Mixed signals

Group Investment Strategy

Monthly Outlook

May 2023

UniCredit

Index

Summary

Mixed signals

MACROECONOMIC UPDATE

The US economy continues to cool down, as indicated by recently published leading indicators. The ISM Manufacturing Index, which measures sentiment in the manufacturing sector, has been pointing to a contraction in economic activity in the US manufacturing sector since the end of last year and has recently fallen even further. We expect this slowdown to continue and the US economy to enter a mild recession around the middle of the year. Even the pessimists among US market observers do not expect a sharp economic slump in the event of a US recession. This assessment is supported by the recent robust US labour market data. The US economy is not in a structural crisis. Essentially, the braking effect of the interest rate hikes is noticeable.

In the euro area, economic and labour market data have recently held up well. Leading indicators are rising and point to a recovery of the economy. And current economic data such as manufacturing in the Eurozone, which increased by 1.0% and 1.5% in January and February, respectively, underline the encouraging economic recovery on this side of the Atlantic. The solid state of the economy should thus largely offset the looming risks from the weakening of the credit cycle as well as the financial market turbulence resulting from the tensions in the US and Swiss banking sector.

INFLATION AND MONETARY POLICY

US Inflation should moderate to around 3% by the end of 2023 and then to 2% by mid-2024. The latest inflation figures for March confirm that the disinflation process of many components in the consumer price index basket continues: the overall rate was 5.0% year-on-year in March (down from 6.0% in February), whereas the core rate remains stubbornly high above 5%.

The US Federal Reserve will thus continue to pursue its goal of fighting inflation, even though many analysts and investors expect that it is now close to the peak of its rate. Markets are now pricing in only one final 25 basis point (bps) rate hike at the upcoming Fed meeting in early May, based on a current US policy rate corridor of 4.75% to 5.0%.

Inflation in the euro area is on a downward trend, similar to the US, although the core rate has not yet peaked. After raising policy rates by 50 bps in March, market expectations regarding the ECB monetary policy suggest further interest rate hikes by a total of 0.75% from a current interest rate level (deposit rate) of 3.0%, bringing it to its peak of 3.75% in the middle of this year. We still do not expect interest rate cuts until mid-2024.

FINANCIAL MARKETS

Although weakening economic momentum is causing increased uncertainty, financial markets interpreted this development primarily as a sign that the interest rate peak – especially in the US – is likely to be reached soon. This recently provided some support to stock markets: the S&P 500 index, for example, gained around 0.6% between the end of March and 18 April, while the Stoxx Europe 600 index rose more than 1.7% over the same period. Yields on 10-year US government bonds rose by about 20 bps during this period, after falling by about 60 bps in March. Yields on 10-year German Bunds also increased, by just under 25 bps.

Experience shows that such turning points are associated with significant volatility across capital markets. We therefore currently advise a rather moderate course in investment strategy – without significant weighting in one direction or the other. Such a neutral positioning in equity markets is facilitated by the meanwhile high returns that can be achieved in bond markets. After the years of low and negative interest rates and the catastrophic year 2022, the bond market is back in the game and should be actively used by investors.

CIO's Letter

Mixed signals

Following the setback in March, stock markets have since largely recovered. The MSCI Europe even recently reached a new high for the year. In the wake of the March weakness in equity markets, government bond yields were also on the retreat, and despite a slight rebound in April, 10-year government bond yields remain well below recent highs, especially in the US. A decisive factor for the US bond markets is certainly the expectation of many analysts and investors that the US Federal Reserve (Fed) is now close to the peak of its rate hike cycle. Markets are now pricing in only one final 25 basis point (bps) rate hike at the upcoming Fed meeting in early May, based on a current US policy rate corridor of 4.75% to 5.0%. These expectations also reflect the increased risk of recession in the US, which has recently been underlined by the deteriorating leading indicators for the US economy. Among others, the ISM Manufacturing Index, which measures sentiment in the manufacturing sector, should be mentioned here. This has been pointing to a contraction in economic activity in the US manufacturing sector since the end of last year and has recently fallen even further.

In Europe, however, the situation is different. Leading indicators are rising (e.g., ifo index) and point to a recovery of the economy. Market expectations regarding the monetary policy of the European Central Bank (ECB) suggest further interest rate hikes by a total of 0.75% from a current interest rate level (deposit rate) of 3.0%. And current economic data such as manufacturing in the Eurozone, which increased by 1.0% and 1.5% in January and February, respectively, underline the encouraging economic recovery on this side of the Atlantic. Compared to the US, the European economy is indeed much more robust, which is also reflected in the development on the capital markets – stronger recovery of share prices and yields, but also a somewhat firmer EUR-USD exchange rate, which brings additional relief for energy prices.

The relatively better situation in Europe than in the US can also be seen in earnings expectations. These have been declining on both sides of the Atlantic since the third quarter of last year. In Europe, however, there are now signs of a bottoming out, whereas expectations for US companies continue to fall. In the US, this applies not only to expectations for the current year, but also to those for 2024, which continue to be successively revised downwards more or less in unison. Concerns about a recession in the US are therefore also weighing on expectations for the coming year. However, capital markets still expect decent earnings growth of around 10% in 2024 compared to 2023. US earnings should also grow by almost double digits in 2025. A clearly noticeable recession in the US is therefore not the base scenario reflected by implicit market expectations.

For Europe, the development of profit expectations is currently more stable than in the US – because it is now moving sideways. However, as is often the case in transatlantic comparisons, expected earnings growth in Europe is likely to be somewhat lower than in the US over the next two years. However, this expectation does not necessarily have to be a burdening factor for the European markets, as valuations measured by the price-earnings ratio (P/E) are significantly lower in this country. On average, European shares are thus valued much more favourably than their US counterparts. At the same time, the still high valuations of US equities in the current environment can depress the return expectations on this asset class for the coming years. A numerical example will illustrate this. The P/E ratio of the MSCI North America is currently almost 18.5 and thus almost on par with the P/E peak of the 15 years before the pandemic. This valuation puts US equities about 25% higher than the average of the 15-year period addressed. Shortly after the pandemic, however, valuations were significantly higher (peaking at P/E ratios of over 22), driven in part by the very low interest rates at the time. Before that, similarly high P/E ratios were found in the US after the turn of the millennium, i.e., during the dot-com bubble.

By comparison, valuations in Europe are a moderate 13. While they have risen in the wake of the stock market recovery in recent months, they are still well below pre-pandemic highs and more in the range of the corresponding average valuations of the pre-pandemic years. On the one hand, high current valuations reduce the medium-term return potential, as they make a significant contribution of a valuation expansion (i.e., an increase in the P/E ratio) to total return less likely. In other words, price gains in the case of high P/E ratios must be driven almost exclusively by earnings growth. On the other hand, high valuations increase the potential for a setback in the event of a recession.

The most important risk factor on capital markets today is therefore a possible recession in the US. It has recently become more prominent due to the significant interest rate hikes in recent quarters, but also because of developments in the US banking system, which have increased the risk of a restriction of credit availability for the US real economy. One of the most common financial market-based recession barometers for the US, the inversion of the US government bond yield curve (i.e., the fact that the yield for a 2-year maturity is higher than that for a 10-year maturity) has been pointing to a growing recession risk for some time. However, the high Compound Annual Growth Rate and the very low implied volatility (which is considered a fear barometer in the US equity market) only fit in with these increased recession risks to a limited extent. The non-congruent development regarding rising recession risks on the one hand and the rather confident attitude of US equity investors on the other is likely to increase the potential for setbacks on the US equity market.

Panic is not advisable, however, because even the pessimists among US market observers do not expect a sharp economic slump in the event of a US recession. This assessment is supported by the recent robust US labour market data. The US economy is not in a structural crisis. Essentially, the braking effect of the interest rate hikes is noticeable. However, should inflationary pressures ease as the US economy cools, which is likely, the central bank would have more leeway to reverse the latest interest rate hikes and provide partial relief for borrowing costs.

Overall, it is not easy to navigate the current economic and market environment, since in all likelihood an important turning point in US monetary policy is imminent with the approaching end of the Fed's interest rate hike cycle. Experience shows that such turning points are associated with significant volatility across capital markets. We therefore currently advise a rather moderate course in investment strategy – without significant weighting in one direction or the other. Such a neutral positioning in equity markets is facilitated by the meanwhile high returns that can be achieved in bond markets. After the years of low and negative interest rates and the catastrophic year 2022, the bond market is back in the game and should be actively used by investors. Interesting returns can be achieved here tactically and risk-adjusted (also compared to the equity markets). However, the following still applies: short-term bond investments such as time deposits make sense for a short transitional period at most (for example, because the capital will be needed elsewhere in the foreseeable future), because even with a time horizon of a few years, short-term interest rate investments perform less well in terms of returns when adjusted for inflation. Even with the increased short-term interest rates, real value preservation is hardly possible in view of the current rates of price increases (even if these should fall to a tolerable level again). The good news is, in view of the quite constructive medium-term economic and capital market outlook, an excessively defensive investment orientation (for example in time deposits) does not seem necessary at all.

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In Focus

Signs of a decline in lending, but impact on the economy remains to be seen

After individual banks with very specific problems in the US and Switzerland got into difficulties in March, which temporarily caused sharp falls in bank share prices and turbulence across financial markets, markets have shown themselves to be very resilient in retrospect – not least thanks to the rapid and decisive intervention of the supervisory authorities and governments in the US and Switzerland. As expected, after the phase of increased volatility, the focus shifted back to inflation and growth issues. At the same time, there are now increasing signs that recent events may be contributing to banks becoming more prudent in their lending – while credit demand is falling – with inhibiting effects on credit growth on both sides of the Atlantic.

US: LENDING BY COMMERCIAL BANKS PLUMMETED IN MARCH, BUT HAS STABILISED RECENTLY

The US economy has so far weathered the strongest monetary tightening in decades remarkably soundly. However, with an uncertain outlook for the economy, major US banks have tightened their lending standards for commercial and industrial loans and commercial real estate borrowers as early as the fourth quarter of 2022, according to the latest available **Federal Reserve (Fed) survey**[1]. In addition, lower demand for credit from firms and households is observed. According to Fed data, US banks expect a further tightening of lending standards, a weakening of demand and a deterioration of credit quality in the coming months. Moreover, in the Fed's **March Consumer Expectations Survey**[2], the share of households saying it was harder to get credit than a year earlier rose to its highest level since the 2014 survey. Small businesses have also found it harder to access credit, according to the National Federation of Independent Business (**NFIB**[3]).

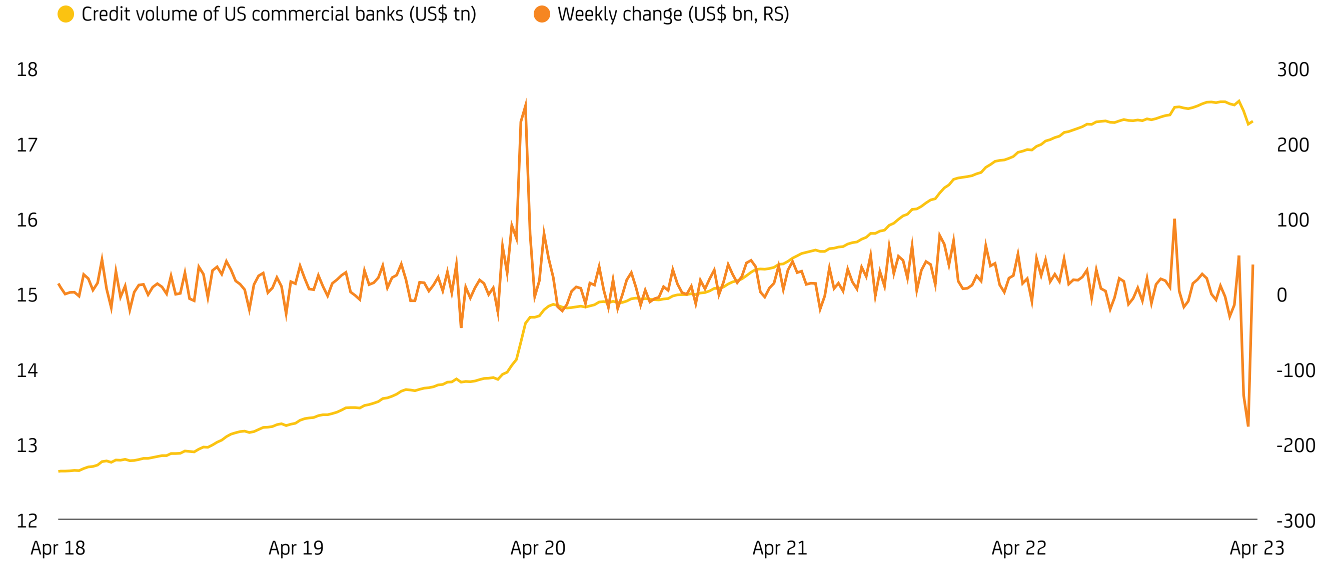
Because of the turmoil in the US financial sector, lending by commercial banks in the US has virtually collapsed (see Chart 1). It fell in the second half of March by the most since 1973, according to Bloomberg, primarily due to a decline in lending by small banks. However, while this development suggests a tightening of credit conditions, the causality is not entirely clear and conclusions as to whether the slump was primarily due to lower credit supply (and tighter lending practices by banks) or to extreme market volatility and its impact on credit demand seem premature. Data from the first week of April, moreover, suggest that the negative trend in the US has already been broken – signs that the effects of last month's banking stress has been successfully contained.

[1] See survey on banks' lending practices from January 2023 (link: https://www.federalreserve.gov/data/documents/sloos-202301-fullreport.pdf)

[2] See Fed survey on consumer expectations (link: https://www.newyorkfed.org/newsevents/news/research/2023/20230410)

[3] See press release from the National Federation of Independent Business (NFIB), a small business association in the US representing small and independent businesses (link: https://www.nfib.com/content/press-release/economy/small-business-optimism-declines-slightly-in-march)

1. LENDING BY US COMMERCIAL BANKS COLLAPSES IN MARCH, BUT SEEMS TO HAVE STABILISED AGAIN



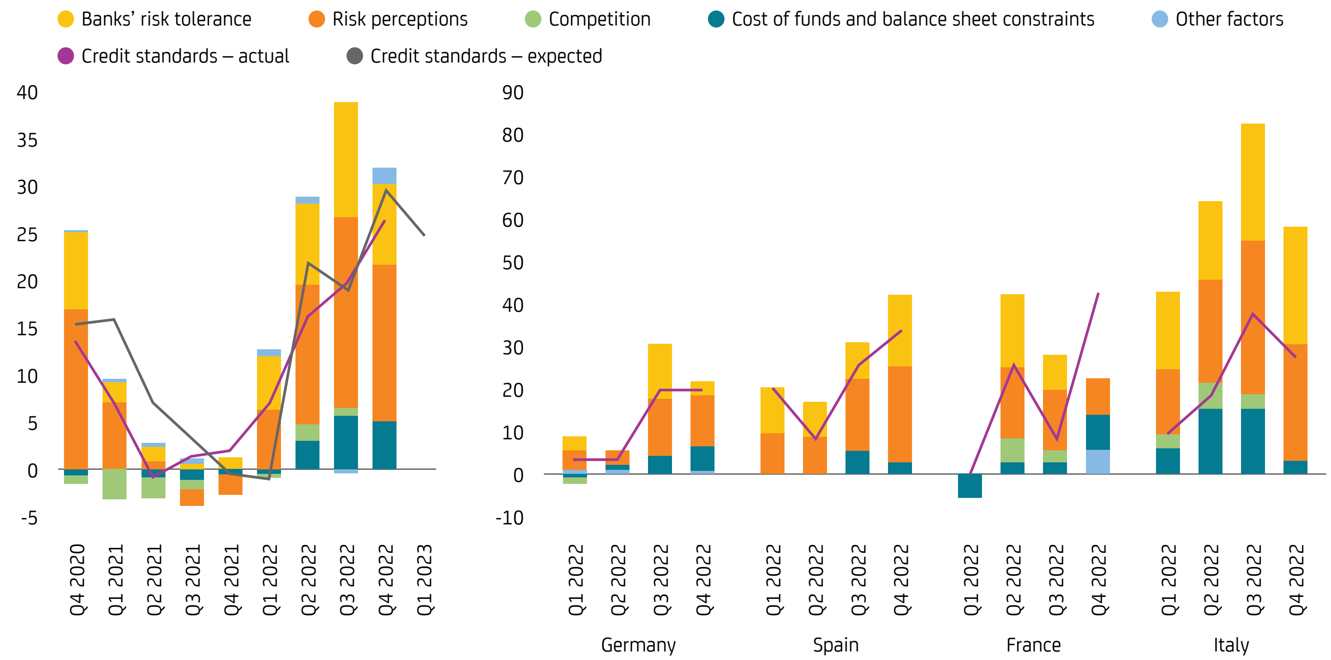
Source: Fed, Bloomberg, Group Investment Strategy
Observation period: 15.04.2018-15.04.2023

EURO AREA: ECB EXPECTS SLOWER CREDIT GROWTH

A look at the results of the latest ECB Euro Area Lending Survey (**Bank Lending Survey, BLS**[4]) from January 2023 shows that the guidelines for loans to companies in the euro area also tightened in the fourth quarter of 2022. Even before the turbulence across global financial markets in March (see Chart 2), 26% of banks reported more restrictive lending guidelines in view of increasing risks related to the economic outlook or sector- or company-specific situation, as well as a declining risk tolerance and higher financing costs – the last time the extent was comparable was during the sovereign debt crisis in the euro area in 2011. The lending guidelines for housing loans to households and for consumer loans or other loans to households also became more restrictive, according to the ECB.

[4]See also Bundesbank press release of 31 January 2023 (link: https://www.bundesbank.de/resource/blob/904056/f638118a4a7478463f978167d761928c/mL/2023-01-31-umfrage-kreditgeschaeft-download.pdf)

2. NET PERCENTAGES OF BANKS REPORTING A TIGHTENING OF CREDIT STANDARDS AND CONTRIBUTING FACTORS



Note: The percentage balance is defined as the difference between the sum of the respective shares (in percent) of banks that responded "tightened significantly" and "tightened slightly" and the sum of the shares (in percent) of banks that responded "loosened somewhat" and "loosened significantly". The item "other factors" includes any other factors that banks said had an impact on credit standards.
Source: ECB, UniCredit Group Investment Strategy

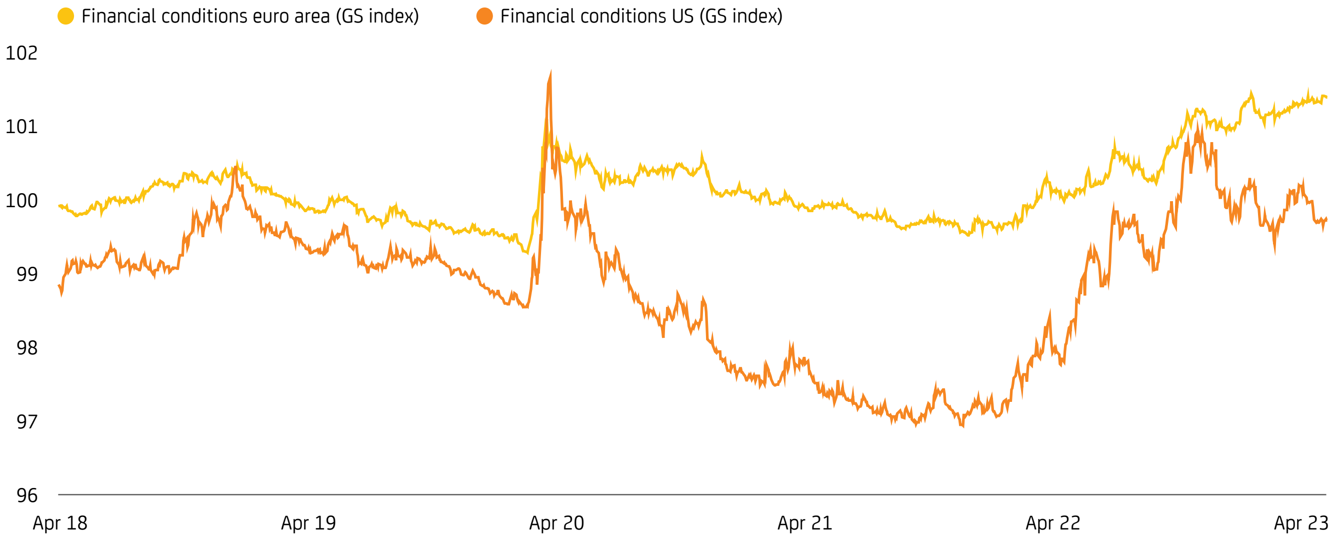
At the same time, however, demand for credit has also declined, for which the increased refinancing costs – because of the interest rate turnaround – are likely to be the cause. Accordingly, the latest monthly data from the ECB show a further slowdown in the growth of loans to businesses and households, although the year-on-year growth rate is still positive. For the first quarter of 2023, banks in the euro area expect a further tightening of guidelines for corporate, housing and consumer loans on balance, according to the ECB.

It seems obvious that credit growth in the euro area will weaken as financing conditions tighten. For example, the **GS Euro Area Financial Conditions Index**[5] indicates that, unlike in the US where conditions have returned to accommodative territory, conditions in euro area financial markets are currently even tighter than at the start of the pandemic (see Chart 3). The **ECB**[6] itself has signalled on several occasions that it expects tighter lending standards and slower credit growth, in addition to the fact that potentially waning consumer and investor confidence could weigh on credit demand.

[5]The Goldman Sachs Financial Conditions Index (FCI) is defined as "a weighted average of riskless interest rates, the exchange rate, equity valuations, and credit spreads, with weights that correspond to the direct impact of each variable on GDP." (see also: https://www.goldmansachs.com/insights/pages/case-for-financial-conditions-index.html)

[6]See, inter alia, remarks by ECB Vice-President Luis de Guindos of 1 April (link: https://www.ecb.europa.eu/press/key/date/2023/html/ecb.sp230401~d66e5a2335.en.html)

3. FINANCING CONDITIONS IN THE EURO AREA AND THE US



Note: A value below 100 indicates accommodative conditions, while a value above 100 indicates tightening.
Source: Bloomberg, Goldman Sachs Research, UniCredit Group Investment Strategy
Observation period: 15.04.2018-15.04.2023

Interestingly, more recent surveys in Germany so far do not indicate that the events in March have led to banks becoming more restrictive in granting corporate loans. According to a survey by the **ifo Institute**[7], 22.7% of companies that were negotiating with their banks at the time of the survey reported in March that the latter had become more cautious in granting loans. Compared with December (30.0%), their share has fallen significantly. Especially in industry (from 27.8% to 17.3%) and in the services sector (from 34.6% to 26.5%), significant decreases in the so-called **credit hurdle**[8] can be observed. Whether this trend will continue, however, seems questionable. For example, a **study by the auditing and consulting firm EY**[9] shows that in Germany, two out of three German banks expect a decline in lending this year.

[7]See also ifo press release of 31 March 2023 (link: https://www.ifo.de/pressemitteilung/2023-03-31/banken-weniger-zurueckhaltend-bei-kreditvergabe-fuer-unternehmen)

[8]In the quarterly ifo business surveys, participating companies are asked to rate the willingness of banks to lend, from which the institute calculates the "credit hurdle" indicator.

[9]See also EY Credit Market Study 2023 (Link: https://assets.ey.com/content/dam/ey-sites/ey-com/de_de/news/2023/04/ey-kreditmarktstudie-2023.pdf)

IMPLICATIONS FOR MONETARY POLICY AND ECONOMIC DEVELOPMENT

The interplay of tensions in the banking sector, persistently high inflation, and restrictive ECB policy has recently been empirically analysed by Goldman Sachs Research, which concludes that sharp falls in bank share prices have in the past often led to tighter credit conditions and subsequently declining lending – with depressing effects on economic growth on the one hand and slightly dampening effects on core inflation on the other, to which the ECB has usually responded by lowering the deposit rate. While it seems premature for the central bank to make a final judgement on the impact of recent developments on growth and inflation, the Governing Council is likely to increasingly weigh the extent to which the recent banking stress could weigh on the economy with a view to the further interest rate path. We expect the impact to be noticeable, albeit manageable, but we assume it to be more pronounced in the US than in the euro area. In any case, investors' and analysts' attention will be focused on the upcoming publication of Fed and ECB bank lending surveys in the US and Eurozone in early May, which should provide new evidence on lending in the euro area – and thus also on further economic and monetary policy developments.

Macro & Markets

US economy on the brink of recession, Euro Area outlook improves

US ECONOMY: LIKELY TO WEAKEN FURTHER, CONTRACTION PROBABLY AROUND MID-YEAR

The US economy continues to cool down. This is indicated by recently published leading indicators (among others, the ISM index for manufacturing and services continued to weaken). We expect this slowdown to continue and the economy to enter a mild recession around the middle of the year (i.e. slightly negative growth in the second and third quarters of 0.3% each compared to the previous quarter). This is also indicated by the dwindling "savings surpluses" of private households, declining growth in consumer credit and a persistently weakening labour market. All in all, the latter factors are likely to weigh on private consumption – until now, a major pillar of GDP growth. A further tightening of credit conditions for households and businesses (see comments in the In Focus section), as a result of tensions in the US banking sector, could also exacerbate the effects of tighter monetary policy. According to the Fed's minutes of the March meeting, the Fed's academic staff also expects a mild recession later this year. We project GDP growth of 0.5% for 2023 as a whole and 0.8% for 2024 (see Chart 4). Inflation should moderate to around 3% by the end of 2023 and then to 2% by mid-2024. The latest inflation figures for March confirm that the disinflation process of many components in the consumer price index basket continues: the overall rate was 5.0% year-on-year in March (down from 6.0% in February), whereas the **core rate**[10] remains stubbornly high above 5%. For this reason, the Fed will continue to pursue its goal of fighting inflation, even though the interest rate peak it is aiming for is approaching. In March it raised the key interest rate to 5% (upper band) and we expect key interest rates to peak in May after a final hike of 25 basis points (bps). We do not expect total rate cuts of 150 bps until 2024.

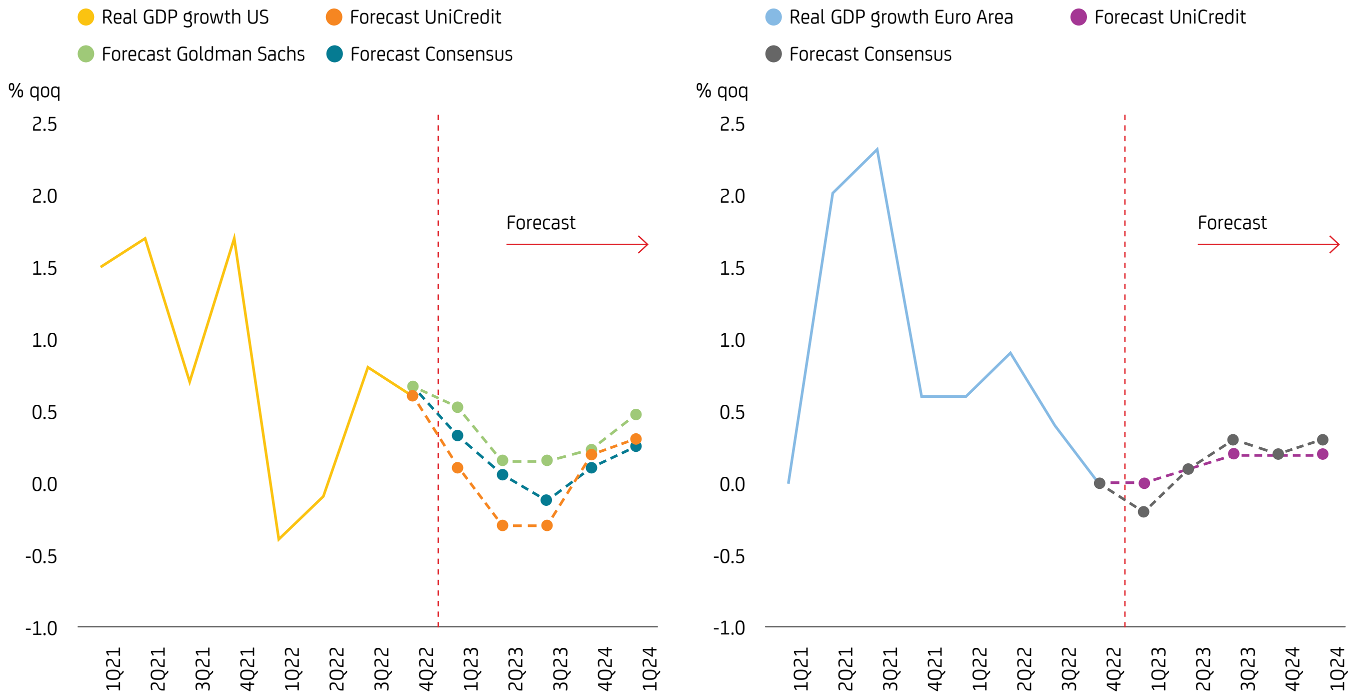
[10] This represents headline inflation excluding the volatile components of energy and food and therefore provides a better measure of underlying inflationary pressures.

EURO AREA: RESILIENT ECONOMY DEFIES RECESSION

In the euro area, economic and labour market data have held up well recently. The solid state of the economy should thus largely offset the looming risks from the weakening of the credit cycle as well as the financial market turbulence resulting from the tensions in the US banking sector and the events surrounding a major Swiss bank. Accordingly, we do not see any significant contraction in the coming quarters and thus **no (technical) recession**[11], which is primarily due to the avoidance of an energy crisis in Europe, especially the absence of a gas shortage. Nevertheless, high inflation and tightening credit conditions are likely to weigh on growth during 2023 (see comments in the In Focus section). We confirm our growth forecast of around 0.5% for 2023 as a whole and 1.0% for 2024 (see Chart 4). Inflation in the euro area is on a downward trend, similar to the US, although the core rate has not yet peaked. Accordingly, we expect the ECB to continue its tightening stance after raising policy rates by 50 bps in March. The deposit rate is likely to be raised again, by 25 bps in May as well as in June and July, which would bring the deposit rate to its peak of 3.75% in the middle of 2023. We still do not expect interest rate cuts of 75 bps in total until mid-2024.

[11] Technical recession refers to two consecutive quarters of negative growth.

4. US ECONOMY ON THE BRINK OF A MILD RECESSION, EURO AREA SHOULD LEAVE SLOWDOWN BEHIND SOON



Source: Bloomberg, Consensus, Goldman Sachs, UniCredit Research, UniCredit Group Investment Strategy

CHINA'S ECONOMY RECOVERS SIGNIFICANTLY AT THE BEGINNING OF THE YEAR

In China, economic indicators have also improved significantly recently. The key purchasing managers' indices were all in economic expansion territory in March, pointing to a continued recovery. Chinese GDP grew by 2.2% quarter-on-quarter in the first quarter, up from just 0.6% in the fourth quarter of 2022. Chinese consumers were primarily responsible for the significant upturn at the start of the year, after having significantly curtailed their spending over an extended period due to the strict lockdown measures resulting from the government's zero-Covid policy. We expect the economic recovery in China to continue throughout the year and project GDP growth of around 5% in 2023 – bringing our figures in line with the new growth target of "around 5%" set by the government in early March. For 2024, we see somewhat lower growth of around 4.5%. The less ambitious growth expectations than in the past result from a number of factors that are a lasting burden on China's economic activity. These include structural challenges such as weak productivity, an ageing population, and a real estate sector that is prone to corrections. On the other hand, the government has again announced that no major stimulus programmes are planned. However, fiscal and monetary policies are likely to remain moderately supportive.

PROSPECT OF AN IMMINENT INTEREST RATE PEAK IN THE US SUPPORTS FINANCIAL MARKETS

After the financial market turbulence in March, which was triggered by the tensions in the US banking sector and the crisis of a major Swiss bank, weaker US economic data in April shifted the focus of the markets increasingly to growth issues, as expected. Although weakening economic momentum is causing increased uncertainty, financial markets interpreted this development primarily as a sign that the interest rate peak – especially in the US – is likely to be reached soon. This recently provided some support to stock markets: the S&P 500 index, for example, gained around 0.6% between the end of March and 18 April, while the Stoxx Europe 600 index rose more than 1.7% over the same period. Yields on 10-year US government bonds rose by about 20 bps during this period, after falling by about 60 bps in March. Yields on 10-year German Bunds also increased, by just under 25 bps. The resulting lower yield differential between US and German government bonds and the markets' continued restrictive key interest rate expectations for the euro area significantly supported the euro in April: the EUR-USD exchange rate continued to appreciate and at times even broke through the 1.10 mark. On the commodity markets, the gold price rose by around 1% between the end of March and 18 April, while the Brent oil price moved largely sideways during – despite the OPEC+ announcement that it intends to cut oil production from May onwards – and was most recently quoted at around USD85 per barrel (as of 18 April 2023).

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

The macro picture resilience has ignited a rebound on equities 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 crucial.

NEUTRAL EUROPEAN EQUITIES

Restrictive ECB policy but first quarter recovery in the PMIs and rising manufacturing output. Cheap valuation, the value/ cyclical bias and investors' underpositioning support European equities, despite the ongoing high geopolitical risk (Russia / Ukraine war).

NEUTRAL US EQUITIES

Still robust jobs market and earnings resilience, but rising uncertainty due to fears of credit crunch / recession. The rich valuation makes US equities vulnerable in the case of an economic downturn.

NEUTRAL EMERGING MARKET EQUITIES

China's economy is benefiting from the economic reopening and supportive monetary and fiscal policies. Overall, valuations are cheap for EM equities. Increasing confrontation between US and China is a major source of concern. Countries and sectors selectivity among EMs is strongly recommended.

NEUTRAL PACIFIC EQUITIES

China's economic reopening is a positive but there is 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 the case of an overheating economy. This will likely lead to a stronger Japanese yen and affect equity markets, particularly exporters.

NEUTRAL GLOBAL BONDS

Competitive yields and main central banks expected to become gradually less hawkish / expansive, although core inflation is showing signs of 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 given the potential for a sharp weakening of the macro picture.

NEGATIVE HIGH YIELD CORPORATE BONDS

Spreads do not yet fully discount the possible economic slowdown, especially in the US, due to more restrictive lending conditions. Also, the asset class is relatively less liquid.

NEUTRAL EMU GOVERNMENT BONDS

Despite high core inflation, we expect the ECB to be sensitive to a slowdown and/or credit crunch concerns.

NEUTRAL NON-EMU GOVERNMENT BONDS

Competitive yields and the Fed is close to a pivot despite a stickier core services inflation.

OVERWEIGHT EMERGING MARKET BONDS

Supported by expectations of the Fed's pivot and weakening USD. We stay defensive and selective, avoiding countries with high external debt and current account deficits.

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 decorrelation opportunities, while real assets benefit from their inflation-hedging role.

NEUTRAL COMMODITIES

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

POSITIVE GOLD

Supported by expectations of falling US rates, weaker 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

CURRENT SCENARIO

MONETARY POLICY

The US Federal Reserve (Fed) will continue to pursue its goal of fighting inflation, even though the interest rate peak it is aiming for is approaching. In March, the Fed raised the key interest rate to 5% and we expect key interest rates to peak in May after a final hike of 25 basis points (bps). We expect the European Central Bank (ECB) to continue its tightening stance after raising policy rates by 50 bps in March. The deposit rate is likely to be raised again, by 25 bps in May as well as in June and July, which would bring it to its peak of 3.75% in the middle of this year. We still do not expect interest rate cuts until mid-2024.

INFLATION

US Inflation should moderate to around 3% by the end of 2023 and then to 2% by mid-2024. The latest inflation figures for March confirm that the disinflation process of many components in the consumer price index basket continues: the overall rate was 5.0% year-on-year in March (down from 6.0% in February), whereas the core rate remains stubbornly high above 5%. Inflation in the euro area is on a downward trend, similar to the US, although the core rate has not yet peaked.

ECONOMIC GROWTH

The US economy continues to cool down, as indicated by recently published leading indicators. We expect this slowdown to continue and the US economy to enter a mild recession around the middle of the year. In the euro area, economic and labour market data have recently held up well. The solid state of the economy should thus largely offset the looming risks from the weakening of the credit cycle as well as the financial market turbulence resulting from the tensions in the US banking sector and the events surrounding a major Swiss bank.

HOW TO INVEST

BOND INVESTMENTS

Corporate bonds currently show very attractive yields overall. In terms of the risk-reward profile – given the relatively high level of benchmark yields and considering current credit spreads – we recommend increasing the allocation to high quality Investment Grade (IG) Corporate Bonds, which are more resilient in the event of a weakening macro picture.

OUR IDEA: HIGH QUALITY CORPORATE IG BONDS

Last year we saw a quick shift from an ultra-low interest rate situation to a more normal context. 2022 was the worst year ever in terms of total return for Euro Corporate IG bonds (-14%); from mid-October 2022 to the beginning of March we have seen signs of recovery as investors have started to price the peak of inflation and central banks pivot, while spreads recovered from post-pandemic highs. In March markets experienced a new wave of volatility – with flight-to-quality into Govies and widening credit spreads, especially for financial paper – due to the regional banks crisis in the US and its spill-over to weaker global players.

Looking ahead, despite this unexpected risk aversion phase, we think that in terms of risk-reward, high-quality corporate IG bonds are the right place to invest. They combine good standing, compelling yield (around 4%, as of April 13th), and appealing credit spreads, particularly after the recent widening. Currently, high rated Euro IG segments, such as the A segment, offer yields similar to what Euro High Yield offered a year ago.

Overall IG credit fundamentals are strong: solid balance sheets, better-than expected earnings, healthy cash balances and leverage levels not stretched vis-à-vis their long-term averages allow European corporates to face even a challenging market environment in a comfortable position. Default rates should remain low even if higher defaults are expected as a consequence of tightening lending conditions after the recent banking turmoil and the slowing economy.

Technicals are sound: net supply should be low for the rest of the year, due to high cash positions, limited M&A activity and conservative financial policies across companies. After a strong start to the year and a stall in March due to the market tensions, demand should come back to the IGs – which are usually the first to attract yield buyers after a period of volatility – providing an offset to the end of the ECB's quantitative easing.

In the second half of 2023 rate hikes will likely pause in a context of a softening economic cycle and decreasing volatility for base yields, the most favourable scenario for high quality IGs. However, credit selection will continue to be a must against tail risks – with still high inflation, uncertain central banks' response and quantitative tightening policies, and a challenging economic backdrop could generate new volatility episodes. This should be considered as a buying opportunity for long-term investors.

EQUITY INVESTMENTS

The macroeconomic resilience has triggered a rebound in equities, 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 crucial. Cheap valuations, the value/ cyclical bias and investors' underpositioning support European equities, despite the ongoing high geopolitical risk. The US market is currently characterised by a still robust jobs market and earnings resilience but rising uncertainty due to fears of credit crunch and recession. Rich valuations make US equities vulnerable in the case of an economic downturn.

OUR IDEA: ARTIFICIAL INTELLIGENCE (AI)

ChatGPT is a natural language foundation model designed for user interactions through human-like conversations. It is built from OpenAI's GPT (Generative Pretrained Transformer) model family. 'Generative AI' can be described as deep-learning models that are trained on vast amounts of data (potentially all Internet). Once trained, they become the 'foundation' model. The parameters of this model are then adjusted and updated such that they become new models, more specific and specialized.

ChatGPT, with its record of one million users reached in five days, is the best example of the accelerating pace of consumer adoption and it represents the "iPhone moment" for AI. The success of the iPhone was essentially linked to the fact that it enabled anyone (from children to the elderly) to use "advanced technologies" because of its extremely intuitive user interface. Its functionality and adoption were immediately boosted by the introduction of the App Store, which allowed third parties to develop and commercialize new business ideas. Similarly, ChatGPT rapidly became popular especially among "non-experts", thanks to a simple interface that offers the user answers to real needs, even complex ones, for own personal and daily use.

All the major technology companies, along with a variety of startups, have started to invest in building their Natural Foundation Model. In the short term, the investment implications of ChatGPT may be difficult to identify, as the costs of this innovative technology will initially weigh on companies' financials, while revenues will follow with lag. Among the big software techs, the greatest beneficiaries will be those who have been first movers as well as the ones who will not suffer from "the innovator's dilemma", a situation in which, faced by a new technology, a company is forced to choose between not adopting it, with the risk of losing a potential competitive advantage, or adopting it, with the risk of cannibalizing its existing business. Along with software companies, the other winners are semiconductor companies that develop the chips that are the engine on which AI algorithms run and provide the significant computing power needed to train the Natural Foundation Model.

DEVELOPMENT OF SELECTED FINANCIAL MARKET INDICES

From	**20.04.22**	20.04.18	19.04.19	20.04.20	20.04.21	20.04.22	20.04.18	**01.01.23**
To	**20.04.23**	20.04.19	20.04.20	20.04.21	20.04.22	20.04.23	20.04.23	**20.04.23**
Stock market indices (total return, in %)								
MSCI World (in USD)	**-3.7**	4.7	-5.4	49.2	4.6	-3.7	48.9	**9.2**
MSCI Emerging Markets (in USD)	**-6.6**	-5.1	-15.2	53.5	-16.6	-6.6	-3.8	**4.1**
MSCI US (in USD)	**-6.5**	10.0	-0.8	51.6	7.6	-6.5	66.4	**8.2**
MSCI Europe (in EUR)	**5.6**	6.1	-11.9	31.5	10.1	5.6	43.0	**11.4**
MSCI AC Asia Pacific (in USD)	**-2.6**	-4.4	-9.0	47.6	-15.2	-2.6	6.1	**5.3**
STOXX Europe 600 (in EUR)	**4.8**	5.9	-11.2	32.8	9.0	4.8	42.6	**11.1**
DAX 40 (Germany in EUR)	**10.0**	-2.8	-12.7	41.7	-5.1	10.0	25.7	**13.5**
MSCI Italy (in EUR)	**15.0**	-5.2	-21.2	42.3	7.0	15.0	30.8	**16.0**
ATX (Austria, in EUR)	**2.6**	-2.4	-35.4	56.7	8.9	2.6	10.5	**5.1**
SMI (Switzerland, in CHF)	**-5.1**	11.7	5.5	17.7	14.3	-5.1	50.4	**8.5**
S&P 500 (USA, in USD)	**-5.8**	10.1	-0.9	48.9	9.4	-5.8	67.4	**8.1**
Nikkei (Japan, in JPY)	**7.7**	2.1	-9.4	50.3	-4.7	7.7	42.9	**10.9**
CSI 300 (China, in Yuan)	**3.4**	10.6	-4.4	34.7	-18.5	3.4	20.0	**6.3**
Bond market indices (total return, in %)								
US Government Bonds 10Y (in USD)	**-2.3**	5.6	23.3	-6.4	-9.6	-2.3	7.6	**4.0**
US Government Bonds (ICE BofA, in USD)	**-2.3**	4.4	15.3	-4.5	-7.1	-2.3	4.3	**2.9**
US Corporate Bonds (ICE BofA A-BBB, in USD)	**-1.3**	5.7	9.2	5.9	-9.1	-1.3	9.7	**3.6**
German Bunds 10Y (in EUR)	**-11.0**	7.1	5.0	-1.5	-9.4	-11.0	-10.8	**2.1**
EUR Government Bonds 1Y-10Y (iBOXX, in EUR)	**-10.3**	2.3	3.7	2.7	-8.4	-10.3	-10.4	**1.4**
EUR Corporate Bonds 1Y-10Y (iBOXX, in EUR)	**-6.1**	2.8	-1.6	6.5	-7.3	-6.1	-6.3	**1.9**
Bond yields (change in basis points = 0.01 percentage points)								
US Government Bonds 10Y (in USD)	**62**	-36	-194	95	135	62	62	**-29**
US Government Bonds (ICE BofA, in USD)	**113**	-21	-198	42	183	113	119	**-27**
US Corporate Bonds (ICE BofA A-BBB, in USD)	**117**	-18	-70	-84	191	117	136	**-24**
German Bunds 10Y (in EUR)	**162**	-57	-47	15	112	162	185	**-12**
EUR Government Bonds 1Y-10Y (iBOXX, in EUR)	**177**	-12	-33	-26	111	177	216	**-5**
EUR Corporate Bonds 1Y-10Y (iBOXX, in EUR)	**207**	-21	52	-103	161	207	297	**-12**
Spreads on government bonds (credit spreads, change in basis points)								
US Corporate Bonds (BofAML US Corporate Master)	**9**	7	119	-140	33	9	28	**0**
US Corporate Bonds (BofAML US High Yield)	**98**	40	379	-417	21	98	121	**-25**
Euro Corporate bonds (BofAML Euro Corporate AAA-A)	**18**	10	73	-88	40	18	53	**-4**
Euro Corporate Bonds (BofAML Euro High Yield)	**33**	57	283	-334	122	33	161	**-39**
Money market rates (change in basis points)								
Libor (USD, 3 months)	**414**	22	-148	-91	95	414	291	**51**
Euribor (EUR, 3 months)	**369**	2	7	-29	6	369	354	**108**
Euro exchange rates (change in %)								
US Dollar (EUR-USD)	**1.1**	-9.1	-3.5	11.0	-10.1	1.1	-11.6	**2.6**
British Pound (EUR-GBP)	**6.3**	-0.6	1.0	-1.2	-3.9	6.3	1.4	**-0.6**
Swiss Franc (EUR-SFR)	**-4.3**	-5.0	-7.6	4.9	-7.0	-4.3	-18.1	**-0.4**
Japanese Yen (EUR-JPY)	**6.5**	-5.3	-7.0	11.6	6.0	6.5	11.0	**4.8**
Commodities (change in %)								
Commodity Index (GSCI, in USD)	**2.5**	-6.0	33.2	0.9	9.3	2.5	41.5	**10.2**
Industrial metals (GSCI, in USD)	**-21.3**	-15.8	-19.3	59.6	31.5	-21.3	12.1	**0.2**
Gold (in USD per fine ounce)	**2.4**	-5.2	32.7	4.9	10.0	2.4	48.7	**10.2**
Crude oil (Brent, in USD per barrel)	**-24.1**	-3.8	-64.3	160.0	60.3	-24.1	8.6	**-4.5**

Please note: Past values and forecasts are not a reliable indicator of future performance. Indices cannot be purchased and therefore do not include costs. When investing in securities, costs are incurred which reduce the performance. The return on investments in foreign currencies may also rise or fall as a result of currency fluctuations. So-called synthetic bonds are calculated to reflect the performance of government bonds in a fixed maturity range. In each case, the most "suitable" real federal bond at the relevant time is used as a reference for the yield opportunity of the synthetic bond. The development of the expected yield to maturity is shown under the following conditions: servicing of interest payments and redemption in accordance with the terms and conditions and holding until maturity. In this respect, it is a yield opportunity. The yield opportunities reflect the different risk assessments of the investors for the respective products or countries (higher yield opportunity=higher risk assessment). The synthetic bonds cannot be purchased and therefore do not include any costs. In the case of currencies and commodities, acquisition and/or custody costs incurred are not included. Source: Refinitiv Datastream. Data as at 20.04.2023.

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