UniCredit

Monthly Outlook

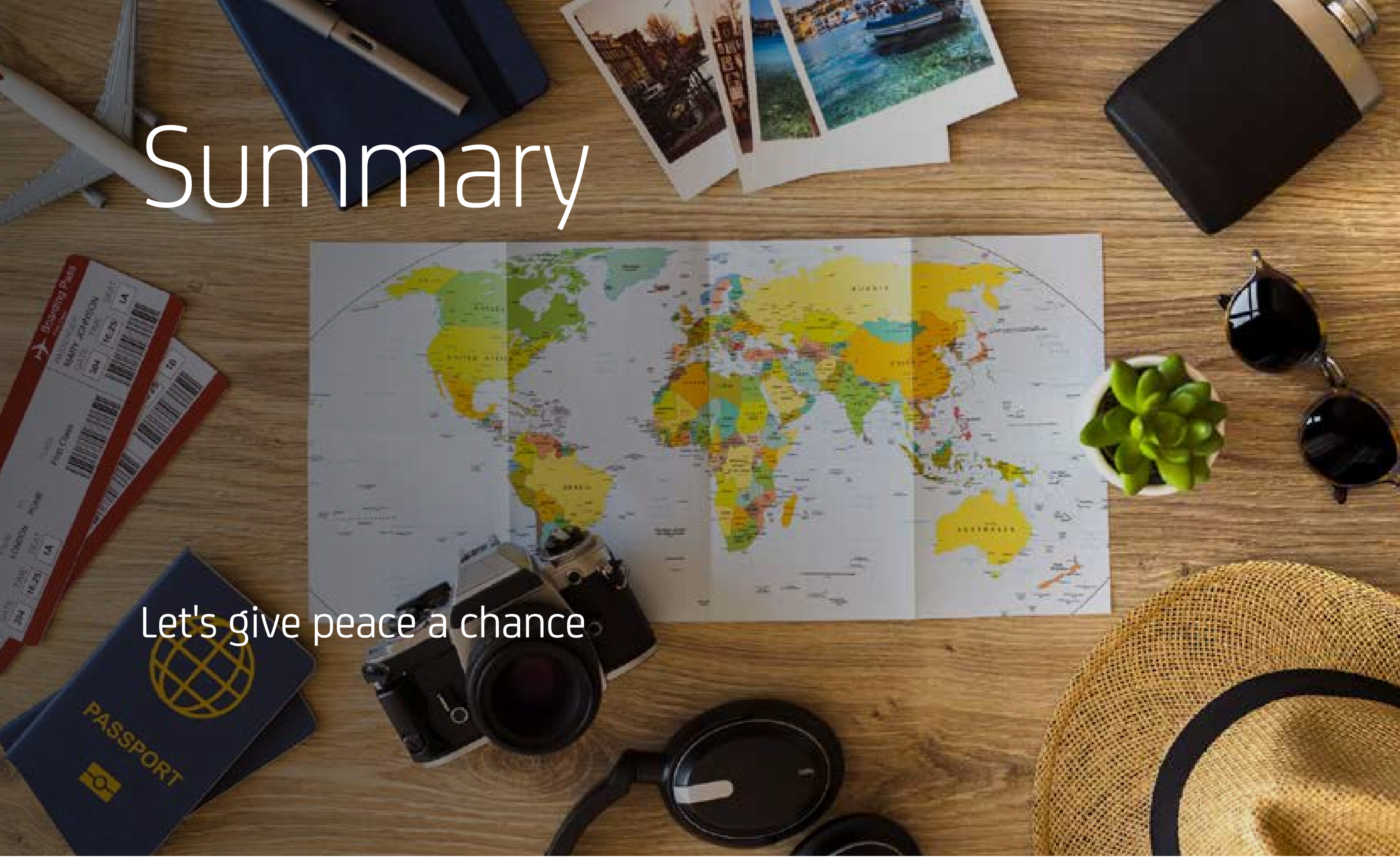
March 2022

# Let's give peace a chance

# Table of contents

# Let's give peace a chance

# Summary



## Let's give peace a chance

### Market Update

An unbounded Vladimir Putin has shocked the world – just as Covid started to throw off its shackles. The invasion of Ukraine is not only a humanitarian catastrophe, but it also has lasting effects on geopolitics, the security and energy architecture in Europe, and on economies and financial markets.

Russia itself is most probably paying a very high price. The far-reaching sanctions should send its economy into recession soon and noticeably slow down its long-term economic potential.

But Europe is also paying the price for its freedom in the form of significantly higher inflation and noticeably slower growth. However, the post-Covid recovery is not likely to break off. Nevertheless, the risk of stagflation, i.e., a sluggish economy combined with high inflation, has increased.

### Monetary Policy

Surprisingly, major central banks once again surprised on the hawkish side. The Fed already started its tightening cycle and – unexpectedly – signaled six more rate hikes of 25 basis points each for this year alone, thus catching up with what markets had expected.

The ECB plans to speed up the reduction of its securities purchases and phase out the program already in Q3 2022. But it decoupled the so-called sequencing, so that a first rate hike this autumn has become unlikely.

## Financial Markets

Financial markets reacted heavily on Russia's invasion of the Ukraine. Safe haven assets like government bonds, gold and the USD were on strong demand, while risky assets like stocks and corporate bonds suffered. In the meantime, however, there have already been some counter-movements, especially in government bonds and equities, which are trading again back at levels prior to the invasion.

While equities remain vulnerable to short term risk aversion and negative earnings revisions, the long-term perspective appears to be attractive in terms of relative valuation, but also growth potential stemming from investment programs that European governments have proposed. However, in the near term, we focus on risk management, preferring companies with stable business profiles, higher pricing power, more resilient to adverse scenarios and with high cash flow generation/high dividend yield. We maintain our overweight European equities but are fully aware that US, Japan and EM equities, especially the EM Asian countries, are less affected by the Russia/ Ukraine conflict.

For bond markets, the outlook is more complex. They will be caught between flight to safe havens in times of great uncertainty (falling yields) and the prospect of tighter monetary policy. Beyond short-term swings, however, nominal yields should rise without real yields emerging from their negative terrain in the foreseeable future. Rising inflation supports our structural underweight in global bonds, although we do not want to lose sight of top-rated corporate bonds and – selectively – Emerging Market bonds.

Also, in the current high uncertainty environment, USD and gold exposure offer interesting portfolio hedging opportunities as well as an increased buffer of liquidity.

# CIOs Letter

## Let's give peace a chance

The conflict in Ukraine has once again shown us the fragility of our civilisation. Only a few weeks ago, hardly anyone could have imagined such terrible images in the middle of Europe. The conflict in Ukraine is causing tremendous suffering to those involved, with the very ideals of peace, freedom and prosperity on which the European Union is based, and which the Ukrainians look forward to joining in the future, now seemingly under threat.

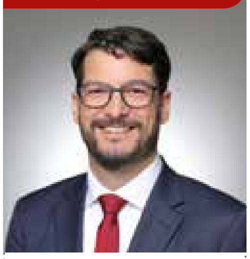
This made the strong response of the West and the EU to Russia's invasion all the more important. Humanitarian, political and military aid to Ukraine, far-reaching, tough sanctions against Russia, a U-turn on our part with billions invested in defence and energy security, and, last but not least, a plan to jointly finance these initiatives – this was truly a turning point!

But the conflict is also a shock to the economy and to markets. It comes just two years after the last major shock, the pandemic, whose consequences we are only just recovering from both in terms of health policy and the economy. The main transmission channel through which the Ukraine conflict is hitting our economy and markets is the rapid rise in energy prices, especially oil and gas, as we have to worry about supply disruptions. Given the high dependence of European energy supply on Russia, this is only too understandable. In addition to energy costs, however, other commodity classes also play an important role. Important industrial metals such as palladium and nickel, but also agricultural materials (wheat) and fertilisers, are worth mentioning here. Their prices are also rising rapidly. Trade restrictions play a less important role from a macroeconomic perspective, as the export volumes of European goods and services to Russia and Ukraine are comparatively low.


Manuela D'Onofrio

**Head of Group Investment Strategy**

Philip Gisdakis



**CIO UniCredit Bank AG** (HypoVereinsbank) (Germany)

These further increases in energy and commodity prices are hitting the global economy at a time when inflation concerns are already a major challenge for the economy and financial markets – and not only in the US, but also in Europe. This puts central banks, and above all the European Central Bank (ECB) and the US Federal Reserve (Fed), in a difficult position. On the one hand, they want to scale back ultra-loose monetary policy and have already signalled corresponding steps at the beginning of the year. On the other hand, the main inflation drivers – namely rising energy costs and supply chain bottlenecks (which are particularly crucial for Europe) – cannot be influenced by monetary policy measures in the short term. In addition, the Ukraine conflict and sanctions are now slowing the economic recovery in the post-pandemic phase. And, in response to the new strategic challenges with regard to defence and energy security, there will be a substantial investment outlay even in the short term.

The central banks' dilemma is that sharply rising yields as a result of excessively tight monetary policy would make it more difficult to find a structural way out of the energy crisis and the problem of the European security architecture (after all, the necessary investments have to be financed). However, too loose a monetary policy would trigger worries about a solidification of price dynamics to the point of a wage-price spiral. The first signs of such a development are already visible in the US, which suggests a much more stringent monetary policy approach for the Fed this year than for the ECB.

For financial markets, this means that bond markets in particular are likely to be subject to dynamics that are difficult to predict. The tension ranges from the flight to safe havens in times of high uncertainty (with declining yields) and the prospect of tighter monetary policy with rising yields, without real yields escaping their negative terrain. In addition, investment programmes will have to be financed on a large scale, which is likely to lead to supply pressure on the bond side. In this environment, it will be interesting to observe how the ECB positions itself. After all, the central bank would like to scale back its bond-buying programmes in the long term.

Meanwhile, for equities, the picture looks much less complex. In the short term, stringent risk management is certainly warranted in view of the high risks and low visibility due to the tense security and energy policy situation. However, should the fog lift and the economic environment prove to be reasonably stable, equities should be well supported. But the returns investors expect from equities should still reflect the subdued growth environment.

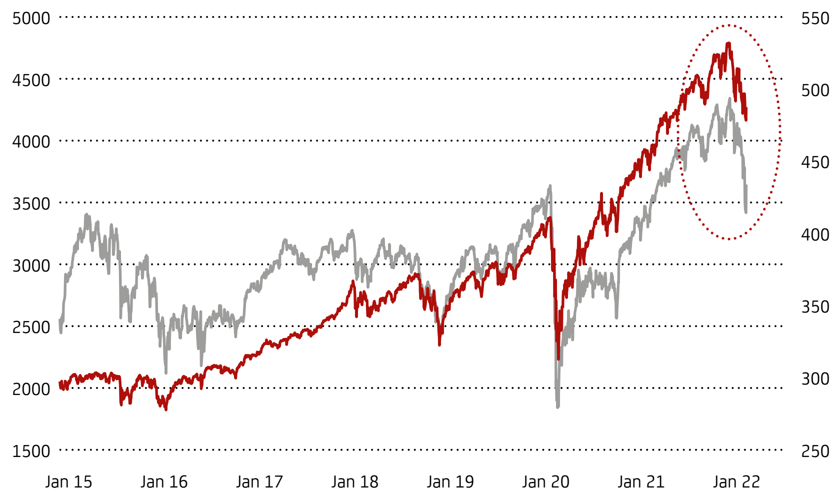
One key lesson can also be drawn from the current crisis. The answer to the strategic challenges is technological progress and targeted investments. The same was true during the Corona crisis. And a considerable portion of the investments needed now fit into the big picture regarding action on climate change anyway. So, why not do the right thing even faster? And one more insight in all this suffering: the European idea is alive and stronger than it has been for a long time.

# In Focus

## Between geopolitical uncertainty and monetary tightening

At present, financial markets are firmly in the grip of the Ukraine conflict. This is causing enormous (geo)political and economic uncertainties (see our article on the Macro & Markets), but also financial distortions. For example, the Euro Stoxx 600 index has lost more than 7% in value at the beginning of the Ukraine conflict as of February 14, 2022) until the end of the week as of 11.03.2022. Its US counterpart, the MSCI US index, fell by a good 3% in the same period (see chart 1). Since then, however, stock markets have been able to regain ground. As the Ukraine conflict is expected to drag on, low appetite for risky assets should continue to prevail in the coming weeks. Even if many (potential) effects of the Ukraine conflict have already been priced into the markets, there will likely always be temporary corrections.

1. UKRAINE CONFLICT SENT STOCK MARKETS TUMBLING...




Source: Bloomberg, UniCredit Group Investment Strategy

Other uncertainties are taking a back seat at the moment. One of them is the envisaged monetary policy normalisation of the major central banks in the course of the economic recovery following the pandemic. There is no doubt that the higher energy and commodity prices caused by the Ukraine conflict, combined with the sanctions against Russia and possible retaliatory measures, will cause inflation to rise further. At the same time, the conflict will also weigh on the macroeconomic environment, putting central banks in a difficult situation. The main question for the equity markets is whether rising or persistently high inflation combined with weaker economic activity will eventually lead to stagflation, or whether the overall impact of the Ukraine conflict will remain manageable (see also our article on Macro & Markets).

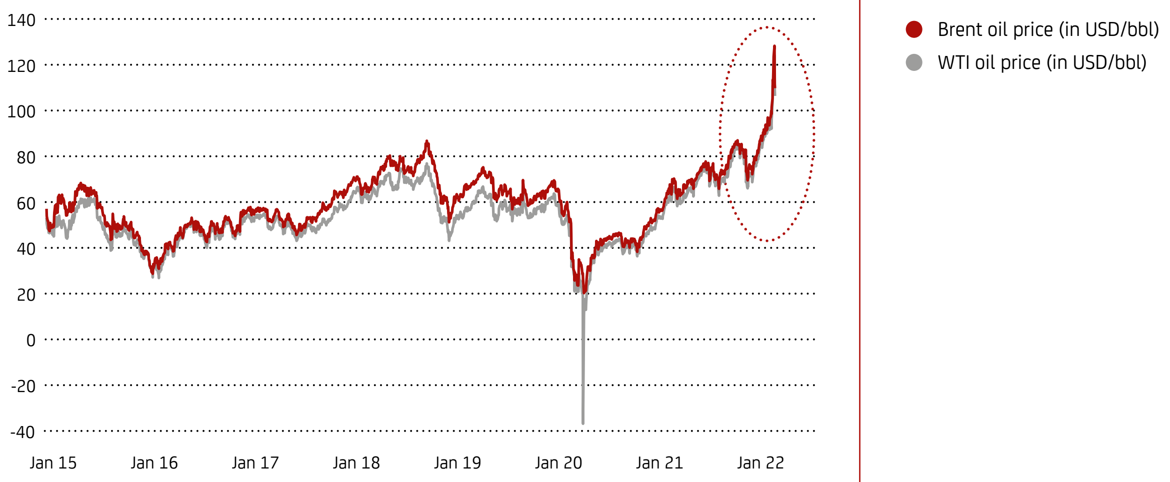
So far, stagflation is not our baseline scenario. But even if the Ukraine conflict does not lead to this, (expected) corporate earnings growth this year will probably fall short of expectations. Currently, we assume that the consequences of the conflict in Ukraine and the sanctions against Russia will dampen the economic recovery in the euro area, but not cancel it out. In the US, on the other hand, the impact on the economy is likely to be less pronounced. This is important for equity markets as it means that corporate earnings growth will also remain positive, albeit at a lower level than our earlier estimates.

Against this backdrop, our research colleagues have revised down their index targets for the Euro STOXX 50, the DAX and for the S&P 500, setting larger discounts for European than for US equities. This reflects the greater downside risk for European equities due to Europe's greater economic interdependence with Russia and Ukraine. While the new index targets imply double-digit upside potential from current levels by the end of the year, any further escalation in geopolitical tensions is likely to pose more short-term downside risk.

## Ukraine conflict causes considerable distortions on the oil markets

However, the Ukraine conflict is also causing considerable distortions on the oil markets. At times, the oil price of Brent crude (the benchmark for Europe) stood at around USD 127 per barrel, while WTI crude (the US benchmark) was quoted at around USD 123 (see chart 2). These are premiums of more than 60% since the beginning of the year! If this increase continues and the higher energy costs of companies are passed on to consumers, then consumer prices are also likely to rise significantly. It can already be assumed that the current turmoil on the commodity markets will cause global inflation rates to rise noticeably in the coming months.

2. ... AND OIL PRICES SKYROCKET




Source: Bloomberg, UniCredit Group Investment Strategy

The main reason for the rising oil prices is the fear of potential consequences of the conflict, in particular that it may soon no longer be possible to obtain oil from Russia if there is a comprehensive embargo on Russian oil imports. Western sanctions are already putting a strain on container traffic to and from Russia, which could also affect trade in raw materials from Russia (including energy exports) in the medium term. Although important Russian export goods, such as oil and gas, are not currently affected by the export bans imposed in Russia, supply bottlenecks could arise sooner or later if major container shipping companies continue to suspend the transport of deliveries to and from Russia. In the week to 5 March, the number of registered tankers in Russian ports has already fallen significantly (see chart 3).

3. NUMBER OF TANKERS IN RUSSIAN PORTS COLLAPSES


Source: Bloomberg, UniCredit Group Investment Strategy

## Pressure of higher yields on equity markets has been limited in the past

Despite the current situation, central banks in the euro area and the US are largely sticking to their monetary policy normalisation. While the Fed raised its key interest rate by 25 bps as announced at its last meeting in March and announced that six further interest rate steps would follow this year, the ECB signaled shortly before a more "hawkish" course than previously expected. It announced its intention to reduce its net bond purchases under the QE (quantitative easing) programme more quickly than had been signalled in December. This tightening was partially mitigated by the decision to decouple the end of the QE programme from the timing of the first rate hike, allowing the ECB to wait as long as necessary before raising rates. Therefore, European equity markets should not face any additional pressure from ECB monetary tightening at the moment. The most immediate risk for further downward corrections results at most from a possibly more aggressive advance by the Fed in its interest rate hikes.

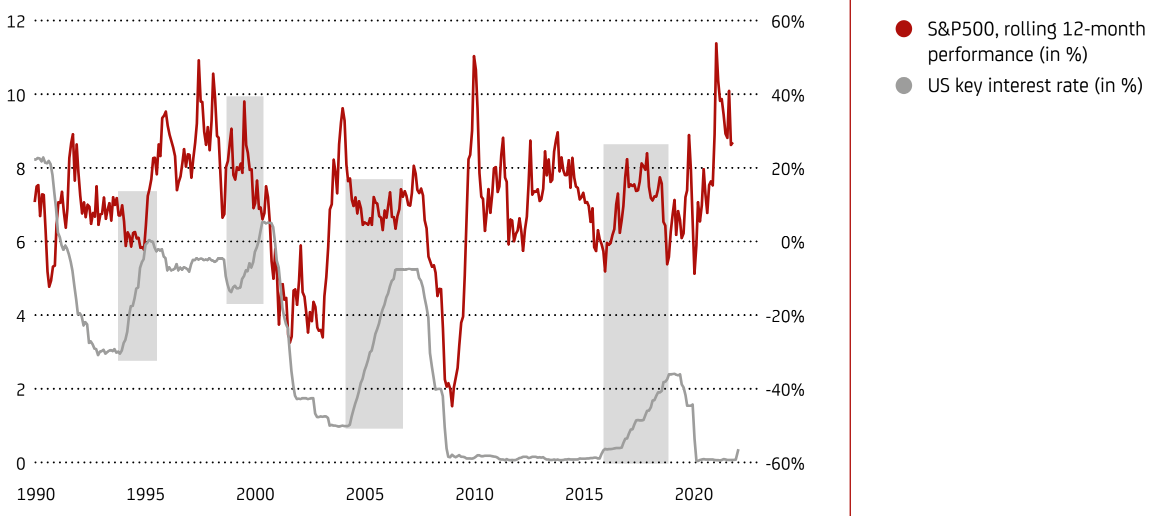
The yield on the 10-year US benchmark government bond fell below the 1.70% mark at times in the second week of March, due to the reduced risk appetite in the wake of the Ukraine conflict, but was then back around 2% towards the end of the week ending March 10, 2022. Thus, it was able to make up for the decline in yields induced by the conflict within a few days. Taking into account a long-term interest rate expectation of the Fed of 2.5%, the assumption of a current neutral real interest rate of 0-0.25% and an expected medium-term inflation rate of slightly above 2%, we assume a nominal yield on the 10-year US government bond of slightly above 2% for this year (for the end of 2023: 2.25%), even though the latest interest rate projections by the Fed are likely to have increased the risks of rising yields. However, financial markets should already have priced in much of this, which is why the pressure on equity markets from rising bond yields in the wake of the Fed's policy normalization, while present, is likely to be limited.

Looking at the Fed's historical interest rate policy, there have been four different interest rate hike cycles over the past three decades, but none of them have really had an overly negative impact on equity markets. Chart 4 contrasts these periods of monetary tightening with the 12-month performance of the S&P 500 index (see red-shaded areas). It shows that, on average, the benchmark equity index posted a solid gain of around 10% during these periods. However, it also shows that the fluctuations in equity performance were sometimes high (up to 40%). This is also in line with our expectation of a still positive but more volatile 2022 for the equity markets. However, due to the increased uncertainty caused by the Ukraine conflict, we must expect significantly higher volatility than we had previously assumed in some areas over the next few weeks.

In theory, rising bond yields lead to a reallocation of assets. Usually this involves swapping equities for higher-yielding bonds, as the latter appear more attractive against the backdrop of a less dynamic economic environment. The risk of monetary policy normalisation is therefore that the removal of central bank support makes equity markets more vulnerable to temporary downward movements.

The neutral interest rate or the natural interest rate usually describes the real interest rate (i.e. the nominal interest rate minus the inflation rate) that brings the economy into equilibrium without stimulating or slowing down the economy. Taking into account the expected inflation, a central bank can then increase its key interest rate accordingly without having a lasting impact on economic development.

4. INTEREST RATE HIKES ARE NOT PER SE BAD FOR EQUITIES ...

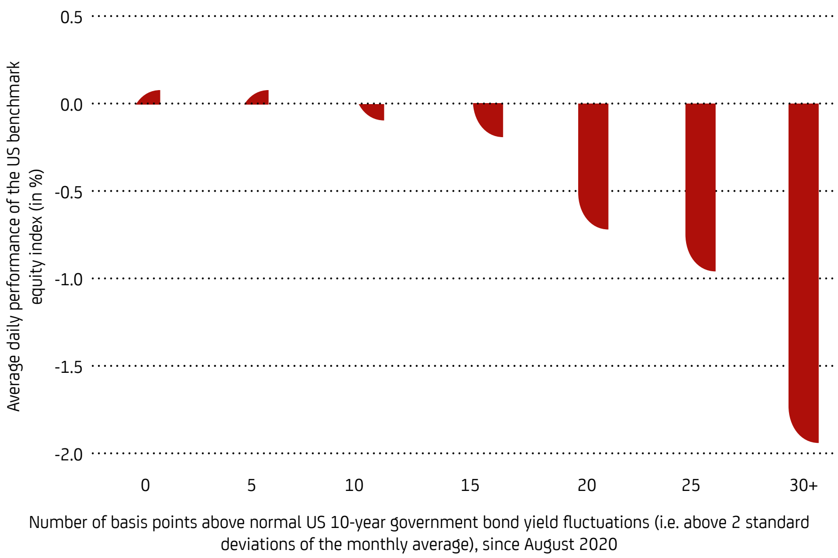



Source: Bloomberg, UniCredit Group Investment Strategy

Looking back to the beginning of the year – and thus before the outbreak of the Ukraine conflict – one could already observe a significantly lower appetite for risky assets. This was triggered by a too fast and strong rise in bond yields. In the past, there was a clear correlation between the pace of rising bond yields and the negative effects on stock markets. The pace of rising yields can be measured by the number of standard deviations that the yield rises above its normal fluctuations (on average two standard deviations). Chart 5 shows the historical relationship between the number of basis points by which the 10-year US Treasury bond yield has been above two standard deviations and the associated average daily performance of the S&P 500 index. The result is clear: the faster yields rose excessively (i.e. above two standard deviations), the greater the negative impact on equity markets. This risk to equity markets arises if the Fed feels compelled to embark on a more aggressive tightening cycle than previously envisaged.

A standard deviation is a statistical measure of the dispersion of returns, indicating the extent to which returns deviate from their mean. Usually, about 95% of returns are within two standard deviations, whereas fluctuations of more than two standard deviations are considered rare events and thus attributed to special exceptional circumstances.

5. ... BUT LEAD TO INCREASED VOLATILITY ON THE STOCK MARKETS




Source: Bloomberg, UniCredit Group Investment Strategy

## What does this mean for our investment strategy?

The current mix of geopolitical risks, the Ukraine conflict and upcoming monetary tightening cycles brings considerable uncertainties about the future development of the financial markets. In this environment, we are increasing the focus on our risk management as well as the execution of tactical allocations. However, as soon as the fog of uncertainty lifts, the inflation and growth outlook, especially for Europe, should also brighten again. Nothing should then stand in the way of a rally on the equity markets. Last but not least, the investment programmes for renewable energies and defence launched by the European governments should also be a tailwind for economy growth (for details on our investment strategy, see the section “Asset Allocation”).

# Macro & Markets

## Ukraine conflict: The next shock

An unbounded Vladimir Putin has shocked the world – just as Covid started to throw off its shackles. The invasion of Ukraine is not only a humanitarian catastrophe, but it also has lasting effects on geopolitics (Cold War 2.0), the security and energy architecture in Europe, and on economies and financial markets. Russia itself is most probably paying a very high price. Putin seems to have underestimated not only Ukraine's will to defend itself, but also the West's reaction. The aggression isolated Russia internationally, welded NATO, the EU and the US and triggered a sea change in Europe.

Putin may likely achieve his ostensible goal of annexing (parts of) Ukraine - or not. However, he is unlikely to achieve his supposed geostrategic goals of further weakening the democratic West, pushing back NATO and extending his sphere of power to the borders of the former Soviet Union – on the contrary. The threatened peoples there will turn even more towards the West, but above all the far-reaching sanctions should send the Russian economy into recession soon and noticeably slow down its long-term economic potential.

But Europe is also paying the price for its freedom in the form of significantly higher inflation and noticeably slower growth. However, the post-Covid recovery is not likely to break off, at least not in our baseline scenario (no NATO intervention, and no abrupt halt to Russian gas and oil supplies). The catch-up and recovery forces are too vital for that. At the same time, the risk of stagflation, i.e., a sluggish economy combined with high inflation, has increased noticeably with the conflict.

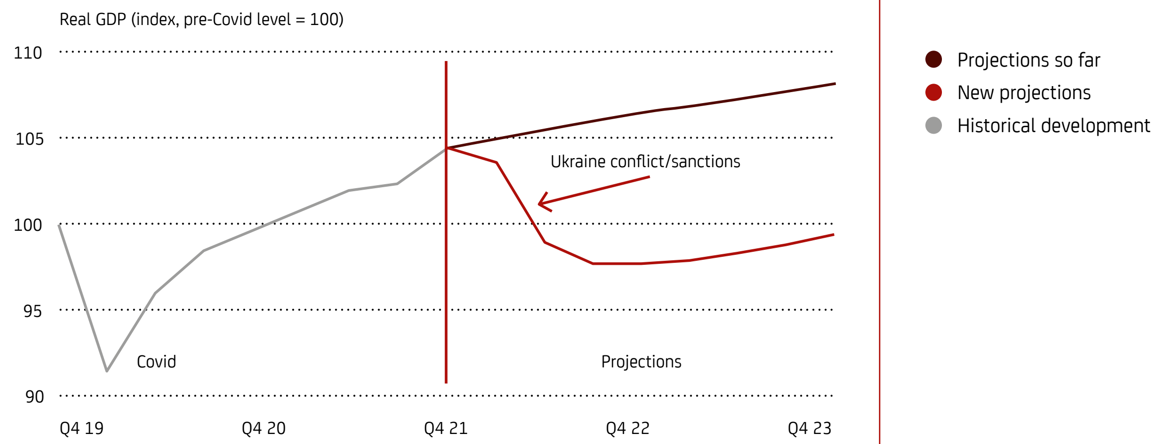
The most obvious is Germany's U-turn on its security and energy policy. An additional EUR100 billion for defence, arms deliveries to crisis areas and the plan to reduce its energy dependence from Russian supplies have turned the previous cooperative approach into the opposite. On the impact of the Ukraine's conflict on the systemic struggle between autocracy and democracy, geopolitics and Europe, see also the Sunday Wrap by Erik Nielsen, Chief Economics Advisor at UniCredit Group, as of March 6, 2022.

## Sanctions to hit Russia hard, recession likely

Russia likely did not expect such swift, concerted and harsh sanctions by the West, especially the freezing of foreign exchange reserves and the extensive disconnection of its banks from the international financial transaction system SWIFT. This is causing serious damage to the Russian economy. In addition, the restrictions on exports to Russia, especially technology and electronics (the EU is Russia's most important partner with a trade share of one third), the sanctions against key Russian industries, against businessmen, oligarchs and officials, as well as the withdrawal of (large) companies from Russia are likely to leave severe traces on the economy – especially since the unprecedented decline of the Russian rouble and stocks coupled with rising inflation have already depressed economic sentiment in the country. At the same time, confidence in the banking system is waning. We therefore expect Russia to slide into recession as early as this spring (see chart 6).

So far, Russian banks involved in the settlement of gas and oil deliveries to the West are still exempt. In the event of a further escalation, however, this option could also be taken.

6. RUSSIA: RECESSION SEEMS INEVITABLE




Source: Refinitiv Datastream, UniCredit Group Investment Strategy

What's more, the sanctions are also likely to curb potential economic growth to a meager 1%-2% and thus lead to Russia falling further behind its Emerging Markets peers. Putin may rehearse closing ranks with Beijing politically – but he economic gap with China will widen dramatically.

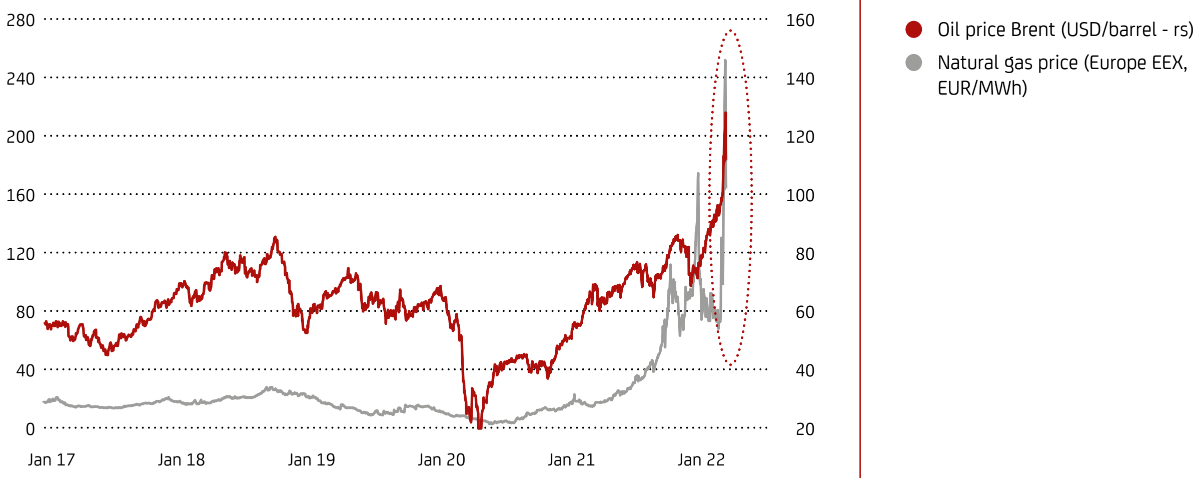
Russia's growth potential is already suffering from a rapidly ageing population, inadequate infrastructure, heavy dependence on fossil fuels and significantly reduced integration into the global economy.

### Europe is also paying its price: more inflation, less growth

However, the sanctions and countermeasures also affect (Western) Europe. The most important transmission channel is the massive increase in energy prices (see chart 7). Europe is particularly dependent on Russian supplies (almost 45% of all EU natural gas imports, and around 27% of crude oil). However, prices for industrial metals and agricultural raw materials have also risen noticeably, as Russia is one of the world's largest producers in these areas as well.

Russia's share of world production of palladium (which plays a central role in catalytic converters) is just under 45%. For wheat it is 11% (and together with Ukraine, it is around 15%).

7. ENERGY PRICES SOARING...

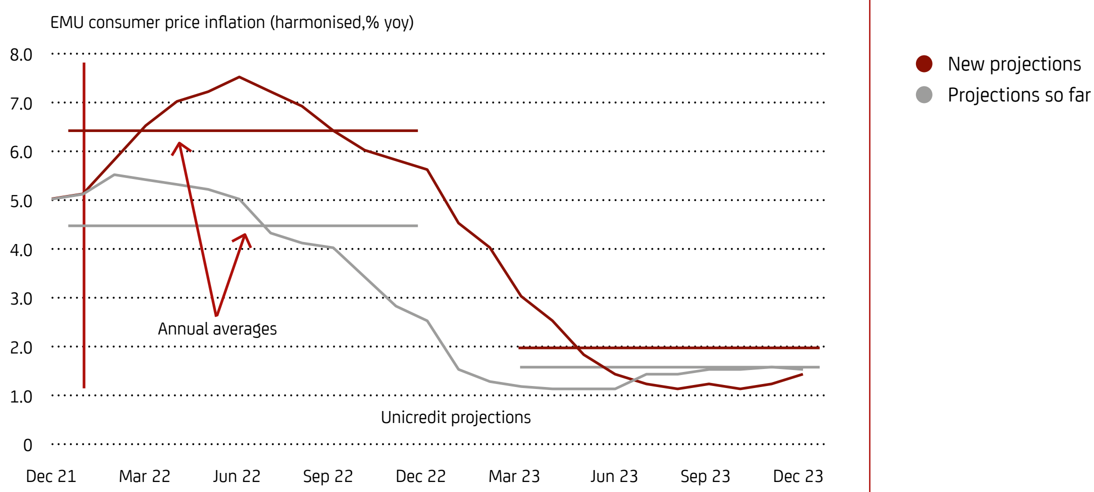



Source: Refinitiv Datastream, UniCredit Group Investment Strategy

This has a noticeable impact on the EMU's inflation trend – and we have to raise our forecasts significantly. EMU-wide consumer prices should rise to 7.5% by mid-year (see chart 8), before – which is typical of exogenous shocks – falling rapidly and significantly thereafter. Inflation should approach the ECB's 2% mark again next year. Nevertheless, the renewed surge in inflation is slowing down economic growth noticeably (loss of purchasing power).

In Italy you have to go back to the mid-1980s, in Germany even to the mid-1970s, to find such high inflation rates.

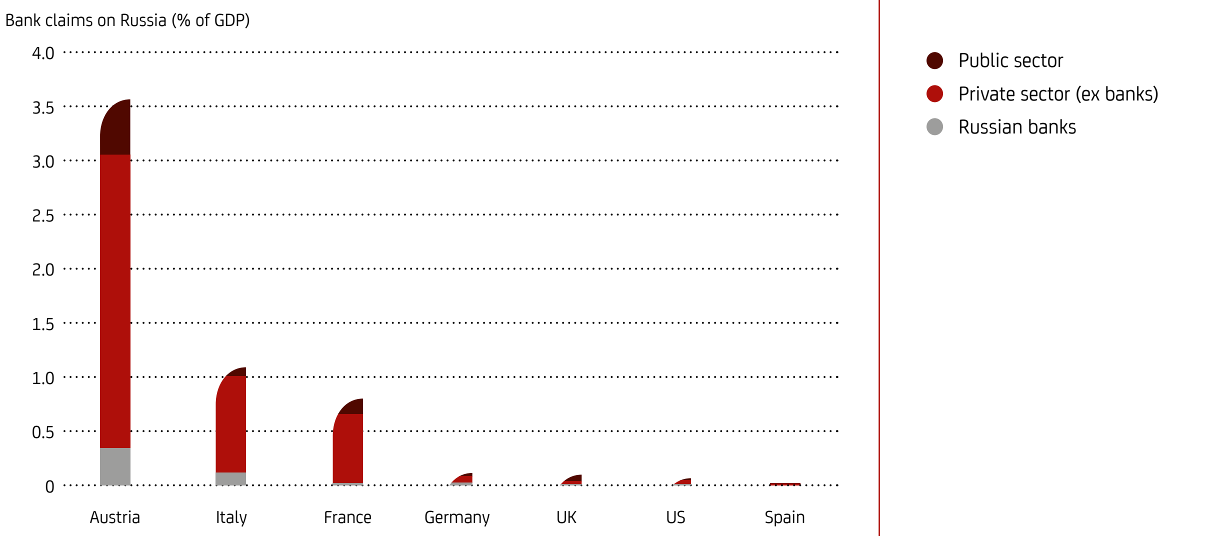
8. ... NOTICEABLY FUELLING INFLATION




Source: Refinitiv Datastream, UniCredit Group Investment Strategy

By contrast, the importance of bilateral trade and financial relations for the euro area is much more manageable. Russia accounts for only 3% of the trade volume, while in the case of bank claims, Austria at best can be described as exposed (see chart 9).

9. MANAGEABLE FINANCIAL RELATIONS WITH RUSSIA




Source: Refinitiv Datastream, UniCredit Group Investment Strategy

That leaves one last transmission canal, the sentiment channel. Both business climate and consumer confidence could experience setbacks that overlay the recent upward tendency – but likely only short-term.

Just before the Ukraine invasion, the EMU purchasing managers' indices, the EU Commission's economic confidence figures as well as the closely watched Ifo business climate have risen again.

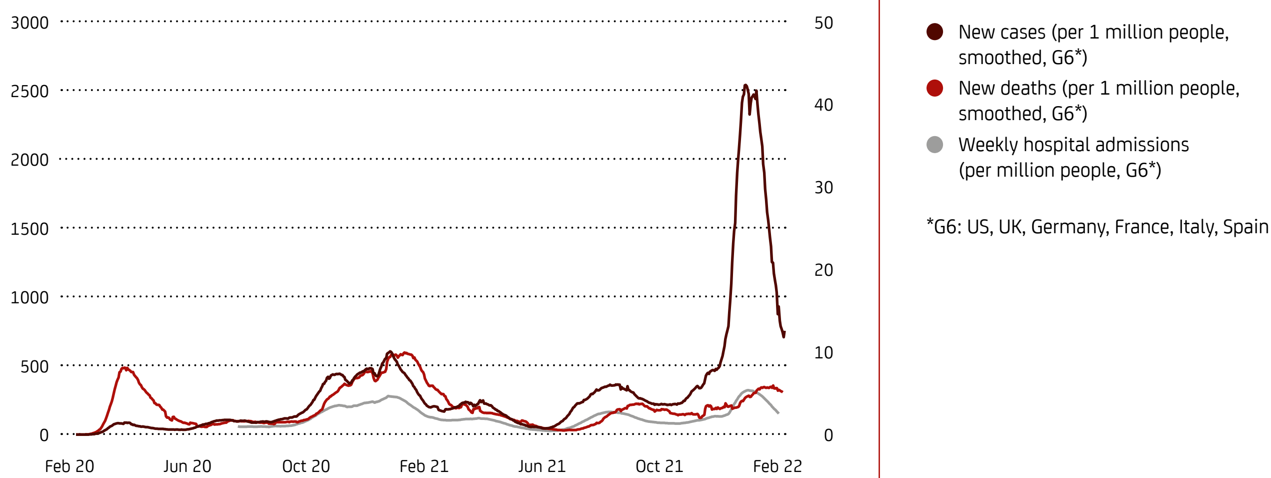
### Post-Covid recovery not to break off, however

All in all, the conflict in Ukraine will have a noticeable negative impact on growth in Western Europe. However, there are a number of reasons for why the post-Covid recovery should not be put on hold:

1. Covid is losing its dread.
   Incidence figures are on the decline worldwide. This also applies to the more important hospitalisation and death numbers (see chart 10). Government restrictions are being loosened, mobility indices are rising noticeably. This is triggering a catch-up effect, especially in the so far hard hit services sector. However, China is beginning to worry us.

Pent-up travel lust: airlines and tour operators reported a sharp rise in holiday and flight bookings, Frankfurter Allgemeine, as of January 18, 2022 (here).

10. THE OMICRON WALL BREAKS DOWN




*G6: US, UK, Germany, France, Italy, Spain

Source: ourworldindata.org/Covidvirus, UniCredit Group Investment Strategy

2. **Savings overhang dampening loss of purchasing power.**
   While the normalisation process has already started, savings rates are still clearly above their long-term averages. This implies upside potential for private consumption.

3. **Fiscal policy becoming expansionary again.**
   New defence initiatives signify additional fiscal policy impulses, thus reducing the so far projected fiscal drag significantly, or even turning it into a fiscal thrust. Tax relief and state aid to cushion soaring energy prices are working in the same direction.

4. **Supply bottlenecks are easing overall.**
   The Ukraine's conflict may delay the development, but it can hardly turn it around. Delivery times and order backlogs are already clearly on the retreat. This also applies to the supply chain pressure composite indices – despite rapidly rising energy prices.

5. **New orders on the rise.**
   Following the dip at the turn of the year, the purchasing managers' new orders sub-indices have risen again with levels clearly in expansionary territory. This also applies to the forward-looking ratio of new orders to inventories. This should not change fundamentally, because the Ukraine conflict-induced loss in economic growth outside Europe remains very manageable.

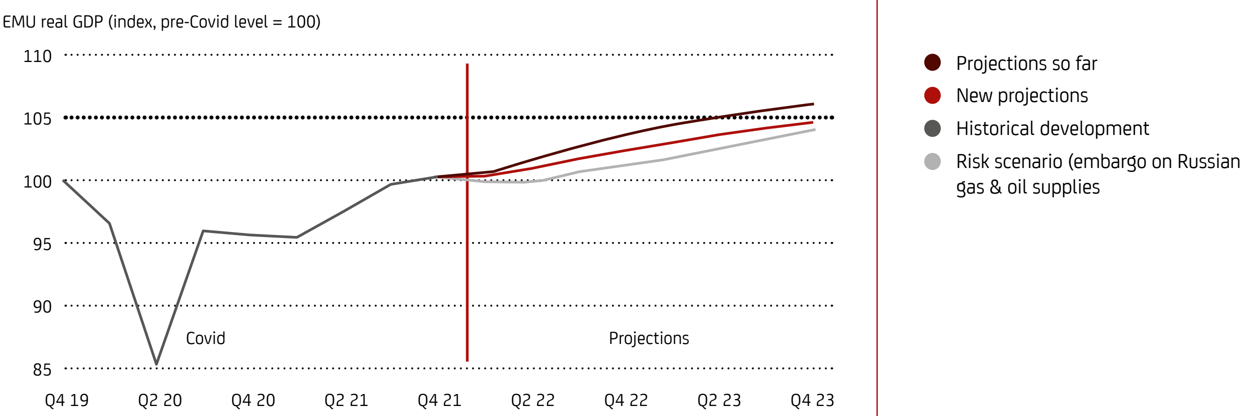
All summed up, we therefore expect the euro area to suffer painful but bearable losses in growth this year. Instead of the previously estimated 3.8%, we now expect real GDP to grow by only 2.8%-3% this year (see chart 11). In 2023, dampening effects should be only half as strong, with GDP growth falling to around 2.2%-2.5%. Therefore, the economic slowdown would have to be much more severe before one can speak of stagnation.

Fiscal drag refers to the loss of growth due to a decline in fiscal stimulus (less growth in spending and/or higher tax revenues).

The average of freight costs, chip prices, gas, coal and oil bills has declined sustainably year-to-date and has only risen slightly recently.

Due to their higher energy dependency on Russia, Germany and Italy are likely to be more affected than France and Spain.

11. NOTICEABLE SLOWDOWN, BUT NO STAGNATION OR RECESSION



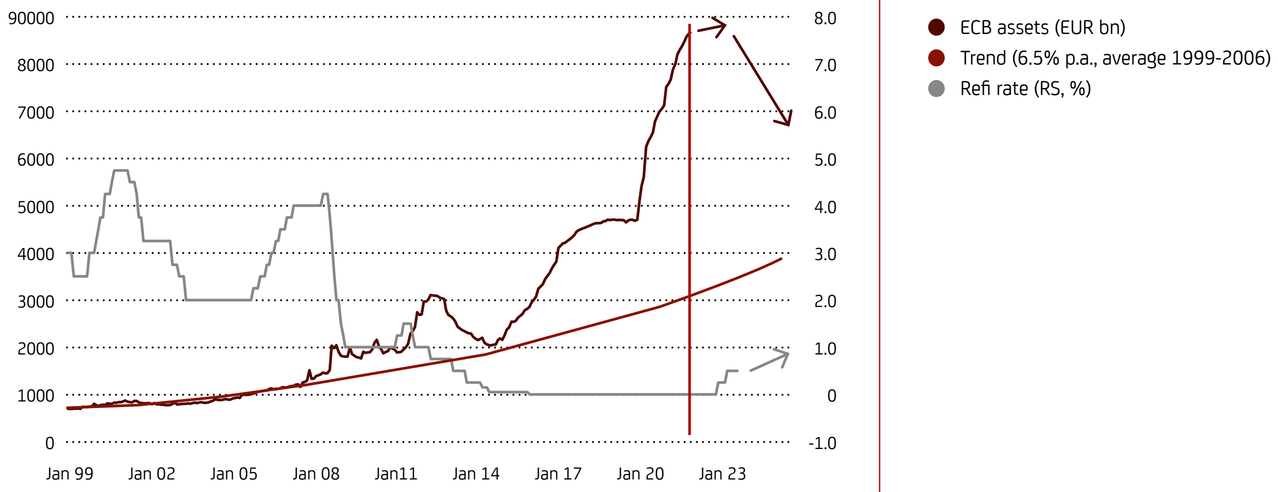

Source: Refinitiv Datastream, UniCredit Group Investment Strategy

### Central banks tighten the reins

Slower growth and higher inflation – this means an additional challenge for the ECB. The central bank has reacted and adopted a more hawkish tone with regard to the reduction of its securities purchases. The ECB now wants to phase out the programme in the third quarter already. At the same time, it has at least verbally decoupled the so-called sequencing, i.e. the termination of the securities purchases followed by the start of its tightening cycle. A first rate hike this autumn (as previously priced in by markets) has thus become unlikely. We expect the start of the cycle in the course of the first quarter of 2023, which will be followed by a second 25 basis point step to 0.50% until mid-next year (see chart 12).

In the second half of 2023, however, the ECB should "wait and see" in order to reassess inflation (expectations) developments. After that phase, however, the signs point to further tightening steps.

12. ECB: FIRST RATE HIKE NOT UNTIL EARLY 2023

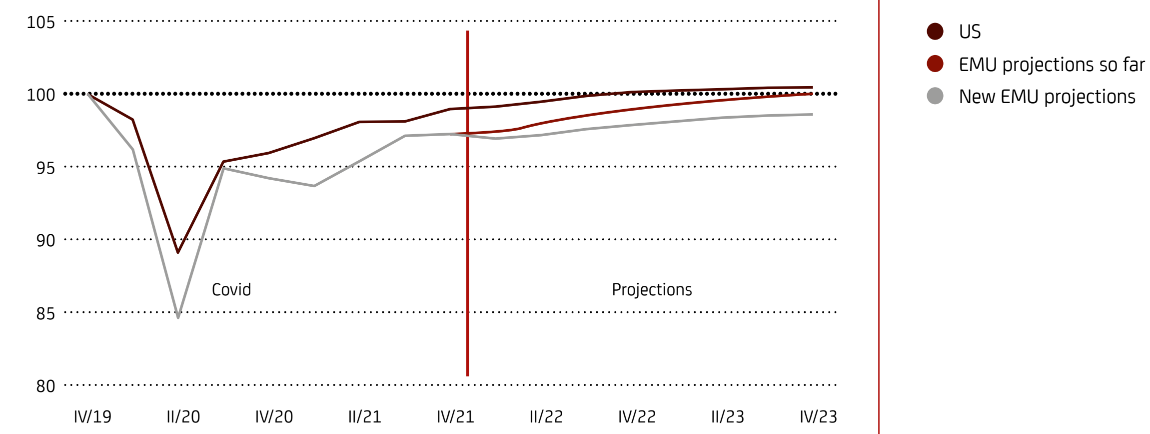



Source: Refinitiv Datastream, UniCredit Group Investment Strategy

The Federal Reserve has even become even more ruly hawkish – and rightly so, in our opinion. After all, the US economy is far less affected by the Ukraine conflict than Europe. However, this will increase the US economic head start even further (see chart 13).

So far, no major investment house has downgraded its US GDP forecast on the Ukraine conflict worth mentioning.

13. US ECONOMIC LEAD WIDENS




Source: Refinitiv Datastream, UniCredit Group Investment Strategy

And the Fed has delivered. As widely expected, it raised the Fed Funds Target Rate by 25 bps to 0.50% in mid-March, justifying its move with continuing inflationary pressure (just recently, consumer price inflation marked a 40-year high at 7.9%), the tightening labour market and robust growth against the background of the soon to be closed output gap. Moreover, the Fed signalled six more rate hikes of 25 basis points each for this year alone, thereby catching up with what markets had expected.

After the Ukraine conflict-induced downward revision, it will take at least until 2025 for the euro area to return to its pre-Covid trend path.

### Where are the risks? How realistic is a stagflation scenario?

The current extraordinarily high level of uncertainty continues to make thinking in terms of scenarios unavoidable. What could be different from our baseline scenario?

Essentially, we see two escalation settings. In a worst-case scenario, NATO would be drawn into the war. A quantitative assessment of inflation and growth effects in such an extreme scenario seems not only unserious, but also misplaced in view of the impending world-wide, or at least Europe-wide, humanitarian catastrophe.

On the other hand, we consider the risk of a full-blown Western embargo on Russian oil and gas supplies to be much higher (it would be irrational for Russia to stop supplies, but it cannot be ruled out). Such a step is currently being increasingly brought into play, but is still met with scepticism in parts of Europe in view of its high energy dependence on Russia.

If there were a rapid and comprehensive embargo, energy prices would likely shoot up again. Western governments would then be tempted to mitigate the effects on households and companies through fiscal policy (lower taxes and levies, subsidies), to minimise the price increase by releasing strategic stocks, to increasingly switch to other supplier countries and to "encourage" the remaining producing countries to ramp up their production (in the case of crude oil, Venezuela and Iran could be suppliers that have hardly been present on the world market recently; in the case of natural gas, on the other hand, the capacity reserves are limited). At the same time, the EU and national governments would push ahead the switch to renewable energies, save energy (scrapping premia) and reduce the energy intensity of production. However, since this should only have effects in the longer term, coal-fired power generation and nuclear energy could also be temporarily ramped up.

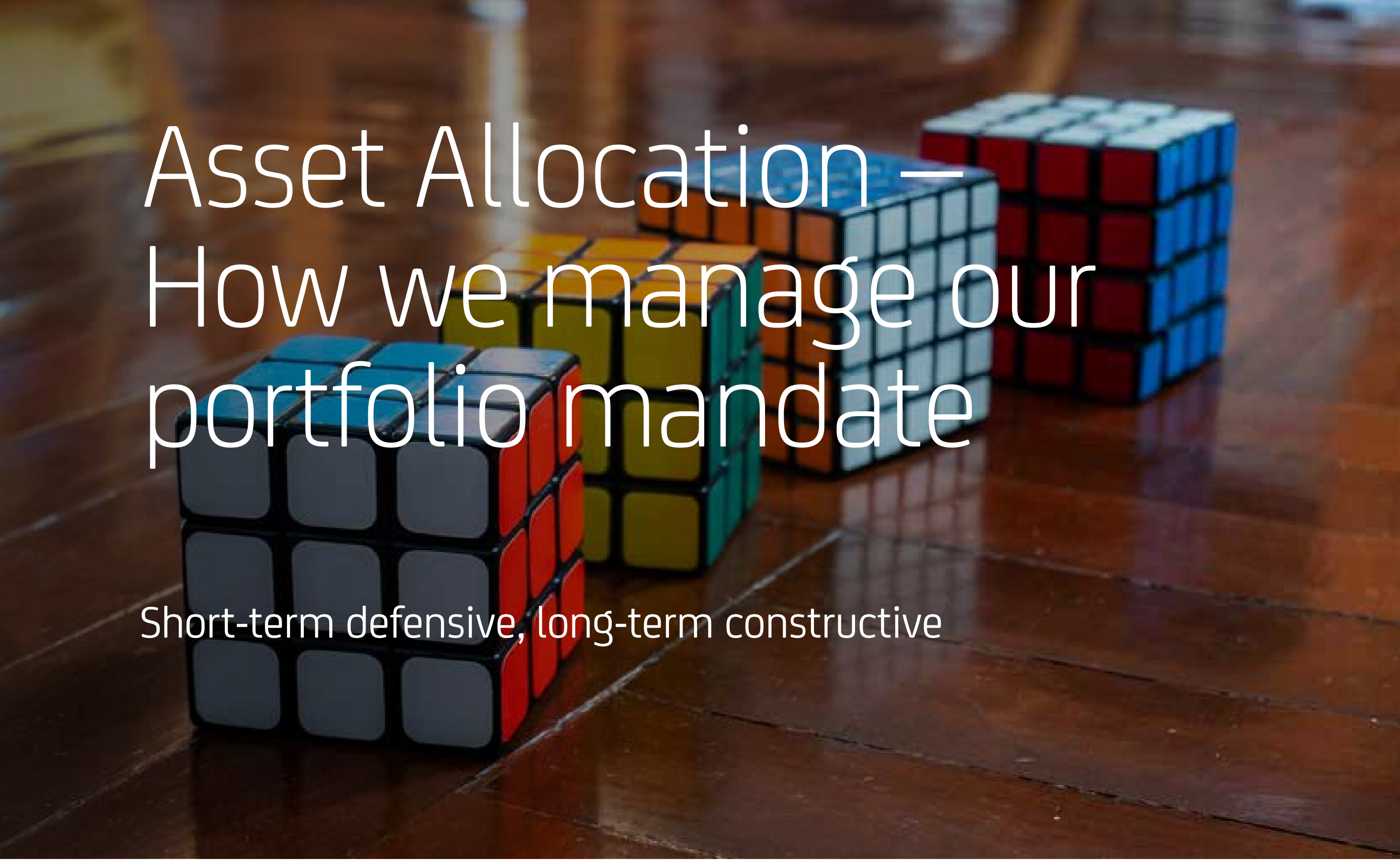
The EU has only recently presented plans for this (here) Joint European action for more affordable, secure energy (europa.eu).

In the short term, European energy supply does not seem to be at risk. The storage facilities are well reasonably stocked. The sticking point, however, is the question of whether we can get through the next winter without Russian gas. According to a study by the renowned Belgian think tank Bruegel, it should be technically possible to replace Russian gas already for next winter without economic activity being devastated, people freezing, or electricity supply being disrupted. But that would require a lot of improvisation, entrepreneurial spirit, as well as public intervention and fiscal flank protection. Liquefied natural gas imports would have to be ramped up to capacity limits, but at the same time gas consumption would have to be reduced by 10%-15%. And the additional cost of replenishing gas storage in time would amount to EUR 60 million – six times more than in normal times.

For the details, please see the Bruegel study as of February 28, 2022 (here). Preparing for the first winter without Russian gas | Bruegel.

It may be that we underestimate the EU's problem-solving capacity in times of crisis. But the reality could be less rosy in the coming winter as pointed out in the study. It is quite possible that the economic recovery will suffer another setback at the turn of the year (possibly even dipping into negative territory short-term) and inflation will rise again.

Technically, that would be stagflation – but presumably a short-lived one because, unlike in the 1970s, the supply shock will not hit encrusted economic structures and is likely to result in a wage-price spiral. We should be spared years of stagnation coupled with high inflation even in a risk scenario of an embargo on Russian oil and gas supplies... hopefully.



# Asset Allocation – How we manage our portfolio mandate

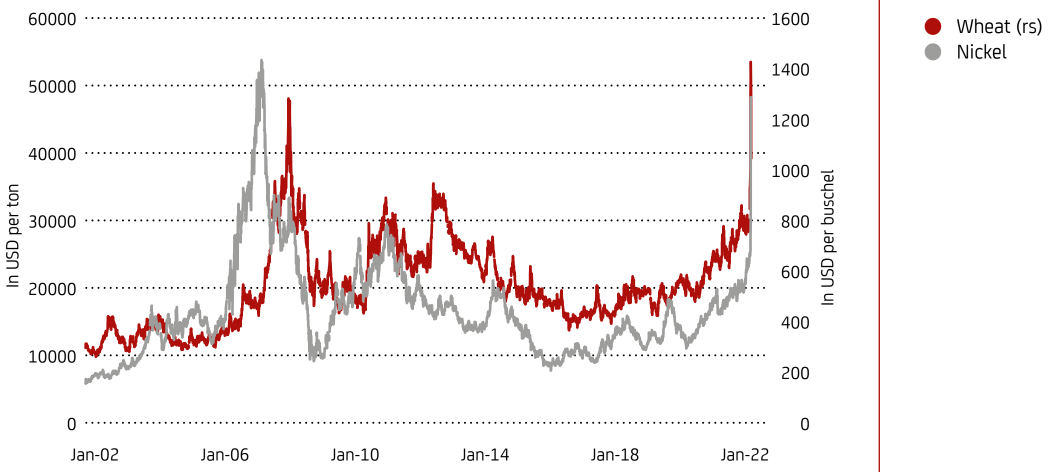
## Short-term defensive, long-term constructive

| ASSET | | INVESTMENT UNIVERSE | INVESTMENT VIEW: NEGATIVE | INVESTMENT VIEW: NEUTRAL | INVESTMENT VIEW: POSITIVE |
|---|---|---|---|---|---|
| MAIN ASSET CLASSES | | Global Equities | ○ | ○ | ● |
| | | Global Bonds | ● | ○ | ○ |
| | | Liquidity | ○ | ○ | ● |
| | | Money Markets | ○ | ● | ○ |
| | | Alternatives | ○ | ● | ○ |
| MAIN ASSET CLASSES IN DETAIL | EQUITIES | US | ○ | ● | ○ |
| | | Europe | ○ | ○ | ● |
| | | Pacific (DM[1]) | ○ | ● | ○ |
| | | Emerging Markets | ○ | ○ | ● |
| | BONDS | EMU Governments 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)

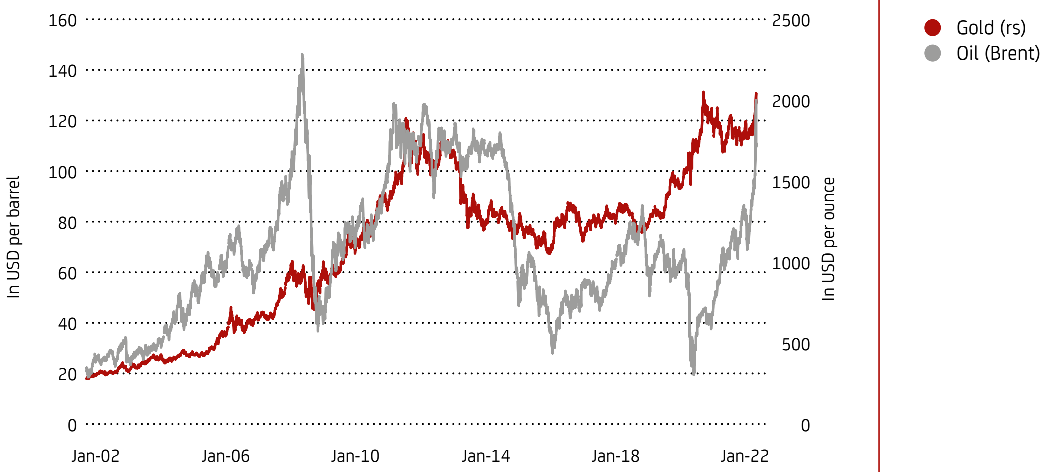
The last few weeks were marked by Russia's invasion of Ukraine, and the subsequent escalation of sanctions that are hitting the Russian economy hard. From February 20 onwards, in addition to the rise in the price of energy commodities, we have seen a "flight to quality", that is an increased risk aversion with corrections in riskier asset classes such as equities, and appreciation of more defensive, 'safer' assets such as government bonds, gold and safe haven currencies like the US dollar.

### 14. GLOBAL COMMODITY PRICES STILL INCREASING ON THE BACK OF THE RUSSIA-UKRAINE CONFLICT




Source: Bloomberg, UniCredit Group Investment Strategy

### 15. BACK TO FLIGHT TO QUALITY: GOLD SPOT PRICE (DOLLARS PER OUNCE) INCREASING




Source: Bloomberg, UniCredit Group Investment Strategy

16. USD AND OTHER SAFE HAVEN CURRENCIES BENEFITTED FROM HIGHER RISK AVERSION


Source: Bloomberg, UniCredit Group Investment Strategy

However, despite all the bad news, the US yield curve has not yet inverted (which is a leading indicator of recession); rather, it has remained flat.

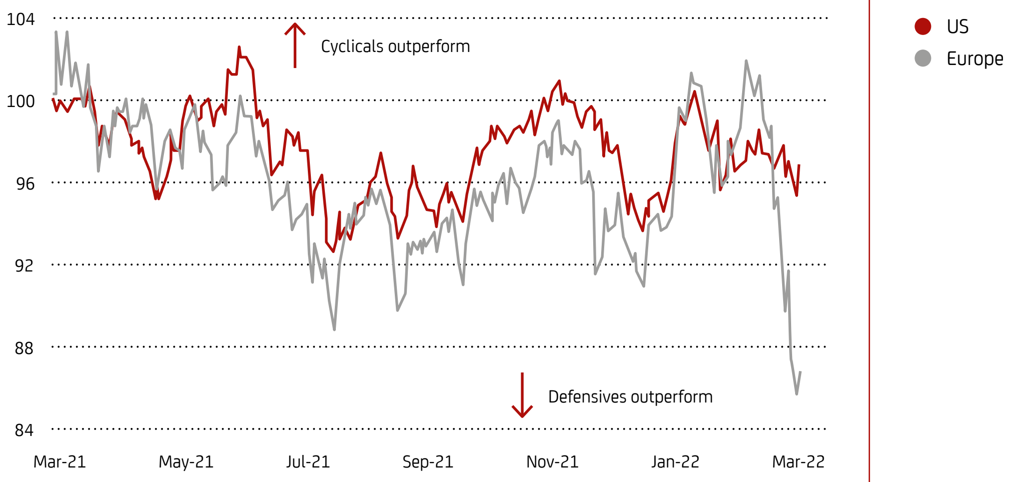
17. US 2YR / 10YR YIELD CURVE


Source: Bloomberg, UniCredit Group Investment Strategy

In fact, the negative impact on growth and inflation is the greatest for the eurozone: Russia supplies about a third of the natural gas and a quarter of the crude oil consumed in the eurozone. The impact on the US, given its energy independence, and China, is lower.

The risk of stagflation, that is higher inflation and lower GDP growth, is therefore more felt in eurozone. Not surprisingly, defensive sectors are overperforming relative to cyclicals.

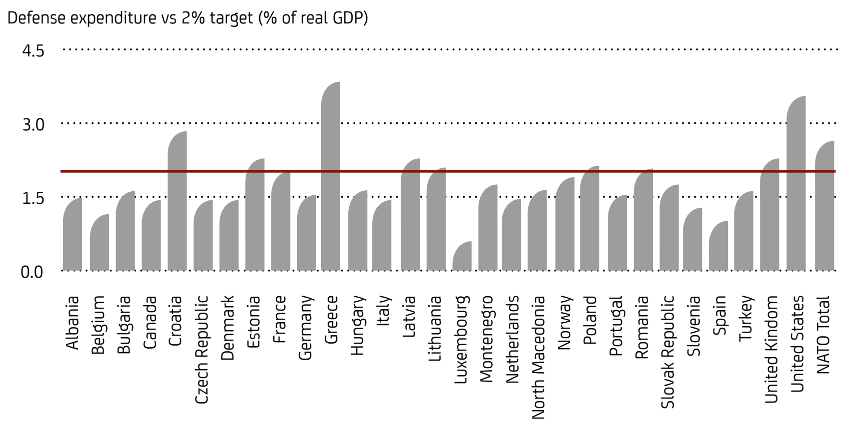
18. CYCLICALS VS. DEFENSIVES COME DOWN MORE SHARPLY IN EUROPE
GSSTCYCL VS. GSSTDEFS (EUROPE) AND GSSBCYCL VS. GSSBDEFS (US)




Source: Bloomberg, Goldman Sachs Global Investment Research

However, in the longer term, we can expect the Ukraine crisis to be a kind of maturity test for eurozone. We expect a strong push towards a common energy and defence policy, which should translate into a revival of long-term investment in these sectors, thus overcoming the effects of short-term stagflation and the savings glut that has condemned Europe to anaemic growth rates in the past.

19. NATO ESTIMATES OF DEFENCE EXPENDITURE IN % OF REAL GDP (2021 DATA)




Source: NATO Communique PR/CP (2021)094, BofA Global Research

As has already happened in the past (it was not until the WW2 military expenses that the US managed to fully exit the “Great Recession”), conflict times offer a long -term buying opportunity as the GDP trend growth benefits from major investments. And the major Western central banks will have to normalise their monetary policies only gradually in order to support the strategic investments of their governments.

The financial markets know this dynamic well and, under this perspective, recent comparisons are also encouraging in terms of recovery time (see table below).

## 20. STOCKS USUALLY TAKE GEOPOLITICAL EVENTS IN STRIDE

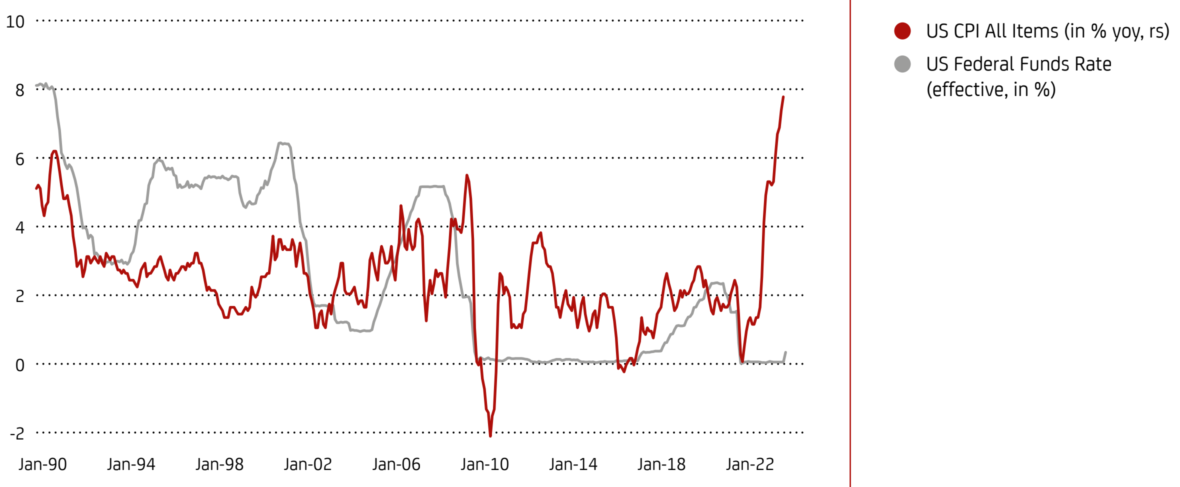
S&P 500 index and geopolitical events

| | S&P 500 RETURNS | | | DAYS | |
|---|---|---|---|---|---|
| MARKET SHOCK EVENTS | EVENT DATE | ONE DAY | TOTAL DRAWDOWN | BOTTOM | RECOVERY |
| U.S. Pulls Out of Afganistan | 8/30/2021 | 0.4% | -0.1% | 1 | 3 |
| Iranian General Killed in Airstrike | 1/3/2020 | -0.7% | -0.7% | 1 | 5 |
| Saudi Aramco Drone Strike | 9/14/2019 | -0.3% | -4.0% | 19 | 41 |
| North Korea Missile Crisis | 7/26/2017 | -0.1% | -1.5% | 14 | 36 |
| Bombing of Syria | 4/7/2017 | -0.1% | -1.2% | 7 | 18 |
| Boston Marathon Bombing | 4/15/2013 | -2.3% | -3.0% | 4 | 15 |
| London Subway Bombing | 7/5/2005 | 0.9% | 0.0% | 1 | 4 |
| Madrid Bombing | 3/11/2004 | -1.5% | -2.9% | 14 | 20 |
| U.S. Terrorist Attacks | 9/11/2001 | -4.9% | -11.6% | 11 | 31 |
| Iraq's Invasion of Kuwait | 8/2/1990 | -1.1% | -16.9% | 71 | 189 |
| Reagan Shooting | 3/30/1981 | -0.3% | -0.3% | 1 | 2 |
| Yom Kippur War | 10/6/1973 | 0.3% | -0.6% | 5 | 6 |
| Munich Olympics | 9/5/1972 | -0.3% | -4.3% | 42 | 57 |
| Tet Offensive | 1/30/1968 | -0.5% | -6.0% | 36 | 65 |
| Six-Day War | 6/5/1967 | -1.5% | -1.5% | 1 | 2 |
| Gulf of Tonkin Incident | 8/2/1968 | -0.2% | -2.2% | 25 | 41 |
| Kennedy Assassination | 11/22/1963 | -2.8% | -2.8% | 1 | 1 |
| Cuban Missile Crisis | 10/16/1962 | -0.3% | -6.6% | 8 | 18 |
| Suez Crisis | 10/29/1956 | 0.3% | -1.5% | 3 | 4 |
| Hungarian Uprising | 10/23/1956 | -0.2% | -0.8% | 3 | 4 |
| N. Korean Invades S. Korea | 6/25/1950 | -5.4% | -12.9% | 23 | 82 |
| Paerl Harbor Attack | 12/7/1941 | -3.8% | -19.8% | 143 | 307 |
| **Average** | | **-1.1%** | **-4.6%** | **19.7** | **43.2** |

Source: LPL Research, S&P Dow Jones Indices, CFRA, 01/24/2021 Goldman Sachs Global Investment Research

To sum up, rising nominal interest rates will not keep pace with rising inflation, and real interest rates will remain negative for an extended period of time, thus favouring real and risk asset classes, primarily equities.

21. NEGATIVE INTEREST REAL RATES WILL REMAIN FOR A WHILE




Source: Federal Reserve Board, Bureau of Labor Statistics

We continue to believe that rising inflation supports our structural underweight on global bonds, where we prefer corporate bonds and, selectively, Emerging Market (EM) bonds.

While vulnerable to short-term risk aversion and negative earnings revision, equities remain attractive on a long-term basis in terms of relative valuation. However, we are increasingly defensive, focusing on companies with higher pricing power, and which are more resilient to adverse scenarios and with high cash flow generation/high dividend yield.

We maintain our overweight in European equities but are fully aware that US, Japan and EM equities, especially the EM Asian equities, are less affected by the Russia-Ukraine conflict. Also, in the current high uncertainty environment, the USD and gold exposure offer interesting portfolio hedging opportunities as well as an increased buffer of liquidity.

## UniCredit Asset Allocation stances

### Overweight Global equities

Decelerating but above trend global growth supports equities, despite headwinds and higher volatility from geopolitical tensions, rising rates in the US and the pandemic. Appealing relative valuation as real rates remain negative.

### Overweight European equities

In the short term, this is the most affected area from the Russia-Ukraine conflict. However, it will benefit in the longer term from higher investments in the energy and defence industries.

### Neutral US equities

High growth but the Fed is now opting for a hawkish tilt. Selective buying opportunities arising from the equities market drop and the earnings season.

### Overweight Emerging Market equities
Attractive valuations, higher commodities prices and an advanced rates hiking cycle offer long -term buying opportunities.
In China, a moderate monetary easing is already under way. Countries and sectors selectivity among the EMs is strongly recommended.

### Neutral Pacific equities
Japanese equities are supported by the global recovery, the domestic fiscal stimulus and the weakening yen.

### Underweight Global bonds
Vulnerable to increasing inflation and rising bond yields.

### Overweight Euro Investment Grade corporate bonds
Still supported by the ECB's purchases but their tighter spread buffer makes them more vulnerable to rising interest rates. We prefer financial subordinated debt, given the increased capital buffer of European banks and shorter duration.

### Neutral High Yield corporate bonds
Attractive carry play and favourable default rate scenario, as we expect above trend GDP growth in 2022. Shorter duration versus Euro government bonds and Euro investment grade corporate bonds is a plus, considering the expectation of a gradual normalisation of interest rates. Their lower liquidity should be taken into consideration in case of further market turmoil.

### Underweight EMU government bonds
We are underweight core Euro governments bonds given their high benchmark duration. We prefer peripheral government bonds, such as the Italian and Spanish govies, supported by the ECB's action and the Recovery Fund. We prefer short-duration and are selectively increasing the positioning on inflation-linked bonds, to deal with the base-scenario of increasing inflation.

### Neutral non-EMU government bonds
We expect US Treasury yields to increase in 2022.

### Overweight Emerging Market bonds
The search for yield supports our positive stance, but we are defensive and selective considering the Fed's tightening and inflation in EM countries.

### Positive Liquidity
To be used mostly as liquidity parking and hedging for uncertainty.

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

### Commodities
Late cycle asset class, supported by global recovery and, as for fossil energy prices and some metals, by the geopolitical tensions.

### Positive Gold
Hedging for uncertainty.

### Currencies
Flight to quality and a more restrictive Fed support the USD.


## Answers from Italy

### What are the main messages of the recent "Versailles Declaration" and the contents of the REPower EU plan?

In recent years, the macroeconomic landscape and financial markets have been heavily influenced by ultra-expansionary monetary policies and targeted fiscal stimulus, measures intended to heal economic and social wounds inflicted by Covid.

The coming years will be profoundly shaped by the Russian aggression against Ukraine, a dramatic event which is causing unspeakable suffering to the Ukrainian population. The European Union (EU) is providing coordinated political, financial and humanitarian support. And it is also planning how to effectively respond to growing instability, global strategic competition and security threats.

These are the issues addressed by the "Versailles Declaration", which concludes the 10-11 March meeting of the EU Heads of State and Government.

It is an important strategic plan because it clearly states the main directions EU private and public investments will take in the next decade. So, we know that monetary policies will gradually be normalised but we can be sure that, regardless of the uncertain scenarios we face, fiscal policy will take an additional expansionary step on top of the Next Generation EU.

## Our experts:

**Alessandro Caviglia**

**CIO Italy**
**UniCredit Spa** (Italia)

The main topics covered by the declaration are:

**Defence capabilities;**

**Energy dependencies;**

**Economic base.**

We will now go through these points, highlighting those which could have major impacts on our investment themes and strategy.

## Defence capabilities

The EU will substantially increase defence expenditures, with a significant share for investments. There will be a special focus on innovative and emerging technologies related to the ever-growing hybrid warfare, in order to strengthen cyber-resilience and protect critical physical and technological infrastructures.

## Energy dependencies

REPowerEU (European Commission, 8 March 2022) is the answer to the current heavy dependency from Russian fossil fuels and is based on two pillars: less Russia, less fossil fuels. For background information, the EU is reliant on fossil fuel (gas, oil and coal) imports for its energy needs, which currently amount to 60% of gross energy consumption. Domestic production of renewable energy sources has increased significantly in recent years, nevertheless the EU remains dependent on imports for gas (90% of consumption), oil (97%) and hard coal (70%). In the gas sector, Russia provided around 45% of the EU's total gas imports in 2021. The other main gas suppliers to the EU were Norway (23%), Algeria (12%), the US (6%) and Qatar (5%). For crude oil, Russia was also the largest supplier of EU imports (27%), followed by Norway (8%), Kazakhstan (8%) and the US (8%). In the hard coal sector, Russia also remains the leading supplier (46%), followed by the US (15%) and Australia (13%). The first pillar of REPower EU aims to diversify gas supplies routes and sources and sees higher Liquid Natural Gas (LNG) and pipeline imports from non-Russian suppliers, boosting the use of biomethane and renewable hydrogen. And before the end of the year, these measures could result in the EU's gas demand going down by volumes equivalent to two thirds of Russian gas imports.

The second pillar is an integrated EU energy system largely-based on renewables and greater energy efficiency to reduce fossil fuels dependence, for buildings and industries. The case for energy efficiency has never been stronger, as lowering energy consumption in households and enterprises means not only reducing energy imports from Russia, but also reducing energy costs for EU citizens and businesses. As a short-term measure, a new state aid Temporary Crisis Framework will be discussed to grant aid to companies affected by particularly high energy costs. By April, the Commission also intends to present a legislative proposal requiring underground gas storage across the EU to be filled up to at least 90% of its capacity by October 1 each year (gas storage usually supplies 25-30% of EU gas consumed in winter).

## Econimic base

In order to make Europe's economic base more resilient and competitive, various initiatives will be set. Here we mention those related to:

**a.** Semi-conductors, where the EU will diversify supply value-chains and further develop internal production capacity with the aim of doubling the European global market share to 20% by 2030 (the European Chips Act, February 8, 2022, aims to mobilise more than EUR43 billion euros of public and private investments);

**b.** Digital technologies, including Artificial Intelligence, Cloud and 5G deployment in Europe supported by the need to swift adopt pending legislative acts (in particular the Data Act, the Digital Services Act, the Digital Markets Act, the Artificial Intelligence Act).

An ambitious plan which could be funded with a similar scheme to the one adopted in each country with the Recovery and Resilience plans. The full implementation will take years but we will already start to see concrete actions in the coming months.

What are the implications for our investment strategies? The European economy will clearly suffer more than US in the current environment, but the measures depicted are another strong step ahead in terms of greater integration and cooperation on one side, and the right ones to address our global strategic deficiencies: energy and technology. That is why we maintain a long-term positive view on European equities. Moreover, the various plan streams and sub-streams make us even more convinced of some of the long-term industry and investment themes we have identified: Technological Innovation, Infrastructure 2.0, Climate Change and Green Transition.

All these measures require great efforts today, and although the path will be far from linear, they have the full potential to shape a better and stronger Europe tomorrow.

## Answers from Austria

### Crisis check for the portfolio

**Oliver Prinz**

**Co-CIO Bank Austria and Schoellerbank** (Austria)

Capital markets are reacting with severe price fluctuations today – and many investors are wondering whether their portfolio is well positioned for such stormy times. The current crisis surrounding the conflict between Russia and Ukraine is a test of whether the portfolio is also crisis-proof. There are no universal answers, but there are a few basic rules that should be observed, especially in difficult periods for the stock market.

Before putting together a portfolio, it is important to first be clear about one's own needs in terms of return and acceptable risk. In particular, the investment horizon plays an extremely important role in investing money, since, for example, a longer investment horizon can also entail a higher risk. Equity investments generally involve more risk than bonds, which is why the investment horizon for equities should be correspondingly longer. However, in the current environment, bonds are also associated with a certain risk, since the price of a bond typically falls as interest rates rise.

Another important point in decision-making is that one should not always follow the herd on stock markets. If you jump on the bandwagon too late, you run the risk of buying an asset overpriced. Anti-cyclical investing and acting as a buyer when shaky hands are looking for a way out – this has always paid off in the past. Sentiment indicators play an important role here. These are used to measure the mood on the stock market, and one then usually positions oneself contrary to the generally prevailing opinion.

When composing a portfolio, another crucial aspect is regional diversification for both equities and bonds. Many investors make the mistake of only buying regionally and thus only using part of the available universe. Specifically, during the pandemic, it became apparent that it can be advantageous to be diversified across the globe. While Asian markets initially coped better with the pandemic, over time it was the US stock market that rushed from one high to the next. In addition, one should keep a close eye on the valuation of stocks and focus on quality stocks with reasonable valuations.

In conclusion, we think it's key to keep a cool head in these hot phases, because in such difficult market constellations, there are also excellent opportunities to make an investment. Anyone who panics or turns their back on the stock market in the long term could be making a big mistake. Caution is certainly important, but those who act too cautiously will not find a serious alternative to stocks in the zero interest rate environment. Having stocks in your portfolio is therefore still essential for yield considerations in the current environment. If the ups and downs on the stock market are too stressful for you, the experts at UniCredit will be happy to support you in your decisions.

## Answers from Germany

### How is the ECB responding to the recent challenges?

In recent months, the leading central banks - above all the Fed and the ECB - have made a noticeable shift away from ultra-loose monetary policy and toward fighting inflation. Then came the Ukraine war and the West's harsh sanctions against Putin. Market participants watched the central banks with bated breath. Would they possibly delay their change of course? But that was not the case. Surprisingly, after their most recent meetings, both central banks once again surprised on the hawkish, i.e. aggressive side.

For example, the ECB allowed its pandemic emergency purchase program (PEPP), with a monthly purchase volume of EUR 80 billion, to expire and, as expected, decided to temporarily increase the old asset purchase program (APP) from EUR 20 billion per month to EUR 40 billion. At the same time, however, it announced that it would scale back the increase in the second quarter. It also let it be known that the remaining EUR 20 billion in monthly purchases would also be phased out in the third quarter. The only concession was the announcement that interest rates would not be raised immediately after the end of the bond purchases. The previous "sequencing", i.e. the (rapid) succession of the end of the securities purchases and the start of the interest rate hike cycle, has been verbally decoupled.

Philip Gisdakis

**CIO UniCredit Bank AG**
(HypoVereinsbank) (Germany)

These developments have led to a significant rise in yields. For example, the 10-year Bund yield, which in the meantime had fallen from +0.30% to -0.05%, recently rose again to well over +0.35%. These sharp price fluctuations on the bond market reflect the high level of uncertainty on the markets in the area of tension between high inflation and the need for security.

The Fed has surprised even more. From its announcements, it can be concluded that it intends to raise interest rates at each of the upcoming meetings until around the middle of next year, possibly even by more than the usual 0.25% steps in some cases. In addition, it intends to provide details on reducing its bond holdings at the next meeting. In addition to a more accentuated path of interest rate hikes, the Fed could thus quite quickly switch from quantitative easing (QE), i.e. from bond purchases, to a quantitative tightening (QT) path.

It is worth noting that the respective growth forecasts of the ECB and the Fed take into account rather moderate cooling effects. This could still change. In this context, one detail of the Fed forecasts is noteworthy. The central bank governors expect to raise the key interest rate to as high as 2.8% in the current rate hike cycle - and to do so as early as the middle of next year. At the same time, however, they see a long-term equilibrium interest rate of only 2.4% (previously: 2.5%). This implies that they first want to raise interest rates enough to slow down strong growth and the associated inflationary pressures - before the Fed can then lower rates again. Whether such fine-tuning of economic developments can succeed remains to be seen, however.

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