Markets Outlook is published twice a year (in April and October) and provides detailed market analysis for major commodity groups, including energy. The report and data are available at: www.worldbank.org/commodities.

1. HISTORICAL COMMODITY PRICES FOR NATURAL GAS IN EUROPE AND THE US RESPECTIVELY AND FORECAST



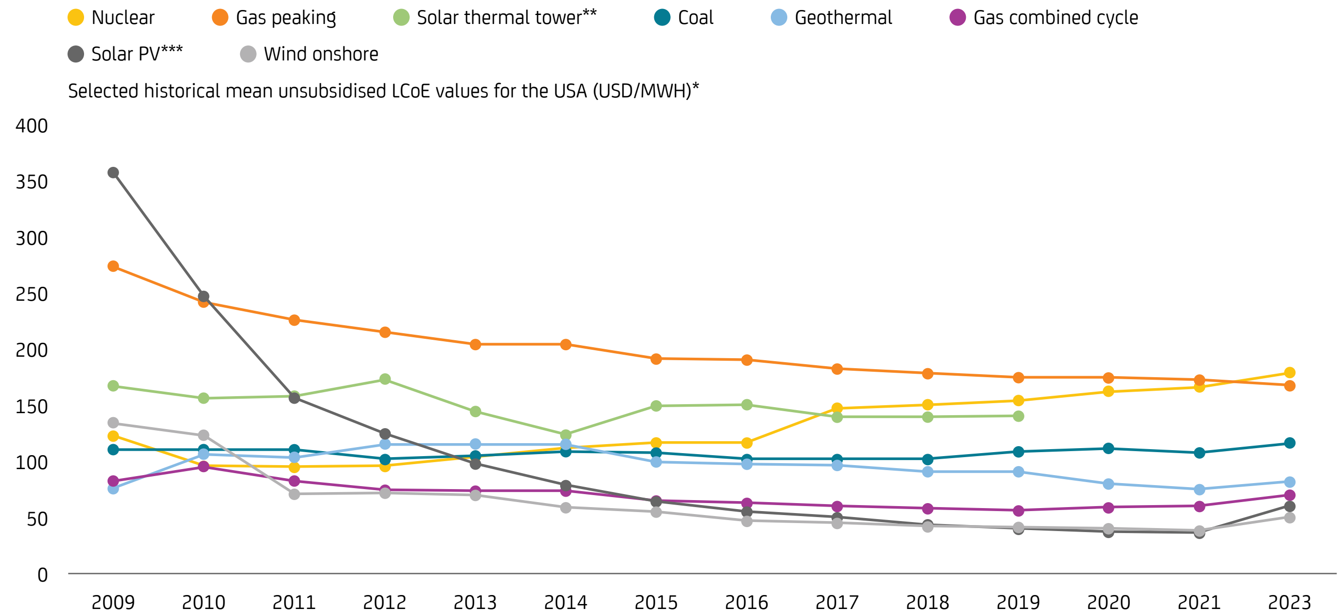
Note: Past performance, simulations and forecasts are not a reliable indicator of future performance. The indices cannot be purchased and therefore do not include any costs. In the case of an investment in commodities, acquisition and custody costs incurred are not taken into account. In the case of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

COSTS FOR THE GENERATION OF RENEWABLE ENERGIES CONTINUOUSLY DECREASED

Against this backdrop, it becomes clear what role the decarbonisation of the energy and electricity system plays not only from a climate protection perspective, but also in economic terms. In the case of electricity generation from renewable energies, a long-term, continuous trend of falling costs can be observed thanks to more favourable plant prices, higher efficiencies, economies of scale and better financing conditions for projects. A recent **analysis by Lazard Asset Management[3]** of the unsubsidised Levelised Cost of Electricity or Energy (LCoE) for the US shows that the cost of renewable energy (RE) technologies has declined significantly over the last few years (see chart 2). The report shows that selected RE generation technologies are cost competitive with conventional generation technologies under certain circumstances.

[3]Each year, Lazard conducts a detailed analysis of energy costs for different generation technologies, energy storage technologies and hydrogen production methods. For the underlying methodology, please refer to the current report (see also 2023 Levelised Cost Of Energy+, link: https://www.lazard.com/media/2ozoovyg/lazards-lcoeplus-april-2023.pdf).

2. COSTS FOR RENEWABLE ENERGY GENERATION TECHNOLOGIES CONTINUOUSLY DECREASED



Notes: *Gives the average of the high and low LCoE for each technology in each year. **Lazard's LCoE no longer analyse the cost of solar thermal. ***Earlier versions of Lazard's LCoE divided utility-scale solar into thin-film and crystalline subcategories.
Source: Lazard Asset Management, Roland Berger, UniCredit Group Investment Strategy

This development, which is due among other things to falling capital costs, optimised technologies and increased competition, seems to be progressing faster than many model calculations predicted years ago. And the trend is likely to continue worldwide, as the upscaling of RE technologies should further reduce costs in the future. In the US, the long-term tax incentives of the Inflation Reduction Act (IRA) should give an additional boost to both photovoltaic (PV) and wind power projects, which should become particularly visible from 2025 onwards, given the deadlines for the construction of large-scale plants.

The International Energy Agency (IEA), **in its latest outlook for the RE markets**[4], also expects electricity generation costs for new onshore wind and solar plants to fall again by 2024, following a recent increase. In most markets outside China, however, they will probably still be 10-15% above pre-pandemic levels. According to the IEA's calculations, electricity consumers in the EU will save around EUR100 billion between 2021 and 2023 by being able to generate additional electricity from newly installed PV and wind power plants. Low-cost new wind and PV plants have displaced around 230 TWh of fossil fuel generation since Russia invaded Ukraine, according to the IEA, which has contributed to lower wholesale electricity prices in all European markets.

[4]See also IEA, Renewable Energy Market Update Outlook for 2023 and 2024 (Link: Renewable Energy Market Update – June 2023 (windows.net) https://iea.blob.core.windows.net/assets/67ff3040-dc78-4255-a3d4-b1e5b2be41c8/RenewableEnergyMarketUpdate_June2023.pdf)

IMPLICATIONS FOR INVESTMENT

Globally, the IEA expects renewable capacity additions of 440 gigawatts (GW) in 2023, up 107 GW from 2022 after two consecutive years of decline, thanks to growing energy security concerns, increasing political support and the improved competitiveness of alternative energy sources to fossil fuels. In addition to accelerating the expansion of RE, increasing energy efficiency should also be one of the keys to lowering energy prices, improving the business environment and securing the EU's energy independence. In the long term, the transformation to an energy system that is independent of fossil energy imports should also strengthen European energy sovereignty and the EU as a whole as an industrial location. However, it will involve significant investments in energy production, grids and industrial capacities in numerous sectors of the economy. In turn, companies that enable innovative, technological solutions for the economic-ecological transformation should benefit from this to a particular degree. In view of the (sustainable) investment strategy and the corresponding portfolio composition, these sectors therefore hold great investment potential in the long term.

Macro & Markets

Fed pauses, ECB hikes again and signals further rate rises

US: NOTICEABLE COOLING OF THE ECONOMY STILL TO COME, WAVE OF INFLATION SEEMS TO BE SUBSIDING

The US economy continues to be surprisingly robust, even if private consumption is losing momentum and the household savings surplus accumulated during the pandemic is shrinking. The latter has recently shrunk to a third. Furthermore, a surprising number of new jobs were created in May: 339 thousand, which is a 4-month high. Together with a strong upward revision of employment figures in March and April, this development does not point to a noticeable cooling or an imminent recession of the US economy. Although the unemployment rate rose slightly to 3.7% and wage growth fell from 4.4% to 4.3% year-on-year, this still puts wage growth above the Federal Reserve's (Fed) target of 3% to 3.5%, which is in line with its inflation target of 2%. Nevertheless, the ongoing trend points in the right direction.

The latest release of consumer prices for the month of May gave new food for thought to both the **hawks**[5] and the **doves**[6] in the Fed's monetary policy council. The US inflation rate weakened significantly, falling to 4.0% year-on-year (from 4.9% in April, see chart 3) – the lowest level since March 2021. The decline was largely due to a significant drop in energy prices, while food prices rose slightly – although the trend in global food prices is expected to continue on a downward path thanks to an improved supply situation. US **core inflation**[7], which excludes volatile components (energy and food), also declined in May to 5.3% year-on-year (after 5.5% in April). Extrapolated for the year, however, it is still around 5% and thus clearly above the level acceptable to the Fed. An important driver of disinflation in the coming months is likely to be rents, which rose by 0.5% month-on-month in May, somewhat slower than in April. Core inflation in the services sector excluding housing – an indicator that Fed Chair Jerome Powell is known to pay particular attention to – rose slightly to 0.2% from the previous month, roughly in line with the pre-pandemic average. A further abatement of the inflation wave in the US is also signalled by producer prices, which slowed considerably in May to 1.1% year-on-year, after having been as high as 2.3% in April and 11.7% in March.

Against the background of the latest data situation, the Fed left the target range for the key interest rate unchanged at 5.00-5.25% at its last meeting, as generally expected, although it was very hawkish in its communication for the interest rate outlook. Powell justified the decision to pause rate hikes by saying that slowing the pace of tightening would give the central bank more time to assess the impact of tighter monetary policy on incoming data. Looking ahead to the next meeting in July, this could give the impression that no decision has yet been made on another rate hike. However, it seems that the few data still to be released before the July meeting (i.e. inflation and labour market reports) would have to surprise rather negatively to dissuade the Fed from another rate hike. The median Fed member now expects another 50 basis points (bps) of rate hikes, which would raise the upper end of the policy rate towards 5.75% by the end of the year (see dot plot in chart 3). However, only two of the 18 Fed members do not expect any further rate hikes this year, and no one expects rate cuts. The median rates for the end of 2024 and the end of 2025 rose approximately 30 bps from three months ago to 4.6% and 3.4%, respectively. On balance, the Fed made it clear that while it sees signs of progress, both in the decline in inflation and in the labour market situation, developments have been too slow for it so far. In our view, while another rate hike in July is likely, another 25 bps move later in the year is more doubtful, especially as we expect economic growth and inflation to be weaker than the Fed expects. However, the risks for the near future lie more with further tightening.

[5] The advocates of a restrictive monetary policy are called hawks.

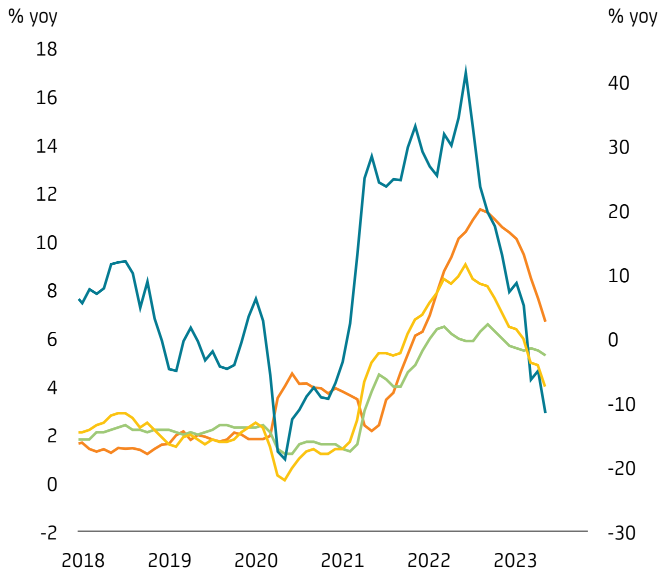
[6] The advocates of an expansive monetary policy are called doves.

[7] Core inflation usually paints a more unbiased picture of underlying inflation trends than the headline rate.

3. DISINFLATION CONTINUES, FED PAUSES BUT SIGNALS FURTHER RATE HIKES

US INFLATION

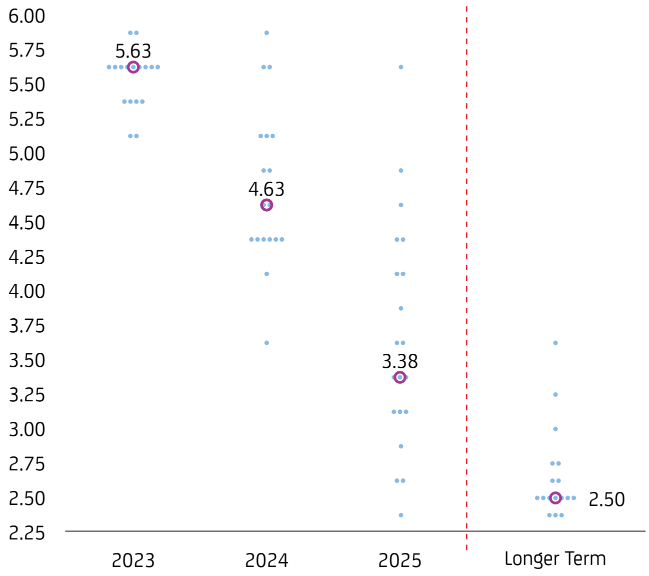
US consumer price index · Food component · Core Index · Energy component (right scale)



FED "DOT PLOT" (JUNE 2023)

Voting member of the FOMC · Median calculated across Dots

FMOC participants' assessments of appropriate monetary policy: Median reflects midpoint of target range for Fed's target rate (in %)



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

EURO AREA: ECB RAISES KEY INTEREST RATE TO HIGHEST LEVEL IN 15 YEARS AND DOES NOT SEE THE END YET

The euro area economy slipped into a **technical recession during the winter months**[8]: Revised gross domestic product (GDP) data show a **decline in growth of 0.1% in both the fourth quarter of 2022 and the first quarter of 2023**[9] (see chart 4). The slowdown was mainly due to a noticeable decline in public spending and weakening consumption. High prices and rising interest rates seem to hit households particularly hard. Employment growth, in turn, accelerated from 0.3% in Q4 2022 to 0.6% in Q1 2023, outpacing GDP growth for the second quarter in a row. After plunging in March with a revised 3.8% decline, industrial production (excluding construction) rose by 1.0% month-on-month in April (slightly above the consensus estimate of 0.8%).

Inflation in the euro area fell significantly in May, as expected, to 6.1% year-on-year (down from 7.0% in April), underlining that the European Central Bank's (ECB) monetary tightening policy is starting to take effect. Energy fell by 1.7% year-on-year, while food and groceries remained the price drivers, rising by 12.5% in May. Since December, they have contributed the most to headline inflation. While headline inflation is expected to moderate further, the focus remains on how persistent the core rate, which excludes the volatile components (energy and food), is. It also fell in May, from 5.6% to 5.3% year-on-year. So while price inflation in Europe continues, confidence is growing that the core inflation rate may have peaked as well. To be sure, services inflation continues to pose some upside risk in the months ahead. Nevertheless, the overall disinflationary trend should accelerate from the third quarter onwards thanks to falling goods prices.

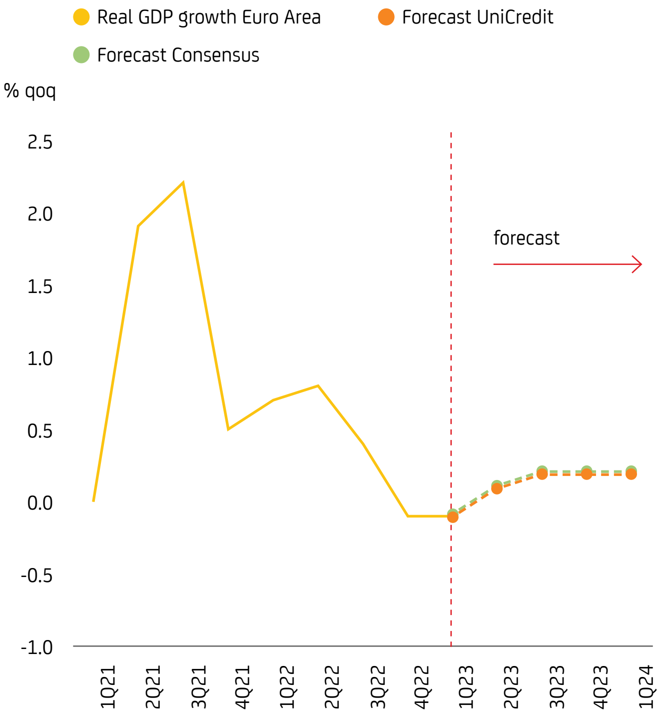
The ECB continues to show its determination to move inflation down to the medium-term target of 2% in a timely manner. As widely expected, it raised its key interest rates again by 25 bps in mid-June – the eighth consecutive rate hike. The increase for this cycle is a cumulative 400 bps, bringing the deposit rate to 3.50%, which is the highest level in 22 years. While the ECB acknowledged that inflation is falling, it made a surprisingly sharp correction to its inflation forecast for the full 3-year forecast horizon: the central bank now expects inflation to be 5.1% this year, then reach 3.0% in 2024 and fall to 2.2% in 2025. At the same time, it lowered its expectations for economic growth this year and next, but only marginally. Compared to the last forecast in March, inflation is thus declining at a slower pace according to ECB expectations, and in our view the updated forecasts – especially for the further path of core inflation – give clear indications that the ECB could continue the rate hike cycle beyond July. There is also little in ECB President Christine Lagarde's rhetoric at the press conference to suggest that the ECB will end its rate hike cycle in July. While reiterating that she will continue to take a "data-driven" approach to future interest rate decisions, Lagarde repeated the phrase from the May meeting that the central bank "has more to do", adding that it is currently "not thinking of taking a break". Accordingly, we are raising our forecast for the deposit rate to peak at 4.00% from 3.75%.

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

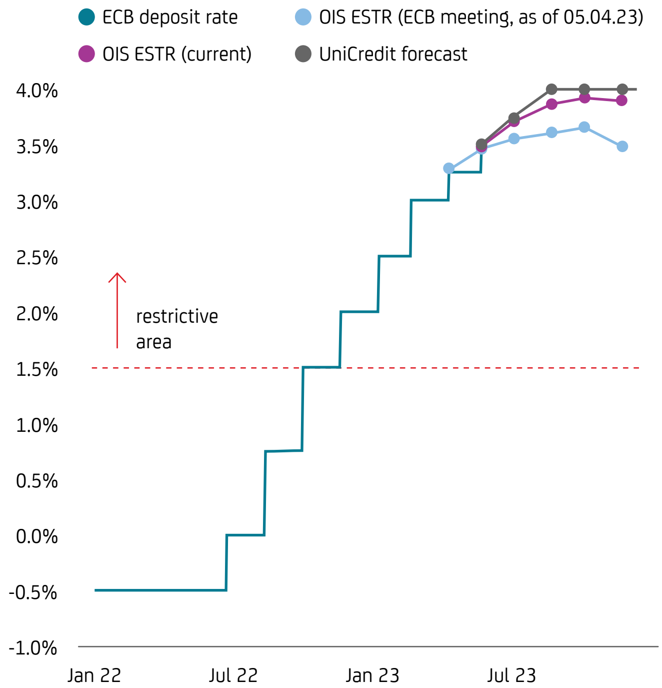
[9] However, the EU economy as a whole managed to avoid the downturn: Across the EU, GDP rose by 0.1% in the first quarter, after falling by 0.2% in the fourth quarter of 2022.

4. EURO AREA IN TECHNICAL RECESSION, ECB RAISES THE KEY RATES AND HINTS AT FURTHER TIGHTENING

GDP GROWTH



INTEREST RATE PATH IN THE EUROZONE



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

Meanwhile, the slowdown in non-financial corporate credit growth in the euro area to 3.8% year-on-year from a peak of 8.1% in October 2022 suggests that the cycle of interest rate hikes is coming to an end in the euro area, although it may not be imminent. Consumer credit growth fell, to 2.5% year-on-year from a peak of 4.5% in June 2022. These developments are in line with the results from the ECB's latest bank lending survey in early May.

CHINA: CENTRAL BANK HEADS FOR SLOWING ECONOMIC RECOVERY

Economic activity in China continued to lose momentum in May. Industrial production slowed from 5.6% to 3.5% year-on-year and fixed asset investment growth declined from 4.7% to 4.0% year-on-year. On the demand side, retail sales declined from 18.4% to 12.7% year-on-year. The growth of money supply and credit volume, which both fell short of market expectations in May, also joined the recent rather disappointing Chinese data releases, which point to a less dynamic recovery of the Chinese economy than expected a few months ago.

The People's Bank of China (PBoC) surprised markets in mid-June by cutting the short-term policy rate (the seven-day reverse repo rate) by 10 bps to 1.9%. The measure is aimed at boosting economic activity in the face of weak inflationary pressures and not jeopardising the achievement of the Chinese government's already unambitious growth target for 2023 (of around 5%), as the recovery of Chinese domestic demand is obviously losing momentum. It was the first rate cut since August 2022. The PBoC also reduced the interest rate on 1-year loans, the so-called medium-term credit facility, by 10 bps to 2.65%. In the coming weeks, the Beijing government is likely to announce further monetary and fiscal policy measures to support the economy, despite recent improved May figures (compared to April) for retail sales, industrial production, fixed asset investment and the services index. However, we expect targeted measures rather than a comprehensive stimulus package.

BOOM IN ARTIFICIAL INTELLIGENCE SUPPORTS STOCK MARKETS

The stock markets were well supported in June. The S&P 500 gained around 4.5% between early and mid-June, while the Stoxx Europe 600 rose more than 3% over the same period. In addition to the settlement of the debt dispute in the US (which provides for a suspension of the debt ceiling until the end of 2024), a key driver of the good performance was the markets' focus on **artificial intelligence**[10]. This gained momentum, especially after the publication of the quarterly figures of US tech company Nvidia, which were significantly better than analysts expected. Even the prospect of further interest rate hikes by central banks was unable to put an end to the upward trend, especially since investors continue to assume a "soft landing" scenario for the US economy and thus no serious recession. The S&P 500 ended the second week of June more than 20% above its closing low of October 2022, thus fulfilling the purely technical criterion for the start of a bull market. However, due to the many uncertainties in inflation, economic development and monetary policy stance, we see the risk of potential setbacks by the end of the year.

In the case of bonds, the interest rate decisions by the Fed and the ECB and the increase in key interest rate forecasts caused only minor price losses, as both had largely been expected by the markets in the run-up to the meetings. Between early and mid-June, yields on 10-year US government bonds rose slightly by around 15 bps, while 10-year Bund yields rose by a good 20 bps. The ECB's rate hikes and the resulting further narrowing of the interest rate differential with the Fed supported the EUR-USD exchange rate, which appreciated by around 1.5% and most recently tested the 1.10 mark again. On the commodity markets, the gold price has largely moved sideways since the beginning of June. By contrast, the Brent oil price gained slightly again (by around 3%) after falling sharply in the previous month (by around 8%). The market was supported above all by the prospect of further production cuts by OPEC+. At the beginning of June, the members of OPEC+ announced their intention to further reduce their production target for 2024 by around 1.4 million barrels per day; Saudi Arabia also announced a unilateral cut in its production by 1 million barrels per day, initially in July. The Brent price was last quoted around USD76 per barrel, up around 3% on the month (as of June 18, 2023).

[10] Artificial intelligence (AI) refers to the human-like thinking or actions of a computer, robot or machine. The system learns from its mistakes and can react differently to the same task or problem without reprogramming. So far, however, many of the applications are still in development. Large corporations such as Google, Facebook and Microsoft have declared the research area of artificial intelligence to be one of the most strategically important directions of their own corporate development.

Asset Allocation – How we manage our portfolio mandate

			Investment View		
Asset		Investment Universe	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 (Hard Currency)	○	●	○
		Emerging Market Bonds (Local Currency)	○	○	●
	Commodities	Oil	○	●	○
		Gold	○	○	●

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

We expect global growth to slow significantly later this year / early next year, once the higher rates fully spread out their effects and consumers gradually deplete their excess savings that were built up during the pandemic. Second quarter macro data are deteriorating globally, especially in the Eurozone where the growth is anaemic and Germany entered a technical recession, and in China, where the recovery is disappointing. Meanwhile, in the US, the job market is surprisingly resilient, likely delaying a more pronounced slowdown to the fourth quarter of this year, or early next year. Also, we expect both headline and core inflation to cool in the coming months in developed markets.

Against this backdrop, we confirm our strong preference for high quality bonds such as corporate investment grade and government bonds. In fact, the rise in US bond yields due to the end of the stand-off on the debt ceiling and the consequent expected liquidity drain from quantitative tightening and Treasury T-bills auctions offer interesting medium to long-term buying opportunities, both in terms of **carry trade**[11] (investment grade corporate bonds) and macro hedging in the event of a sharp slowdown / recession (long duration government bonds).

We remain cautious on high yield corporate bonds given the relatively lower liquidity in these markets, as well as spreads that are not yet fully discounting the slowdown of their relevant economies.

Despite their interesting carry, we downgraded EM bonds in hard currency to neutral from positive, as we prefer high quality bonds. We remain defensive and selective, avoiding countries with high external debt and current account deficits.

[11]"Carry trades" here refers to a strategy that invests in assets with higher rate of return.

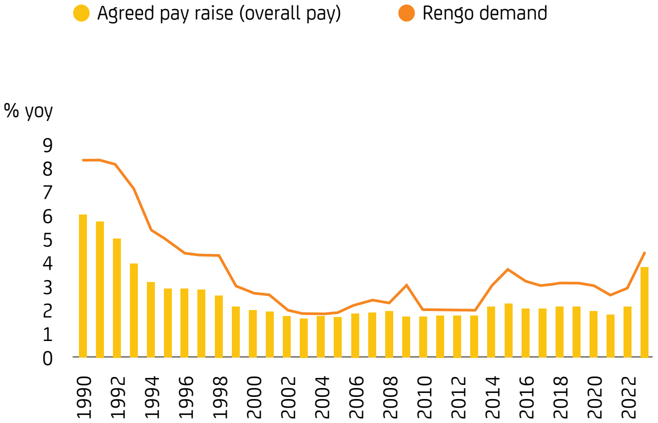
Equities have been supported by the positive second quarter earnings season, the resolution of the debt ceiling stand-off, and by reduced fears over banking sector stress. In addition, investors positively discount a central bank policy pivot in the medium term, and believe that the economic slowdown will not result in a heavy recession (or a hard landing). In other words, they are not yet fully discounting the material risk of an earnings disappointment in the coming months, considering the lagged effect of higher interest rates.

We remain constructive on equities, and we are actively managing our regional, industry and style allocation.

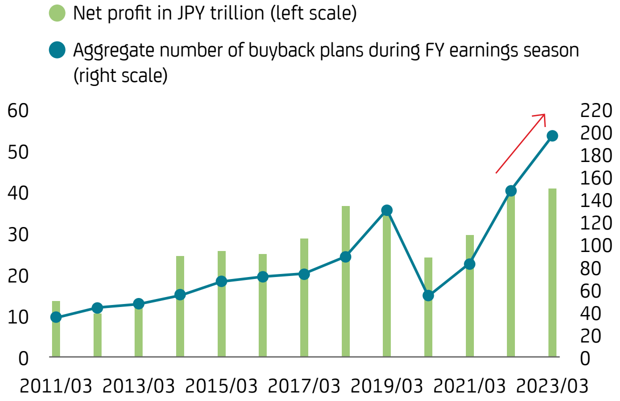
Under this perspective, we have started sharpening our regional equity allocation focus by upgrading Japan to positive from neutral. In fact, wage growth and rising inflation – without a relevant risk in the short term of more restrictive policy from the Bank of Japan and appreciation in the Japanese yen – are positive factors for Japan, which is emerging from a long phase of deflation. In addition, the increase in corporate profits and the reform of the Tokyo Stock Exchange are encouraging intense share buyback activity (see Chart 5).

5. JAPAN: WAGES ON THE RISE

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



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



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

We remain neutral on the other macro areas, with US equities boosted by growth stocks, namely Big Tech and in particular the “Magnificent Seven” stocks, and more in detail by Artificial Intelligence prospects, but also from the rebound in small caps.

6. CONCERNING S&P 500 MARKET CONCENTRATION

Source: BoFA Global Investment Strategy, Bloomberg, Unicredit Group Investment Strategy

European equities' relative outperformance is no more justified given the weakening macro momentum, as testified by tighter lending, the end of the boost from falling gas prices, a restrictive ECB, and the lower weighting of tech stocks. EMs have been affected by the weakening Chinese economic recovery but are now bouncing on expectations of monetary and fiscal easing, which we expect targeted and limited in size to avoid the Global Financial Crisis overshooting.

In terms of style and sector allocation, we are more flexible as we expect the recovery of the growth sectors to continue on medium term expectations of a more dovish Fed. However, given the macro uncertainties, we prefer focusing on quality growth. More generally, we reaffirm our preference for companies with high pricing power and superior cash flow generation.

As for the US dollar, it should trade range-bound versus the Euro, as expectations of delayed Fed rate cuts and a weakening macro picture for the Eurozone are balanced by the last hawkish ECB meeting.

As for commodities, oil prices are penalised by fears of a global growth slowdown despite recent Opec+ cuts. Gold should continue benefitting from its role as a safe heaven and from medium-term expectations of Fed easing.

NEUTRAL ON GLOBAL EQUITIES

Equities resilience due to investor expectations of a Fed pivot, as well as confidence that a hard landing will be avoided. Risk of earnings deceleration in the coming months is material considering the lagging effect of higher interest rates.

NEUTRAL EUROPEAN EQUITIES

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

NEUTRAL US EQUITIES

A robust although weakening job market, and earnings resilience, but uncertainty on the magnitude of the economic slowdown. Also, the Fed in a "hawkish pause" in June, and excessive S&P 500 market concentration.

NEUTRAL EMERGING MARKET EQUITIES

China's recovery is losing steam and we expect targeted monetary and fiscal easing. Overall, valuations are cheap for EM equities. Countries and sectors selectivity among EMs is strongly recommended.

POSITIVE FROM NEUTRAL ON PACIFIC EQUITIES

Wage growth and rising inflation – without a material risk in the short term of a more restrictive BoJ and yen appreciation – are positive factors for Japan, which is emerging from a long phase of deflation. In addition, the increase in corporate profits and the reform of the Tokyo Stock Exchange are encouraging intense share buyback activity.

NEUTRAL GLOBAL BONDS

Weakening growth and cooling inflation in the coming months support our preference for "high quality bonds".

OVERWEIGHT EURO INVESTMENT GRADE CORPORATE BONDS

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

NEGATIVE HIGH YIELD CORPORATE BONDS

Spreads in this market do not yet fully discount a possible economic slowdown, especially in the US, due to more restrictive lending conditions. Also, liquidity is relatively low.

NEUTRAL EMU GOVERNMENT BONDS

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

NEUTRAL NON-EMU GOVERNMENT BONDS

Supported by expectations of Fed easing in the medium term and falling inflation.

NEUTRAL FROM POSITIVE ON EM BONDS IN HARD CURRENCY

Interesting carry but the focus on high quality bonds leads us to downgrade EM bonds in hard currency to neutral from positive. We remain defensive and selective, avoiding countries with high external debt and current account deficits.

POSITIVE ON EM BONDS IN LOCAL CURRENCY

Expectations for Fed easing in the first half of 2024, as well as US dollar weakening.

NEUTRAL MONEY MARKETS

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

NEUTRAL ALTERNATIVES

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

NEUTRAL COMMODITIES

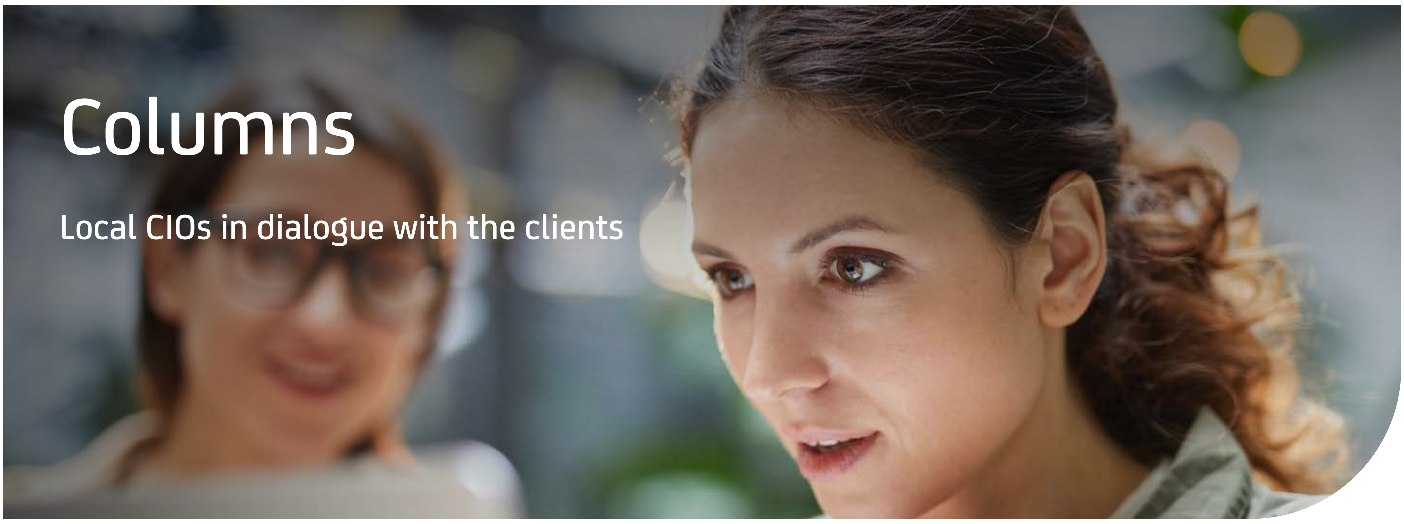
Penalised by fears of a global slowdown with a potential relief in case of a more aggressive than expected monetary and fiscal easing in China.

POSITIVE GOLD

Supported by medium-term expectations of falling US interest rates.

CURRENCIES

The US dollar should trade range-bound versus the Euro. The ECB appears to be more hawkish in the near term than the Fed, but macro momentum in the Eurozone looks more concerning than the US.



Answers from Italy

WITH THE ECB CONTINUING TO RAISE RATES, WHAT ARE THE RISKS FOR EURO AREA GOVERNMENT BONDS?

At its meeting on 15 June, the ECB raised the three reference rates by 25 bps: the interest rates on the main refinancing operations, and the operations of the lending facility and the deposit facility were therefore raised to 4.00%, 4.25% and 3.50% respectively, with effect from 21 June 2023. The main reason for this decision lies in the dynamics of inflation. While inflation shows signs of cooling and reducing, the ECB fears that this dynamic is still too slow and gradual and could trigger side effects in the labour market with wage increases. These in turn could then fuel further increases in goods and services prices. In short, the stated goal is to break a possible vicious circle.

This rate increase by the ECB was widely expected by the market. Instead, the subsequent statements in the press conference surprised. In fact, before the June meeting it was widely believed that the ECB would conclude the cycle of hikes in the following two meetings: June and July. Now it seems instead that there may be further increases even after the summer. Contrary to what we might have expected, this negative surprise had no particular effects either on the level of long-term yields or even less on the spreads of countries with higher debt, such as Italy, compared to AAA-rated countries such as Germany.

The reasons for this are varied. Investors believe that the euro area economy is slowing down: this is demonstrated by some macro data and also by surveys on credit conditions, which show lending rates at the highest levels in the last decade and a sharp drop in credit demand by businesses and consumers. Therefore, greater short-term hikes are likely to turn into greater cuts during 2024 and therefore the net effect is almost nil on the yields of longer maturities. The spreads of peripheral countries, and in particular of Italian government bonds, remain stable because the credibility of the ECB in wanting to counter the fragmentation in the euro area (very different financing conditions by the governments of the area) remains high. This is because the reduction of purchases is proportional to the various debt stocks and therefore also impacts Germany and France. Finally, the demand from domestic investors is increasing as evidenced by the recent success of the BTP Valore issuance in Italy, where the Treasury placed a record amount of EUR18 billion.

This set of factors therefore makes it more interesting to invest in government bonds, which today represent an effective combination of good potential return – especially given that nominal yields are at the highest levels of the last decade – and protection from any phases of instability.

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

WHY ARE JAPANESE EQUITIES ONCE AGAIN MOVING INTO INVESTORS' FOCUS?

Conversations with our clients rarely turn to the topic of Japanese equities. Factors such as the banking crisis of the 1990s, decades of deflation, an ageing population and high national debt are quickly on the table and nip many discussions in the bud. These are certainly valid arguments against investing in Japanese equities and represent risks. However, we also want to look more closely at the opportunities. Perhaps the reputation of the asset class is worse than the market presents itself. Already in 2022, the Japanese stock market outperformed those in the US or Europe (excluding the effects of currency developments). This trend has continued in 2023. Warren Buffet also recognised this and gradually increased his exposure to Japanese equities in the course of the year. But what is driving the fact that Japanese equities are once again moving into investors' focus?

The valuation of Japanese equities has been extremely cheap for years, if not decades. However, this was never quite enough to lift the market to new unimagined heights. However, there are other arguments in favour of investing in Japan:

- With the rise in inflation rates around the globe, deflation in Japan is also history, at least temporarily. But the country is not struggling with double-digit percentage increases, as was partly the case in Europe. Rather, a "healthy" level of inflation has returned. The core inflation rate (excluding energy and fresh food) has hovered around the 4% mark in recent months. For this reason, the Japanese central bank (Bank of Japan) has so far seen no need to turn the interest rate screw. This is in contrast to the US or Europe, where higher interest rates pose a risk to the economy.
- Japan maintained restrictive measures to contain the pandemic for a long time. This also put a strain on tourism. Foreign guests were only sparsely allowed into the country, thus missing an important support for many industries. The reopening is now also bringing momentum back into the tourism industry. The weak Japanese yen, compared to many other currencies, supports not only the export industry, but also tourism, which makes Japan look like an affordable holiday destination again.
- Japanese companies have high levels of cash reserves. For some years now, these dividend increases have also increasingly been used to buy back shares in order to benefit shareholders. This could be done without noticeably increasing the payout ratios (in relation to the profit generated).
- Japanese Prime Minister Fumido Kishida has implemented his announced reforms to make investment attractive once again for domestic citizens. The taxation of dividends and capital gains at the rate of 20% will be abolished if certain criteria are met. With these measures, the government expects domestic savers, who have about JPY2,000 trillion (about EUR13 trillion) in savings, to invest more in equities. Especially against the background of higher inflation, which makes it necessary to generate additional returns for pensions.

When investing in Japanese equities, a selective approach must be taken at best and attention must be paid to diversification. The risks mentioned above as well as potential negative effects from a change in central bank policy, should also be taken into account. In addition, the development of the yen against other currencies can significantly influence the return for foreign investors. Overall, we believe the opportunities outweigh the risks. Against this background, we have raised the weighting of Japanese equities from "neutral" to "overweight". Since the majority of international investors have given Japan a wide berth in recent years, we see a good chance that they will also jump on the bandwagon.

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

EURO AREA COMPANIES ARE REPEATEDLY ACCUSED OF FUELLING INFLATION BY WIDENING THEIR PROFIT MARGINS. IS THERE ANY EVIDENCE FOR THIS SO-CALLED GREEDFLATION?

Inflation in the euro area, which had already picked up in 2021, accelerated markedly last year – particularly because of supply bottlenecks, which led to higher costs in many sectors (cost-push inflation). In fact, it can be observed that as a result of the outbreak of COVID two years ago, corporate profits in the euro area initially fell more sharply than employees' wages. However, after the pandemic-related accumulation of high household savings, corporate profits recovered more strongly than wages and nominal GDP in the post-pandemic phase, especially last year. Given that profit margins are a key determinant of when and how fast core inflation cools in the euro area, several ECB Executive Board members, including President Christine Lagarde, have also recently pointed out that many companies in the EU have not only been able to pass on their higher input costs in full to customers, but have actually raised their prices above their cost increases.

However, several surveys suggest that margin growth has now peaked and there may be potential for some margin compression in certain sectors. For their part, unions are keen to negotiate higher wages in the face of higher corporate profits, which should be helped by the tight labour market. Historically, higher wages have held back margin growth, as rising labour costs generally reduce corporate profits. Looking at the development of inflation figures in the coming months, the focus is therefore likely to be not only on profit margin growth, but also on wage growth.

PHILIP GISDAKIS, *Chief Investment Officer Germany, UniCredit Bank AG (HypoVereinsbank)*

DEVELOPMENT OF SELECTED FINANCIAL MARKET INDICES

From	**19.06.22**	19.06.18	19.06.19	19.06.20	19.06.21	19.06.22	19.06.18	**01.01.23**
To	**19.06.23**	19.06.19	19.06.20	19.06.21	19.06.22	19.06.23	19.06.23	**19.06.23**
Stock market indices (total return, in %)								
MSCI World (in USD)	**21.6**	5.0	3.5	35.9	-15.4	21.6	55.0	**14.9**
MSCI Emerging Markets (in USD)	**5.4**	-1.4	-2.2	40.0	-24.3	5.4	6.7	**8.3**
MSCI US (in USD)	**22.0**	7.9	7.8	37.6	-13.7	22.0	72.4	**16.0**
MSCI Europe (in EUR)	**18.8**	4.3	-4.0	27.4	-8.3	18.8	39.8	**11.6**
MSCI AC Asia Pacific (in USD)	**10.7**	-3.6	2.3	33.5	-22.8	10.7	12.3	**9.4**
STOXX Europe 600 (in EUR)	**18.4**	4.0	-2.8	27.8	-9.4	18.4	39.5	**11.4**
DAX 40 (Germany in EUR)	**23.4**	-2.9	-0.2	25.8	-16.5	23.4	26.2	**16.4**
MSCI Italy (in EUR)	**34.3**	0.7	-9.1	30.4	-11.4	34.3	44.3	**20.1**
ATX (Austria, in EUR)	**9.7**	-6.0	-21.1	53.4	-9.8	9.7	14.0	**5.3**
SMI (Switzerland, in CHF)	**11.6**	21.6	6.4	20.7	-10.5	11.6	54.9	**8.6**
S&P 500 (USA, in USD)	**22.1**	8.1	7.0	35.9	-11.7	22.1	73.5	**15.8**
Nikkei (Japan, in JPY)	**31.5**	-2.2	7.1	31.6	-8.8	31.5	62.8	**29.2**
CSI 300 (China, in Yuan)	**-6.6**	5.1	9.4	28.6	-13.9	-6.6	16.5	**2.3**
Bond market indices (total return, in %)								
US Government Bonds 10Y (in USD)	**-1.3**	11.0	16.2	-4.3	-12.9	-1.3	5.7	**2.1**
US Government Bonds (ICE BofA, in USD)	**-0.6**	7.5	10.4	-3.0	-10.2	-0.6	2.8	**1.9**
US Corporate Bonds (ICE BofA A-BBB, in USD)	**2.3**	9.6	9.8	4.0	-14.3	2.3	9.7	**3.0**
German Bunds 10Y (in EUR)	**-4.4**	7.9	1.5	-1.4	-15.8	-4.4	-12.7	**1.9**
EUR Government Bonds 1Y-10Y (iBOXX, in EUR)	**-3.5**	6.2	2.4	0.3	-14.3	-3.5	-9.5	**1.8**
EUR Corporate Bonds 1Y-10Y (iBOXX, in EUR)	**0.7**	4.1	-0.2	3.4	-13.7	0.7	-6.3	**1.9**
Bond yields (change in basis points = 0.01 percentage points)								
US Government Bonds 10Y (in USD)	**58**	-87	-131	74	173	58	90	**-1**
US Government Bonds (ICE BofA, in USD)	**95**	-79	-136	41	234	95	150	**9**
US Corporate Bonds (ICE BofA A-BBB, in USD)	**74**	-71	-103	-19	271	74	149	**4**
German Bunds 10Y (in EUR)	**86**	-66	-13	19	190	86	212	**-4**
EUR Government Bonds 1Y-10Y (iBOXX, in EUR)	**88**	-55	-22	3	198	88	209	**-3**
EUR Corporate Bonds 1Y-10Y (iBOXX, in EUR)	**71**	-46	19	-43	310	71	306	**2**
Spreads on government bonds (credit spreads, change in basis points)								
US Corporate Bonds (ICE BofA US Corporate Master)	**-15**	6	29	-71	63	-15	13	**-3**
US Corporate Bonds (ICE BofA US High Yield)	**-100**	76	199	-283	200	-100	81	**-64**
Euro Corporate bonds (ICE BofA Euro Corporate AAA-A)	**-27**	1	20	-39	90	-27	44	**0**
Euro Corporate Bonds (ICE BofA Euro High Yield)	**-117**	30	140	-212	250	-117	79	**-69**
Money market rates (change in basis points)								
Libor (USD, 3 months)	**342**	6	-204	-17	196	342	319	**75**
Euribor (EUR, 3 months)	**372**	-1	-7	-16	37	372	387	**142**
Euro exchange rates (change in %)								
US Dollar (EUR-USD)	**4.2**	-2.8	-0.9	6.0	-12.2	4.2	-6.0	**2.4**
British Pound (EUR-GBP)	**-0.3**	1.5	1.5	-4.7	0.0	-0.3	-2.7	**-3.9**
Swiss Franc (EUR-SFR)	**-3.3**	-2.8	-4.4	2.6	-7.5	-3.3	-15.4	**-0.8**
Japanese Yen (EUR-JPY)	**9.7**	-4.2	-1.6	9.3	6.9	9.7	20.8	**10.2**
Commodities (change in %)								
Commodity Index (GSCI, in USD)	**6.4**	4.9	23.9	-0.2	2.9	6.4	45.6	**7.4**
Industrial metals (GSCI, in USD)	**-8.7**	-16.3	-6.4	48.4	4.8	-8.7	11.1	**-5.2**
Gold (in USD per fine ounce)	**6.1**	5.5	25.7	3.0	3.8	6.1	52.7	**7.5**
Crude oil (Brent, in USD per barrel)	**-32.7**	-17.1	-34.2	77.1	54.7	-32.7	1.9	**-10.3**

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 19.06.2023.

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