Balancing act

Group Investment Strategy

Monthly Outlook

November 2023

UniCredit

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Summary

Balancing act

MACROECONOMIC UPDATE

Global economic growth is expected to slow to 2.9% this year. We do not expect too strong a recovery in 2024 either, with GDP growth estimates of 2.5%. The slowdown is largely due to the lagged effect of tighter monetary policy, while buffers from pandemic-induced household savings surpluses continue to diminish and support from fiscal policy weakens.

For the US, we now expect somewhat stronger growth around 2% this year but anticipate a significant weakening of economic momentum at the turn of the year 2023/24 and largely stagnant annual growth in 2024 as a whole. Economic indicators have so far proved to be quite robust. Private consumption was unexpectedly strong in the third quarter. However, this strength is unlikely to last, as the labour market in particular continues to weaken, credit conditions are becoming much more restrictive, and savings are expected to decline further.

In the euro area, growth is likely to stagnate at best in the second half of the current year, after we had previously assumed moderate expansion. While we see GDP growth unchanged at 0.5% this year, we expect only 0.6% for 2024. Economic indicators have cooled down further recently, with industry in particular still in a marked phase of weakness, and the services sector has also noticeably lost momentum.

INFLATION AND MONETARY POLICY

At its September meeting, the Fed left the key interest rate unchanged at the upper end at 5.50%, although the so-called “dot plot” (the interest rate outlook of the Monetary Policy Council) continues to point to a further increase this year. For the two following years, the central bank now expects fewer rate cuts than before, with policy rates falling to only 5.1% in 2024 and 3.9% in 2025. On the inflation side, we expect the headline inflation rate to fall back to around 2% by the end of next year, with the core rate still slightly above target. Given this macroeconomic environment, we assume that the Fed has reached its interest rate peak and expect interest rate cuts of a cumulative 150 bps from March 2024 until the end of the year.

In September the ECB raised key interest rates by 25 bps and it signalled that the tightening cycle is now probably complete. On the inflation side, we expect inflation to reach 3.5% this year and 2.6% in 2024. Accordingly, we assume that the central bank will start cutting interest rates next year. Overall, we expect a key interest rate cut by a cumulative 75 bps in the course of next year, probably starting in the middle of the year.

FINANCIAL MARKETS

In the current environment, there is much to be said for an investment strategy with a balanced allocation of equities and bonds. Within the bond portion, longer-dated bonds appear increasingly attractive. With longer maturities, investors secure the currently higher yielding environment, and with the recent rise in yields at the long end, the interest rate disadvantage compared to very short-dated paper has decreased.

CIO's Letter

Balancing act

The terrible terrorist attack by Hamas on Israel at the beginning of October has once again shown us the fragility of the Middle East. The depressing images, and a second war in the immediate vicinity of Europe, are weighing on sentiment and increasing uncertainty across global financial markets. However, the market's reaction to the newly flared-up conflict has not been lasting. For example, unlike during previous crises, there were no massive price increases in either oil or government bonds in the week following the terrorist attack. Only the price of gas increased significantly, but this was not only driven by Israel suspending production in a gas field off its southern coast, but also by a damaged pipeline between Finland and Estonia. Nevertheless, the war hangs over the heads of investors like a sword of Damocles. Increasing tensions in the north of Israel, on the Lebanese-Israeli border, heighten fears of a possible escalation, and as long as there is no sign of an easing, the situation is likely to remain volatile across markets as well.

The most important transmission channel of events in the Middle East into the economy and markets is the oil price. This has been quite volatile in recent weeks – even before the terrorist attack. How can this transmission channel be classified and what risks could materialize for the economy and markets? It is also important to consider how limited, in a regional sense, the conflict remains (see also In Focus section). While in the case of a local limitation, the effects on the economy and markets should also remain manageable, an escalation of the conflict in the region that produces about one third of the world's crude oil, i.e. an active intervention of further countries, such as Iran, would have far-reaching consequences – not only for the oil market, but presumably for financial markets as a whole.

Given the nature of the conflict, it seems difficult to forecast the future course of events. However, an escalation with massive economic repercussions is a risk, and not a base case scenario, in our view. The oil price as a transmission channel creates a complex (because it is non-linear) risk profile for the capital markets: A moderate and slow increase in the oil price (which is, for example, what the production cuts of the OPEC+ oil exporters are aimed at) means increasing inflationary pressure on the one hand, but does not necessarily lead to further interest rate hikes by the central banks. A massive and sudden increase in oil prices, on the other hand, has an inflationary effect in the short term, but would lead to a significant slump in growth in the medium term, which could have a strong disinflationary or even deflationary effect as a result. In such a scenario, it would not be impossible that the central banks would be forced to even lower interest rates in order to stabilise the economy.

In the current mixed situation, it seems important for investors to observe three (partly interdependent) framework conditions very closely and to assess their implications for global financial markets. The first component describes the cyclical (or business cycle) position in the growth cycle. This is currently essentially characterised by the economic slowdown desired by central banks, which is ultimately inevitable in order to get inflationary pressures under control. However, despite the massive interest rate hikes of the past quarters, the economy in both Europe and the US is proving surprisingly robust. The second component is of a structural nature and comprises possible burdens, but also opportunities, of an economy. Europe is confronted with numerous, multi-dimensional challenges. For example, the transformation of our energy supply requires significant investments, which in turn can generate growth and boost markets. The third component is the newly flared-up conflict. From an economic perspective, it is a (possible) exogenous shock that can have both cyclical and structural effects, but could also have a temporary impact.

For investors, the question is what might happen next following the turbulent and volatile start to the final quarter of this year? While the Middle East conflict has caused risk premiums to rise in the short term (and is likely to continue doing so in the event of a further escalation), the cyclical and structural components argue for a good mix of equities and bonds in a multi-asset portfolio in the medium to long term, in which high yielding investments such as equities and corporate bonds should not be neglected. In the medium term, it is likely to be difficult to achieve real (i.e. inflation-adjusted) value preservation with overly defensive investment strategies, as the yield on bonds is likely to fall in parallel with falling inflation rates.

Despite the numerous uncertainty factors, we believe that a continuation of the recent constructive trend is possible. Although this is characterised by the expectation of an economic slowdown, a long and severe recession is not expected. Growth rates – both for the euro area and the US – should accelerate again in the course of 2024. However, the scenario of a (limited) economic slowdown is already reflected in the markets. At the same time, the war in Israel and Palestine represents an additional risk for the global economy, to which one should not close one's eyes. Moreover, statistically speaking, a year-end rally is not unusual in the year before a US presidential election. For such a rally to materialise, however, a number of factors would have to play a role. In particular, yields on 10-year US Treasuries would have to stabilise or, even better, fall sustainably. With a view to further developments on the markets, much therefore depends on the future course of monetary policy, i.e. on the question of whether interest rates (and bond yields) have peaked or when the Federal Reserve (Fed) can start to lower interest rates. We expect that it has already reached the interest rate peak and anticipate interest rate cuts of a cumulative 150 basis points (bps) in the coming year (possibly starting in March). Concerns about a further economic slowdown in the euro area should also prevent the European Central Bank (ECB) from raising interest rates further.

In the current environment, there is much to be said for an investment strategy with a balanced allocation of equities and bonds. Within the bond portion, longer-dated bonds appear increasingly attractive. With longer maturities, investors secure the currently higher yielding environment, and with the recent rise in yields at the long end, the interest rate disadvantage compared to very short-dated paper has decreased. In addition, a balanced mix of currencies, taking into account the usual safe haven US dollar and not ignoring gold, should adequately reflect the current market environment.

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In Focus

Is the war in the Middle East causing a new rise in energy prices?

Hamas' surprise attacks on Israel are rekindling old concerns about high energy costs. Even though neither Israel nor the Palestinian territories produce relevant quantities of oil, the impact of the conflict on the region is fuelling fears that the war could further affect the oil production of the leading producers in the Middle East (and thus the global energy markets), and lead to a prolonged period of high oil prices. The extent to which energy prices, and thus global financial markets, will be affected by the situation in Israel is likely to depend primarily on whether a supra-regional conflict is to be expected. We try to classify possible scenarios, and consider the related effects for inflationary pressures worldwide.

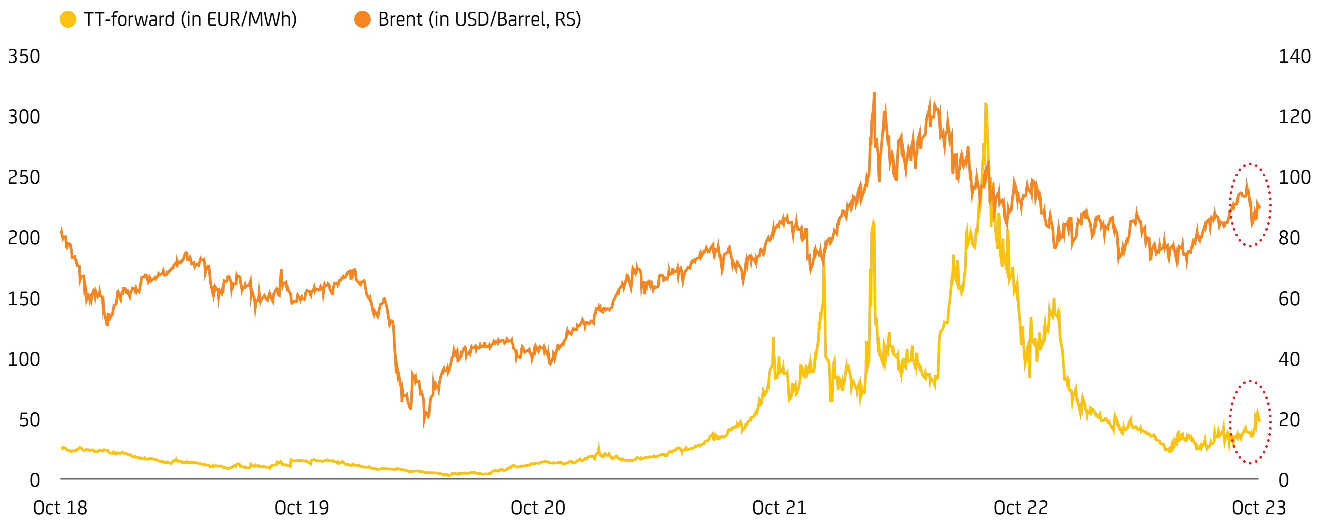
BASELINE SCENARIO: LIMITED IMPACT ON OIL PRICES IN THE EVENT OF A LOCALISED CONFLICT

The violence in Israel and the Palestinian territories will put a lasting strain on Israel's relations with the Arab world, but we assume that the conflict itself will remain locally limited to Gaza and the surrounding area. It cannot be ruled out that Hezbollah, which has close ties to Hamas, will open up an additional military front in northern Israel on the border with Lebanon, which would complicate matters for Israel. The war is also likely to complicate efforts by the US administration of Joe Biden to normalise relations between Saudi Arabia and Israel – continuing the Saudi-Israeli rapprochement in the face of a fierce Israeli military counter-offensive seems hard to imagine. Even though Saudi Arabia may have no interest in becoming involved in the conflict itself, it presumably cannot conclude an agreement with Israel as long as the conflict with the Palestinians continues.

Since July, the **OPEC+**[1] countries led by Saudi Arabia and Russia had driven oil prices above USD95 per barrel by announcing production cuts. This development threatened to give a new boost to inflation around the world. However, at the beginning of October, before the outbreak of the conflict in Israel, significantly higher interest rates initially caused the oil price to fall again by more than 10% to below USD84. Hopes that the global economy would transition from high inflation to a calm phase and a "soft landing" gave way to concerns about a slowdown in global economic growth as a result of a longer restrictive monetary policy on the part of the major Western central banks, especially the Fed and the ECB. The Hamas attack on Israel has partially reversed this price decline – with the Hamas attack, crude oil prices initially jumped. The price rose to USD89 per barrel immediately after the attack, but then fell again (Chart 1).

[1] The OPEC+ countries comprise the oil-producing countries of OPEC and the non-OPEC countries, such as Russia.

1. HAMAS ATTACK SENDS CRUDE OIL PRICES SOARING, BUT ONLY TEMPORARILY



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: Bloomberg, UniCredit Group Investment Strategy
Observation period: 16.10.2018-16.10.2023

If the conflict remains localised (our baseline scenario), the impact on oil prices should also be limited. Neither Israel nor the Palestinian territories produce relevant quantities of oil. However, Iran's oil supply and exports are of central importance. It is conceivable that recent events will result in stricter enforcement of existing sanctions by the US against Iran, which were eased this year out of concern about rising fuel prices. The Middle East is not only home to some of the world's most important oil-producing nations, but also to the Strait of Hormuz, a key transport route. About one fifth of the global oil supply could be affected in case of closure by Iran. However, at the moment it seems unlikely that such an escalation will occur, because the oil-producing countries have no interest in that.

But even assuming that the West adopts a more conciliatory attitude towards Tehran, significant quantities could be withdrawn from the oil market (namely those from Iran) – and this at a time of undersupply after Saudi Arabia and Russia want to maintain the production cuts they have made for the time being. Theoretically, there is sufficient production capacity to compensate for any shortfalls from Iran. But that would require countries like Saudi Arabia and the United Arab Emirates to be willing to do so. Indeed, Saudi Arabia has recently reiterated its support for OPEC+ efforts to balance global oil markets. So, it seems possible that Brent prices could settle near current levels, although investors should brace themselves for further volatility for now. The impact on inflation should then remain rather limited, especially since the effect on core inflation is limited. It is also reasonable to assume that neither the Fed nor the ECB would react directly to supply-side factors in inflation (as they would in the case of an energy price shock). In the medium term, we expect Brent prices to fall to around USD85 per barrel at the end of 2024, when OPEC+ is expected to release more production.

RISK SCENARIO: PRESSURE ON OIL PRICES IN THE EVENT OF AN ESCALATION WITH DIRECT INVOLVEMENT OF IRAN

A significant increase in the oil price over a longer period would only be expected in the event of a significant expansion of the conflict. We consider such a risk scenario unlikely, especially since the US and the EU are likely to exert pressure on Israel not to drag Iran into the conflict. A direct confrontation between Israel and Iran is unlikely to be in Iran's interest anyway, nor would it be in Israel's interest, as the operation in Gaza is already likely to draw on large parts of the country's military capabilities. Nevertheless, should a direct military confrontation between Israel and Iran develop, other regional actors might feel compelled to intervene. Unlike in the 1970s, however, there is today no joint, coordinated action by the countries of the Middle East against Israel, and in view of the Shiite-Sunni rivalry it seems questionable why Saudi Arabia, for example, should support Iran, its archenemy. Support for Israel seems equally unlikely. A dangerous development would be one in which the Shiite-Sunni rivalry escalates, and Saudi Arabia is drawn into the conflict, for example through Iranian provocations. In this scenario, there would be three non-allied camps: Israel, the Sunni countries (represented by Saudi Arabia), and the Shiite countries (represented by Iran).

In such a risk scenario, oil prices above USD100 could not be ruled out. This could noticeably slow down the current weakening of inflationary pressures. The Fed and the ECB could then be forced to raise interest rates again or further postpone possible rate cuts in the coming year, whereby the central banks' task would be made more difficult by the fact that persistently high oil prices would simultaneously weigh on the economy. This would then entail an easing rather than a tightening of monetary policy, although the timing of such a monetary policy measure is likely to prove extremely difficult. The bottom line is that this is not an easy balancing act.

NATURAL GAS: FIERCE PRICE REACTION SEEMS EXAGGERATED

Furthermore, with regard to Germany and Europe, it should not go unmentioned that in the wake of the Hamas attack on Israel, gas prices (TTF futures contract for delivery in one month on the Amsterdam exchange) also rose at times by more than 28%, to their highest level since the end of March this year (see Chart 1 above). A reason for this was that Israel shut down an important gas field. In addition to this, there was a possible act of sabotage on the Baltic Connector gas pipeline between Finland and Estonia. The pipeline is currently at a standstill. For a long time, Israel was one of the few countries in the Middle East without significant gas and oil reserves, but it has recently developed gas fields in the Mediterranean. The war jeopardises the country's plans to become a major regional energy supplier. Ultimately, this could also lead to less liquefied natural gas being delivered to Europe. However, we consider the strong price reaction to be exaggerated. The starting situation for supply on the European natural gas market is significantly better than last year. European gas storage facilities were 95% full at the end of September – well above the five-year average of 87%. The big unknown when looking at the gas price remains how cold the winter will be. The long-term forecasts for the winter so far point to a few cold events, but overall the **calculations based on the European weather model (ECMWF)[2]** rather see a too warm winter in Europe.

[2] The European Centre for Medium-Range Weather Forecasts (ECMWF) is an independent international research institute and weather service for global numerical weather prediction and climatology.

Macro & Markets

Growth outlook: US and Euro economic activity weakens, China likely to achieve growth target

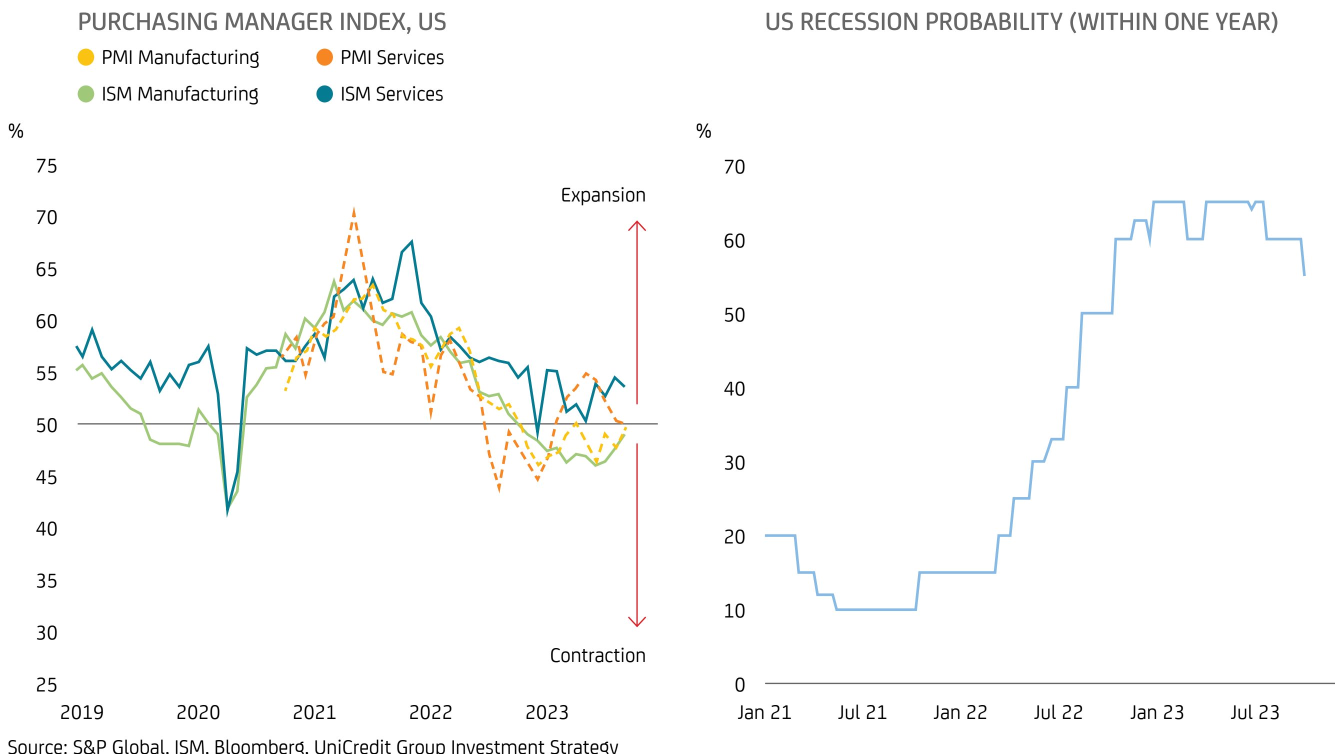
Global economic growth is expected to slow to 2.9% this year. We do not expect too strong a recovery in 2024 either (GDP growth of 2.5%). The slowdown is largely due to the lagged effect of tighter monetary policy, while buffers from pandemic-induced household savings surpluses continue to diminish and support from fiscal policy weakens. Headline inflation has declined significantly since its peak in 2022, mainly due to lower energy prices, but core inflation is also falling thanks to easing input price pressures. The recent rise in oil prices is unlikely to significantly alter the underlying disinflation trend as aggregate demand continues to weaken. Policy rates in most advanced economies are likely to have peaked. However, rate cuts are likely to be a while in coming until central banks see clear data-based evidence that core inflation is moving sustainably towards their targets.

FORECAST REVISIONS US: ECONOMY ROBUST, BUT CURRENT DEVELOPMENTS MAKE FURTHER INTEREST RATE HIKES UNLIKELY

For the US, we now expect somewhat stronger growth around 2% (after 1.3%) this year but anticipate a significant weakening of economic momentum at the turn of the year 2023/24 and largely stagnant annual growth in 2024 as a whole. Economic indicators have so far proved to be quite robust, the downward trend in industry seems to have stopped, and the service sector remains in expansionary territory (see Chart 2). Accordingly, the analyst consensus expected recession probability for the US has recently fallen to below 60%. Private consumption was unexpectedly strong in the third quarter. However, this strength is unlikely to last, as the labour market in particular continues to weaken, credit conditions are becoming much more restrictive, and savings are expected to decline further. On the inflation side, we expect the headline inflation rate to fall back to around 2% by the end of next year, with the core rate still slightly above target. Given this macroeconomic environment, we assume that the Fed has reached its interest rate peak and expect interest rate cuts of a cumulative 150 bps from March 2024 until the end of 2024.

At its September meeting, the Fed left the key interest rate unchanged at the upper end at 5.50%, although the so-called “dot plot” (the interest rate outlook of the Monetary Policy Council) continues to point to a further increase this year. For the two following years, the central bank now expects fewer rate cuts than before, with policy rates falling to only 5.1% in 2024 and 3.9% in 2025 (i.e. 50 bps more than before in each case), mainly due to the raised growth and inflation forecasts. However, the most recently published minutes of the meeting show that the central bank representatives were definitely more cautious in their outlook than the updated economic forecasts suggest. On the one hand, the upward revisions of the forecasts indicate that the Fed is optimistic about the prospects for a soft landing of the economy. On the other hand, the meeting minutes also indicate that the central bank continues to keep a close eye on a number of risks to growth and inflation (such as the decline in savings, tightening credit conditions, weakening labour market, and easing wage pressures). Overall, the Fed indicated that upside and downside risks were now increasingly balanced and that the stance of monetary policy was seen as restrictive and thus dampening the economy.

Developments since the last Fed meeting have led to a significantly less aggressive stance by the central bank, which is also reflected in the market comments of individual central bank representatives. In addition to the rise in 10-year US government bond yields by around 40 bps (which roughly corresponds to another key interest rate hike), the resignation of House Speaker Kevin McCarthy and the conflict between Israel and Hamas have also contributed to this. This in turn reinforces our view that the Fed has reached its interest rate peak, even if another rate hike is not yet completely off the table.



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

PROGNOSES EURO AREA: TOUGH ENVIRONMENT WEIGHS ON ECONOMY AND POINTS TO RATE CEILING

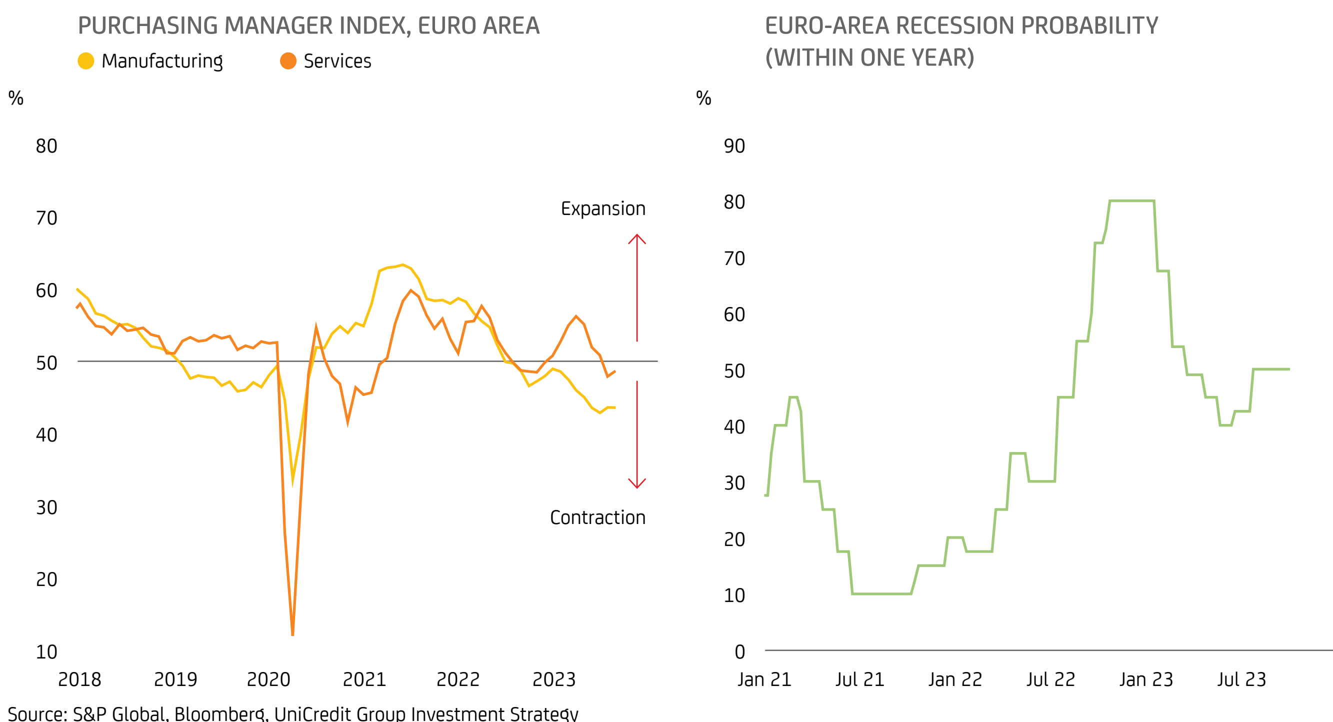
In the euro area, growth is likely to stagnate at best in the second half of the current year, after we had previously assumed moderate expansion. While we see GDP growth unchanged at 0.5% this year, we expect only 0.6% for 2024 (previously 1.0%). Economic indicators have cooled down further recently, with industry in particular still in a marked phase of weakness, and the services sector has also noticeably lost momentum (see Chart 3). So it is not surprising that the consensus of analysts has recently raised the probability of a recession for the euro area to 50%, as the survey results show. Pressure on corporate profit margins in the face of weaker demand seems to have set in and is likely to continue for the time being. On the inflation side, we expect inflation to reach 3.5% this year and 2.6% in 2024. Accordingly, we assume that the ECB's tightening cycle is over and that the central bank will start cutting interest rates next year. Overall, we expect a key interest rate cut by a cumulative 75 bps in the course of next year, probably starting in the middle of the year.

At its September meeting, the ECB raised key interest rates by 25 bps to 4.0%. In addition, it signalled that the tightening cycle is now probably complete. With regard to the reduction of the central bank balance sheet, ECB President Lagarde dismissed speculation about an imminent change in the **PEPP**[3] guidelines and reiterated her commitment to maintaining the first line of defence against an unjustified widening of the yield spreads of euro area government bonds over German government bonds, the so-called transmission protection instrument (TPI). The minutes of the September meeting also indicate that another rate hike is rather unlikely, although the hawks in the ECB Governing Council had previously warned against further tightening. Indeed, the Governing Council's overall view is that inflationary pressures in the euro area have peaked and will continue to weaken. On the other hand, the Governing Council was increasingly concerned about the economic slowdown in the region. All this is likely to deter the ECB from further interest rate hikes.

[3]The Pandemic Emergency Purchase Programme (PEPP) is a temporary programme to purchase bonds of public and private debtors, which was set up at the beginning of the pandemic to ensure the ECB's monetary policy transmission channels.

Nevertheless, there is a certain residual risk for further interest rate hikes should the inflation expectations of private households turn out to be significantly higher than expected due to rising energy prices. In conjunction with continued historically high energy costs as a result of the Russia-Ukraine conflict (despite significant declines since the highs in 2022), a renewed rise in energy prices (not least due to the Middle East conflict; see the section “In Focus” for a more thorough analysis) could force the ECB to take further interest rate hikes towards the end of the year (not our baseline scenario).

3. FURTHER COOLING AND STAGNATION OF THE EURO AREA ECONOMY EXPECTED



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

FORECAST REVISIONS CHINA: GROWTH TARGET FOR 2023 LIKELY TO BE ACHIEVED

The slowdown in the global economy is also reflected in China’s weaker economic activity. Following the latest GDP growth release in the third quarter, we still expect China to reach its self-imposed growth target of “around 5%” in 2023, but a number of downside risks remain. After a strong rebound in the first quarter of 2023 as the economy reopened, economic momentum in China has disappointed on many fronts. Consumption has been rather subdued since then and youth unemployment remains at historically high levels. The real estate sector remains a major source of uncertainty for the economy, burdened by excessive leverage and debt at a time when the urbanisation process appears mature and demographic trends are unfavourable. Due to the rather weak economic momentum, inflation in China continues to hover on the edge of deflation. Nonetheless, China’s third-quarter growth of 4.9% year-over-year (1.3% quarter-over-quarter) was still very satisfactory, as targeted stimulus measures, particularly in the manufacturing sector and infrastructure investment, had an impact. For the coming year, we expect growth of around 4%.

Despite the burdening factors, there are also positive developments. For example, the latest purchasing managers’ indices have stabilised on a broad basis. Both industry and the service sector are showing slight expansion again after months of contraction. While the government has not yet taken any comprehensive measures to support the economy on the fiscal side (only some easing of credit standards for home buyers to support the construction sector), it has taken more significant steps on the monetary policy side. For example, the Chinese central bank not only lowered reserve requirements for large and medium-sized banks several times this year, but also cut the interest rate on the one-year medium-term credit facility. We expect further such measures in the future.

FINANCIAL MARKETS: TENSIONS OF A LONGER RESTRICTED MONEY POLICY

Financial markets were able to recover somewhat in October after significant price losses in many asset classes in September. The main reason for the sell-off in September was the reorientation of the markets to the unexpectedly clear signal from the two major Western central banks, the Fed and the ECB, to keep key interest rates in the restrictive range for longer and higher. The stock markets in particular fell significantly after the central bank meetings in September. The S&P 500 lost more than 5% and the DAX more than 3% in the reporting month of September. On the bond side, the price losses led to yield increases of around 50 bps for US government bonds and more than 30 bps for German Bunds. The EUR-USD exchange rate and the gold price fell by almost 3% and 6% respectively in this environment of sharply increased bond yields.

However, the renewed flare-up in the Middle East following the Hamas attack on Israel brought demand for safe investments back to the fore at the beginning of October. This led to significant gains in bond prices, especially for longer-dated bonds. Subsequently, the US and European stock markets also benefited from the declining bond yields – they showed price gains of over 2% for the S&P 500 and a good 1% for the DAX in the reporting month of October (as of 16 October), although the price gains could not fully compensate for the losses from September. The euro gained 0.6% against the US dollar in the same period. Gold was able to play out its character as a "safe haven" and so far recorded significant price gains of over 5% in the reporting month of October. The medium to long-term performance of gold, however, is likely to depend primarily on the development of US yields. The price of Brent oil, which in September had still reached values above the USD95 per barrel mark due to the scarcity situation on global markets, initially dropped significantly at the beginning of October due to emerging economic concerns and fell below the USD85 mark. In the wake of the Middle East conflict and concerns about a further shortage of oil supply, the oil price has recently recovered somewhat, but is still below the highs of September (see also In Focus section, as of 16 October 2023).

Asset Allocation – How we manage our portfolio mandate

Staying defensive

Asset		Investment Universe	Investment View: Underweight	Investment View: Neutral	Investment View: Overweight
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)

NEUTRAL ON GLOBAL EQUITIES

Equities resilience and confidence that a hard landing will be avoided. However, the negative lagged effect of higher interest rates is yet to be felt.

NEUTRAL EUROPEAN EQUITIES

Weakening macro momentum and vulnerability to higher oil and natural gas prices while the ECB remains restrictive in the short term. However, European equities offer good opportunities for value and quality investors.

NEUTRAL US EQUITIES

Strong GDP growth in Q3 2023 driven by the robust jobs market and earnings resilience, but uncertainty on the magnitude of the economic slowdown in the coming months due to the lagged effects of higher interest rates.

NEUTRAL EMERGING MARKET EQUITIES

Q3 2023 China GDP higher than consensus due to targeted stimuli, but the stress in the real estate sector is rising.

In Latin America, Brazil is becoming a bright spot due to expectations of rate cuts, as inflation is falling, and fiscal reforms are likely. Overall, valuations are cheap for EM equities. Countries and sectors selectivity among EMs is strongly recommended.

OVERWEIGHT ON PACIFIC EQUITIES

Wage growth and rising inflation – with the BoJ set to remain expansive – 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 this year support our preference for "high quality bonds", such as Euro Investment Grade corporate and government bonds.

OVERWEIGHT ON EURO INVESTMENT GRADE CORPORATE BONDS

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

UNDERWEIGHT ON HIGH YIELD CORPORATE BONDS

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

NEUTRAL EMU GOVERNMENT BONDS

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

NEUTRAL NON-EMU GOVERNMENT BONDS

Supported by expectations of falling inflation and Fed easing around mid-next year.

NEUTRAL ON EMERGING MARKET BONDS IN HARD CURRENCY

Interesting carry but we prefer focusing on "high quality bonds". We stay defensive and selective, avoiding countries with high external debt and current account deficits.

OVERWEIGHT ON EMERGING MARKET BONDS IN LOCAL CURRENCY

Supported by expectations of Fed easing around mid-next year and US dollar weakening. In LatAm, falling inflation opens the way for material central banks easing.

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

Oil prices are supported by low inventories and rising geopolitical risk. However, the prices of other cyclical commodities, such as copper, are not rising.

NEUTRAL GOLD

Upside limited by the last hawkish Fed meeting and by the stronger US dollar.

CURRENCIES

Short-term support by the last hawkish Fed meeting and the stronger momentum of the US economy.

How to invest

Investment ideas in the current scenario

EQUITY INVESTMENTS

OUR IDEA: SEMAGLUTIDE: UNLOCKING HEALTHCARE POTENTIAL

In the early 2000s, facing declining US oil production, American energy companies joined engineering efforts to combine two oil extraction techniques – hydraulic fracturing and horizonal drilling – previously deemed impractical and too risky. The breakthrough unlocked vast shale reserves, propelling US crude oil production from five million barrels per day in 2008 to over 12 million in 2019. This transformed the industry's fortunes, revitalised the US economy, and changed the global energy dynamics. This transformative power of horizontal disruptions and lateral thinking parallels today's healthcare space where top insulin makers harnessed their research capabilities to pioneer new applications of insulin beyond diabetes, uncovering the efficacy of injectable semaglutide for obesity management.

Insulin was discovered in 1922 and was originally extracted from the pancreas of cows and pigs. As it became a standard treatment for diabetes, advancements led to the creation of synthetic human insulin in the 1980s. This development simplified production, turning insulin into a commodity, and the resulting USD20 billion market consolidated around a handful of companies. Operating in a mature environment and facing significant unmet medical needs, a couple of players challenged traditional views through a lateral approach that moved the focus from treating diabetes to targeting one of its major root causes: obesity. The R&D efforts led to semaglutide, a drug that mimics **GLP-1 hormone**[4] and stimulates insulin production, in turn lowering blood sugar and reducing appetite. The new solution unlocked an estimated global obesity market of USD100 billion by 2030, of which a duopoly has a combined 82% market share, thanks to the strength and depth of the product pipelines, enormous supply chain investments, and most recent reimbursement perspective. This disruptive innovation, akin to the shale revolution, extends beyond profits and has implications for public health and economic sustainability. Obesity is the underlying cause for more than 200 complications, often chronic and costly, including cardiovascular disorders, various cancers, and kidney failure. Semaglutide, by reducing the incidence of these debilitating events, stands as a relief to the healthcare burden, with anticipated savings that could amount to approximately USD170 billion annually in the US alone. The impact is especially noteworthy considering that health spending already constitutes a substantial 10% share of GDP across OECD countries and is the primary factor contributing to the projected surge in national debts.

In the equity market, disruptive stocks have often been excellent performers in both bull and bear markets, representing a top choice among high volatility. So far, these pharmaceutical players have proven to be no exception, as their share prices have tripled since January 1, 2021. This success underscores the importance of active portfolio management. Specifically, while benchmarks and passive funds tend to miss these unique opportunities, being by nature "backward-looking" and able to only reward the proven winners, an active approach allows investors to seize transformative opportunities and capitalize on them.

[3]Glucagon-like peptide 1 (GLP-1) is a gut-derived peptide secreted from intestinal cells after a meal. GLP-1 has numerous physiological actions, including potentiation of glucose-stimulated insulin secretion. The antidiabetic effects of GLP-1 have led to intense interest in the use of this peptide for the treatment of patients with diabetes

BOND INVESTMENTS

THE OUTLOOK OF GOVERNMENT BONDS

In September government bond yields rose sharply, with the 10-year Treasury yield hitting 4.88% – its highest level since 2008 – and the 10-year Bund yield at 3%, a level not seen since 2011.

There are many reasons for this sharp rise in interest rates. In particular, the jump in oil prices – from USD70 per barrel to a high of USD95 during the summer, after the oil production cuts decided by OPEC countries – has alarmed investors about a possible resumption of inflationary dynamics. In addition, the US labour market remains extremely strong, with 336,000 new jobs created in September. The Fed's warning of higher rates for longer has also penalised bond prices. Another factor that is weighing on the market is the significant increase of bond supply in the coming months.

A more structural factor could also weigh on bond prices. Investors could want higher risk premia for the long end of yield curves, reflecting a growing imbalance between supply and demand, and concerns on debt sustainability and a new inflationary regime that is much more volatile than in the past.

Of course, there are pros for government bonds as well. In the US alone, money market funds amount to about USD6 trillion. These assets could quickly move to government bonds especially if the economy shows signs of slowing and central banks become more dovish about their monetary policies. Furthermore, at the current level of yields, institutional investors such as sovereign wealth and pension funds are increasing their exposure to government bonds. Finally, as the correlation between Treasuries and risk assets has turned negative in 2023, if risk aversion was to increase, there would be a sharp increase in demand for government bonds.

In conclusion, between the pros and cons the market will remain very volatile. However, with nominal yields at levels not seen in over 10 years, we believe investing in fixed income today can be rewarding in the long term.

In terms of asset allocation, we have confirmed our neutrality on the asset class. At these yields, government bonds offer an attractive coupon flow that can compensate for possible new price declines as well. Moreover, as written before, the correlation between bonds and equities has returned negative, and considering the recent conflict between Israel and Hamas, government bonds are a "safe haven" in case of an escalation of tensions across the Middle East. Strategically, we see value especially in the two- to 10-year curve segment, while for longer maturities we still expect a phase of elevated volatility.

Tactically, taking advantage of market weakness, early in October we reduced our duration underweight against our benchmarks in government bond models, as we expected a price rebound. In particular, we bought bonds of "core" countries while maintaining a cautious stance on countries with more debt, which fuels doubts around the future sustainability of their public finances.

DEVELOPMENT OF SELECTED FINANCIAL MARKET INDICES

From	**16.10.22**	16.10.18	16.10.19	16.10.20	16.10.21	16.10.22	16.10.18	**01.01.23**
To	**16.10.23**	16.10.19	16.10.20	16.10.21	16.10.22	16.10.23	16.10.23	**16.10.23**
Stock market indices (total return, in %)								
MSCI World (in USD)	**24.1**	7.7	13.3	30.0	-21.4	24.1	56.4	**12.9**
MSCI Emerging Markets (in USD)	**13.0**	7.1	12.1	17.3	-29.6	13.0	12.2	**1.5**
MSCI US (in USD)	**24.3**	8.6	20.7	30.6	-20.0	24.3	73.1	**15.8**
MSCI Europe (in EUR)	**19.1**	11.5	-5.5	33.1	-11.9	19.1	46.1	**9.6**
MSCI AC Asia Pacific (in USD)	**16.1**	7.3	12.0	16.0	-27.5	16.1	16.7	**2.4**
STOXX Europe 600 (in EUR)	**18.9**	11.8	-4.0	32.8	-13.4	18.9	46.0	**9.2**
DAX 40 (Germany in EUR)	**22.5**	7.6	2.0	22.7	-19.6	22.5	31.2	**9.4**
MSCI Italy (in EUR)	**42.3**	18.3	-15.5	41.4	-15.4	42.3	69.2	**24.3**
ATX (Austria, in EUR)	**20.4**	-3.5	-26.4	78.5	-23.2	20.4	17.1	**5.9**
SMI (Switzerland, in CHF)	**8.8**	17.9	5.4	22.4	-10.7	8.8	46.9	**4.7**
S&P 500 (USA, in USD)	**24.1**	8.6	18.4	30.3	-18.0	24.1	73.3	**15.4**
Nikkei (Japan, in JPY)	**19.4**	1.9	6.3	25.7	-3.0	19.4	57.3	**23.7**
CSI 300 (China, in Yuan)	**-3.2**	29.4	24.6	4.6	-20.1	-3.2	29.1	**-4.2**
Bond market indices (total return, in %)								
US Government Bonds 10Y (in USD)	**-2.0**	16.3	12.7	-5.0	-17.9	-2.0	0.6	**-3.8**
US Government Bonds (ICE BofA, in USD)	**-0.4**	10.9	8.3	-3.4	-14.4	-0.4	-0.8	**-2.3**
US Corporate Bonds (ICE BofA A-BBB, in USD)	**5.0**	13.5	8.6	1.4	-19.5	5.0	6.0	**-0.1**
German Bunds 10Y (in EUR)	**-0.5**	9.7	2.4	-3.7	-19.8	-0.5	-13.4	**0.8**
EUR Government Bonds 1Y-10Y (iBOXX, in EUR)	**-0.5**	11.1	2.9	-2.6	-18.5	-0.5	-9.5	**0.2**
EUR Corporate Bonds 1Y-10Y (iBOXX, in EUR)	**4.7**	5.7	1.6	0.5	-16.3	4.7	-5.4	**2.5**
Bond yields (change in basis points = 0.01 percentage points)								
US Government Bonds 10Y (in USD)	**70**	-142	-101	84	249	70	155	**87**
US Government Bonds (ICE BofA, in USD)	**59**	-129	-119	57	331	59	192	**78**
US Corporate Bonds (ICE BofA A-BBB, in USD)	**21**	-124	-98	19	383	21	198	**72**
German Bunds 10Y (in EUR)	**39**	-88	-22	44	254	39	224	**19**
EUR Government Bonds 1Y-10Y (iBOXX, in EUR)	**51**	-110	-28	35	274	51	219	**34**
EUR Corporate Bonds 1Y-10Y (iBOXX, in EUR)	**-4**	-78	-13	8	395	-4	309	**20**
Spreads on government bonds (credit spreads, change in basis points)								
US Corporate Bonds (ICE BofA US Corporate Master)	**-43**	4	14	-45	80	-43	12	**-11**
US Corporate Bonds (ICE BofA US High Yield)	**-88**	56	94	-189	197	-88	78	**-52**
Euro Corporate bonds (ICE BofA Euro Corporate AAA-A)	**-50**	-4	1	-14	112	-50	46	**3**
Euro Corporate Bonds (ICE BofA Euro High Yield)	**-151**	-12	97	-136	295	-151	97	**-25**
Money market rates (change in basis points)								
Libor (USD, 3 months)	**146**	-44	-175	-9	407	146	321	**89**
Euribor (EUR, 3 months)	**257**	-9	-10	-4	195	257	429	**184**
Euro exchange rates (change in %)								
US Dollar (EUR-USD)	**8.4**	-4.9	5.7	-0.8	-16.2	8.4	-9.0	**-1.2**
British Pound (EUR-GBP)	**-0.3**	-1.2	4.7	-6.8	2.6	-0.3	-1.7	**-2.4**
Swiss Franc (EUR-SFR)	**-2.6**	-3.9	-2.5	0.3	-8.7	-2.6	-16.8	**-3.5**
Japanese Yen (EUR-JPY)	**9.7**	-7.7	2.3	7.7	9.1	9.7	21.6	**12.0**
Commodities (change in %)								
Commodity Index (GSCI, in USD)	**16.7**	20.7	23.9	-8.3	-9.0	16.7	48.7	**5.3**
Industrial metals (GSCI, in USD)	**-2.9**	-6.7	7.3	56.2	-21.0	-2.9	15.6	**-11.5**
Gold (in USD per fine ounce)	**16.6**	21.0	27.6	-6.7	-8.3	16.6	56.5	**5.8**
Crude oil (Brent, in USD per barrel)	**-2.2**	-26.5	-27.1	96.4	9.1	-2.2	11.2	**5.7**

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 16.10.2023.

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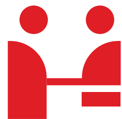

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