Table of contents

Crossroads

Page 3  Summary
Page 5  CIOs Letter
Page 7  In Focus
Page 10  Macro & Markets
Page 18  Asset Allocation - How we manage our portfolio mandate
Page 23  Columns
Summary

Crossroads

- The rapid spread of Omicron worldwide, a noticeable slowdown in the growth momentum, the earlier and more aggressive tightening of monetary policy and the escalating of the Russia-Ukraine conflict – these are the issues impacting economy and markets at the beginning of 2022. While these developments have been already on our radar, in the short term they are likely to cause greater strains, or at least higher volatility than previously projected.

- The MSCI World was down 5% at the end of January, on the back of rising yields amid expected tightening of monetary conditions. Driven by a larger share of “growth” stocks, which underperformed due to rising yields, US stock indices declined more than European ones. The latter benefitted from a larger share of value stocks, which outperformed as the economy continues to recover.

- US stock markets, which are dominated by a handful of growth stocks, outperformed global markets considerably over the last few years. However, this outperformance drove their valuations sky-high, which makes them considerably sensitive to yield increases. Therefore, they underperformed over the last few weeks, as they declined 15% from recent highs, resulting in overall US indices declining 10% – while the European market declined only 5%.

- The FED signaled its intention to raise the key interest rate “soon”. More recently, the ECB also shifted its tone by sending out a more hawkish message. The central bank will not only accelerate the exit from quantitative easing, but also turn the interest rate earlier than previously thought.
Summary

• In this environment, value stocks will continue to feel a tailwind, while growth stocks will remain under pressure. Bonds are less attractive than equities, but remain an important part of investment portfolios, as they provide stability in times of volatility. Moreover, with increasing yields, investments in bonds will become more attractive.

Our Investment Strategy:

• Though we expect uncertainty and volatility to state at higher levels than in 2021, corrections in the stock market should be interpreted as long-term buying opportunities.

• Amid a higher uncertainty and volatility backdrop, active management is key, as well as the lengthening of the investment horizon and an increasingly ESG oriented approach.

• We prefer European equities on the back of still expansionary monetary and fiscal policies and a value tilted sector composition. We are constructive on Emerging Markets equities, where long-term investment opportunities are occurring, due to their cheaper valuation, surging commodities prices and a more advanced rates hiking cycle. We stay neutral US - but ready to take advantage from the current correction - and Japan equities, supported by the global recovery and a weaker yen.

• We continue to believe that rising inflation supports our structural underweight on global bonds, where we prefer corporate bonds and, selectively, Emerging Market bonds.
The beginning of 2022 has been extremely volatile. At the same time, the performance of various segments has already highlighted the main drivers and potential risk factors for the year ahead. Following the strong performance of stock markets last year, they were weak overall in the first month of the new year. The MSCI World, which tracks the stock markets of the industrialised countries worldwide, was down 5% at the end of January. The emerging markets were unable to escape this; they fell by around 2%. And this performance materialised against a background of rising long-term interest rates: the yield on 10-year US government bonds (Treasuries) rose by 27 basis points (bps or 0.27 percentage points) to 1.78% since the start of the year, while the yield on German Bunds (as a benchmark for the EUR market) rose by 17 bps to 0.0%.

Within the MSCI World index, however, there were clear regional and sectoral differences. The MSCI USA, for example, fell by around 6% in January, while the MSCI Europe lost only half of that amount. However, if we divide the stock markets into the two “Growth” (growth stocks) and “Value” (value stocks) segments, a further differentiation emerges. Growth stocks fell by 9% in January in both Europe and the US. The risk factors for this segment, above all the rising yields due to the expected tightening of monetary conditions, therefore had an equal impact in the US and Europe. However, there were major transatlantic differences on value stocks. In Europe, this segment gained 2.6% in January, while it lost 2.6% in the US. Substantial stocks, especially in Europe, are therefore making the difference.

This fits in with the underlying economic development. The economic recovery after the Covid shock is progressing. On one hand, this is likely to lead to longer-lasting high inflation rates, which the central banks intend to counter by tightening their monetary policies. On the other hand, economic growth in 2022 is not expected to be as high as in the previous year, but still well above the pre-pandemic trend path. This above-average growth momentum should
continue into next year. Increasingly, sectors that fell behind during the Covid crisis are also likely to benefit from such recovery. However, they are typically not as highly valued and are more likely to belong to the substance stocks segment. The rotation from growth to substance stocks should likely continue in 2022 and will be favoured by the combination of robust economic growth and a tightening of monetary policy conditions. The key question arising from the tightening of monetary policy conditions is therefore not whether to hold equities in the portfolio, but which ones. However, there are some risks that investors should keep an eye on. In our view, the most important ones to watch are Covid, stubborn inflation and geopolitical risks.

The Omicron wave continues to burden economies and societies around the globe. Beyond the short term, however, there is justifiable hope for relief as progressive immunisation – whether through vaccination or contagion – poses less and less threat to healthcare systems or critical infrastructure. Contact and mobility restrictions are likely to become fewer and fewer and will soon be eliminated. Residual risks, however, remain, such as the emergence of mutants that bypass acquired immune protection. In any case, further Covid waves cannot be ruled out for the fall. However, their economic impact should remain limited and at best create increased volatility in the capital markets.

High inflation rates continue to shape the global market environment. The US Federal Reserve (Fed) has already tightened its rhetoric significantly. We expect the first interest rate hike as early as mid-March, followed by further interest rate steps, so that the interest rate level should rise from currently close to zero to 2% by the end of 2023. More recently, the ECB became more hawkish as well signaling not only an accelerated exit from quantitative easing, but also an earlier rate hike than previously expected (end of this year). Many market participants expect inflation to slow noticeably in the current year and to fall back to or below the ECB’s 2% target in 2023. However, the latest data releases are disappointing in this respect, as the inflation rate in December and January were much more persistent than experts had expected. If this trend continues and inflation in Europe remains more stubborn than expected, a discussion around interest rate hikes could also gain momentum for the ECB. Although this would influence markets and cause higher volatility, substantial setbacks on the stock markets are not expected in this case.

Recently, geopolitical factors, in particular the conflict between Russia and Ukraine, played an important role in the markets. At the same time, the conflict between China and Taiwan should not be underestimated. The risk/return profile should be strongly asymmetric in this respect. In the event that geopolitical risks materialise across markets, the potential (temporary) setback should be significantly greater than the potential profit in the event that conflicts do not further escalate. At present, however, developments that are unlikely to have a major impact on the capital market environment seem the most likely outcome. Further escalations thus remain risk scenarios and will not be part of the base scenario. Nevertheless, we will monitor these developments closely.

Overall, we remain optimistic. The impact of the pandemic is waning, and a further normalisation of social life is imminent. The European economy will grow perceptibly, inflationary pressures will gradually ease, and monetary policy environment conditions will tighten – and more markedly in the US than in Europe. But yields will also rise in this country. However, as this will take place in the context of a progressive economic recovery, this rise in yields should not jeopardise the economy.
In Focus

US stock market - a handful of companies makes the difference

The past year has once again confirmed the dominance of the US stock market. In 2021, US stocks rose for the third year in a row with double-digit performance. On average, they gained almost 25% in these three years – every year! The performance of European equities fell significantly in comparison. They gained "only" 12% per year between 2019 and 2021. If you compare the annual performance metrics of the MSCI USA with the MSCI Europe, you have to go back to 2015 to find an outperformance of European stocks. What is the reason for this dominance of US stocks?

If we analyze the size distribution (based on the market capitalization of individual stocks), we find a significantly stronger concentration of large companies in the MSCI USA index. The top 10 stocks in the US equity market currently account for 28% of the total market capitalization of the index. In Europe, the 10 largest companies account for only 20%. Of these 10 largest US companies, seven stocks can be broadly classified as belonging to the growth-oriented technology sector: Apple, Microsoft, Amazon, Tesla, Alphabet (Google), Meta (Facebook) and NVIDIA. In Europe, there are only two companies from this segment in the top 10: ASML and SAP.

Another fact that is worth noticing: not a single European company would make it into the top 10 of the US index. Accidentally, this dominance also applies in a global comparison. In the MSCI All-Country World Index, which combines the largest companies worldwide (including emerging markets), there is currently only one non-US company in the top 10: Taiwan Semiconductors.

The seven US companies mentioned are not only the largest in terms of market capitalization, they have also shown strong performance in recent years. In chart 1 below, we compare the price performance of MSCI USA and MSCI Europe and have also plotted the performance of the aforementioned top seven US
companies, as well as that of the US market excluding the top seven companies. The result is impressive: the stock market value of the top seven has increased about six-fold since 2015. Over the same period, the MSCI USA has slightly more than doubled. The MSCI Europe, on the other hand, has only risen by around 50%. However, if the MSCI USA is adjusted for the top seven, it has only increased by 80% since 2015. Moreover, most of the outperformance of this adjusted index compared to the European market materialised in the post-Covid period.

1. COMPARISON OF US AND EUROPE SHARE INDICES

These data show that most of the difference between the US and European stock markets are attributable to half a dozen companies with a global dominance. For equity investors, however, this also means that exposure to the US, even in an index with several hundred stocks, involves a fair amount of single stock risk.

This risk was also evident recently. By the end of January, the top seven companies had lost an average of around 15% from their highs, thus weighing on the US market, which fell by around 10%. The European index, on the other hand, gave up only about 5% from its peak. This development is also behind the trend reversal away from so-called growth stocks and towards value stocks (see our In Dialog section).
Growth stocks have benefited strongly from loose monetary policy in recent years and are typically relatively highly valued, i.e. have high price/earnings ratios. They have come under pressure due to rising yields. However, as the economy continues to grow strongly, which should benefit value stocks due to rising earnings, the focus is now shifting to so-called value stocks. This does not mean, by the way, that the winners of the past are now completely uninteresting. Some of the large technology stocks in the US have robust business models, are highly profitable and very well-positioned for the future. In the medium term, their share prices could rise again. However, in the current environment, value stocks seem more interesting. And European markets in particular should benefit from this, as European companies are particularly well-positioned here.
Macro & Markets

Global economy: a weak start, but reasons to hope

The rapid spread of Omicron across the world, a noticeable slowdown in growth momentum, the earlier and more aggressive tightening of monetary policy, as well as the escalating Russia-Ukraine conflict – these are the issues hitting the global economy and markets at the beginning of this year. While we had all of these developments on our radar already, in the short term they are likely to cause greater strains, or at least higher volatility, than previously projected. However, the false start should soon be over again.

Omicron: From pandemic to endemic - but only from spring onwards

Covid is still keeping the world on tenterhooks in its third year. The highly infectious Omicron variant is spreading rapidly. However, its virulence is much milder. In recent weeks, the number of infections has exploded around the globe. This is why experts no longer speak of a wave, but of the Omicron wall. The increase in hospital admissions and deaths, on the other hand, has been quite modest (see chart 2).
2. CASE NUMBERS EXPLODE, BUT HOSPITALISATIONS RISE SLOWLY

A year ago, countries were imposing comprehensive contact and mobility restrictions (lockdowns) to bring the infection under control. At that time, vaccination campaigns had only just begun. Accordingly, recent mobility restrictions are mostly voluntary.

On the other hand, experience shows that hospitalisations and death numbers lag behind infections, but above all the sheer number of new infections could still bring health systems and critical infrastructure to their limits.

On the other hand, mobility indices, which are so important economically, have fallen as sharply in recent weeks as they did a year ago (see chart 3) – although government restrictions have not really been tightened this time (with the exception of Germany). In some cases, politicians are even holding out the prospect of a comprehensive relaxation in the near future.

3. RECENT DECLINE IN MOBILITY DAMPENING GROWTH

A year ago, countries were imposing comprehensive contact and mobility restrictions (lockdowns) to bring the infection under control. At that time, vaccination campaigns had only just begun. Accordingly, recent mobility restrictions are mostly voluntary.
Therefore, a pronounced global economic slowdown at the beginning of the year cannot be avoided, especially since Omicron, unlike earlier Covid variants, has spread almost simultaneously across continents. Global economic growth in Q1 2022 could therefore be one of the weakest in the post-Covid recovery.

But there is also reason for hope! The exploding case numbers should decline just as quickly given the high infectiousness of Omicron ("the virus is running out of hosts"). The first signs are already there (see chart 2). What is even more, with the rapid spread of Omicron, the chance of a more rapid natural immunisation of the population is increasing. New infections are increasingly closing the vaccination gaps. As early as this spring, the pandemic could successively turn into an endemic and lose its dread – provided that no immune-resistant mutants emerge (forecast risk). Mobility should then quickly return to its pre-Covid levels. This could make up for the current losses of economic growth as early as the second quarter. From the middle of the year, the Covid-driven, high economic volatility should increasingly normalise.

**Global economy: a bout of weakness, followed by spring rebound**

Recently published GDP figures show how strongly Covid is still shaping the economic cycle. The fourth wave in continental Europe – which was initially Delta-driven, before Omicron took over the reins at the end of last year – has led to a massive slowdown in EMU-wide economic growth from 9% annualised to only 1% in Q4 2021. Of course, the strong loss of purchasing power against the backdrop of much higher inflation has also contributed to this. According to estimates, private consumption in the EMU hardly grew any more towards the end of last year (Q3 2021: +17.5% annualised). This was deepened by the numerous supply shocks and bottlenecks (see chart 4), which primarily affected the manufacturing sector. This is also the most likely explanation for the unusually poor performance of Germany, which is so deeply embedded in the global economy.

![Global supply chain pressure Index (New York Fed)](image)

![Supply chain pressure (average of freight costs, DRAM, natural gas, coal & oil prices, in % yoy)](image)

In Germany, real GDP contracted by an annualised 2.9% in Q4 2021. In France and Italy, on the other hand, it grew by 2.9% and 2.5%, respectively, in Spain even by 8.3%. But there, too, the pace of growth has slowed considerably.

**4. SUPPLY CHAIN DISRUPTION WEIGHING ON GROWTH BUT THE PEAK HAS PROBABLY BEEN PASSED**

Global GDP is expected to grow by an annualised 3% in Q1 2022. In Q4 2021, it was still 6%.

As with the influenza virus, Covid outbreaks will then be seasonal and/or regionally limited, high-risk patients (primarily the elderly) will need a booster vaccination and contact or mobility restrictions will no longer be necessary. In economic terms, such waves hardly have any measurable effects.
By contrast, other major economic regions fared much better. In Q4 2021, the US economy expanded by an annualised 6.9%, China by 7.5% and Emerging Asia by probably as much as 8.5%. These regions all benefited from the fact that they were spared from the Delta component of the recent Covid wave (as Omicron only emerged at the end of last year, which was too late to shape Q4). Moreover, the post-Covid recovery has so far been out of phase. US and Asia had their slumps in the summer quarter and benefited from (technical) catch-up effects in Q4. The euro area, however, had to pay tribute to its summer high.

But this year, the global economic development is likely to become more synchronised – albeit initially at a very low level. In continental Europe, growth remains weak, and elsewhere, it is weakening noticeably, especially in the US. There, sentiment figures have fallen significantly, especially in Covid-sensitive services (see chart 5). Consumer confidence has also weakened again. In addition, there will be a technical backlash in inventories, which were the growth driver par excellence in Q4 2021, contributing almost five percentage points to growth.

5. US SENTIMENT INDICATORS DECLINE AGAIN

In addition, hard economic data such as retail sales, durable goods orders and production figures also fell well short of expectations of late. In addition to Omicron, ongoing real wage losses (CPI inflation rose to a high 7% in December) may also have contributed to this. This implies that US growth will grow not more than a meager 2% annualised this quarter, possibly even less.

In Asia, the growth slowdown should be less pronounced, as Omicron case numbers are significantly lower than in the West. China’s rigorous zero-Covid strategy (with the closure of entire mega cities) could also dampen growth. In addition, structural problems, such as in real estate, energy and debt crises, continue to have an impact. Even renewed economic policy support (interest rate cuts) will most likely not prevent GDP growth falling back to 4% - 4.5% this quarter and thus below target (more than 5%).

US GDP grew by a meagre 2.3% annualised in Q3 2021, China’s and Japan’s economic output even declined by 2.5% and 3.5%, respectively (Emerging Asia: +1.8%).

The US Economic Surprise Index, which measures the deviation of releases from the expectations of a variety of indicators, has declined significantly since its interim high in early December and has even dipped into negative territory more recently.
And continental Europe? The euro area could remain the global growth laggard at the beginning of the year. Due to Omicron, GDP growth in the first three months should be limited to an annualised 1%. At least that is not another growth setback. The latest economic figures suggest stabilisation at a low level as well. Although the purchasing managers’ index for the service sector fell noticeably again, the majority of sentiment indicators have recently managed to consolidate or, like the highly regarded Ifo index, even improved slightly (see chart 6). This also applies to hard economic data.

6. EMU: FIRST SIGNS OF STABILISATION

![Graph showing economic data](source: Markit, Refinitiv Datastream, UniCredit)

In spring, however, the economy should pick up noticeably. Once the Omicron brake has been released, the upward forces already in place can unfold. These include the demand backlog (especially services), which became even more accentuated in the winter half-year, rising incomes, wealth and profits, a resurgence of purchasing power (declining inflation), healthy household and corporate balance sheets, fading supply shocks (see chart 3), which are already stabilising the manufacturing sector, as well as progress in natural and vaccinated immunisation or Covid treatment.

And because growth is likely to be shifted from the first to the second quarter, EMU-wide GDP could even increase somewhat more sharply in the spring than previously projected. Starting this summer, growth should gradually weaken, but stabilise (less volatility) and remain above trend in 2023 as well. Our overall economic picture therefore remains largely unchanged.

Fed tightens the reins earlier and more aggressively than expected

In the midst of the Omicron-induced weakness of the global economy, central banks are adopting a tougher tone. The Fed and the Anglo-Saxon central banks in particular have become hawkish. This has led to a reassessment of monetary policy both for the markets and for us. The Fed should have completed the tapering of its securities purchases to zero within a few weeks, announce the first interest rate hike in mid-March, follow it up with another seven hikes of 25 basis points each by the end of 2023, and start Quantitative Tightening – i.e. reducing its securities holdings and thus its balance sheet later this year (see chart 7).
 concerns about inflation (expectations) against the backdrop of an impending wage-price spiral – the unemployment rate already fell to the NAIRU threshold in December (Non-Accelerating Inflation Rate of Unemployment, estimated at around 4%) – and the soon closing output gap may have prompted them to take a tougher stance. The US economy should be able to cope with this, even if the monetary drag will now be more pronounced than previously estimated.

The Fed, however, is not the only major central bank to tighten their policy. The Norges Bank and, more recently, the Bank of England, have already raised their key rates (with more hikes to come). The Bank of Canada and the Reserve Bank of New Zealand are about to do so soon, and Australia is likely to follow too. Together with the Emerging Markets central banks, which have been in hiking mode since the end of 2020, this should channel the global key interest rate back to its pre-Covid level over the year (see chart 8).
For a long time, the European Central Bank (ECB) exercised verbal restraint. There may have been good reasons for this – for example, the expectation that, unlike in the US, inflation would slip below its 2% target again in the medium term. Moreover, it will take until autumn 2023 and thus one and a half years longer than in the US to close the output gap in the euro area. More recently, however, the ECB shifted its tone by sending out a more hawkish message. Stubborn inflation as well as the topic of the labour market and wage developments likely tipped the balance. In addition, the tougher stance of the Fed & Co is likely to put the central bank under pressure. Finally, the tougher stance of the Fed & Co is likely to put the central bank under pressure. Moreover, the increasing transatlantic interest rate differential is continuously weakening the euro. Devaluation, however, means an increased import of inflation, which would not be conducive to the ECB’s goal. We are therefore adjusting our assessment of the ECB’s monetary policy. The central bank will most likely not only accelerate the exit from quantitative easing, but also turn the interest rate earlier than previously thought – possibly towards the end of this year. However, the tightening cycle is likely to be relatively measured (minor steps) and selective (likely targeting only the deposit rate in the beginning).

Russia-Ukraine conflict: the sword of Damocles

No one can seriously say whether Russia will invade the Ukraine. That is why analysts have to limit their work to risk scenarios. But the risks have increased noticeably. If war were to break out, this would have serious repercussions effects for economies and markets as well – not only for those countries directly affected, but also for Western Europe. Economic collateral damage would primarily result from the interruption of Russian gas supplies. Natural gas and energy prices are likely to rise again, driving up inflation and slowing the economic recovery. However, the headwind for European financial markets would be felt earlier. Past experience shows that a noticeable increase in global political uncertainty alone makes the US dollar a safe haven and US markets outperform their counterparts (at least in relative terms, see chart 9). The economic damage, however, would be nothing compared to the humanitarian catastrophe and the long-term geopolitical consequences. One can only hope that the conflict can be resolved diplomatically.
9. POLITICAL UNCERTAINTY TENDS TO BENEFIT US MARKETS

Source: www.policyuncertainty.com, Refinitiv Datastream, UniCredit
Asset Allocation – How we manage our portfolio mandate

A challenging start of the year

<table>
<thead>
<tr>
<th>ASSET</th>
<th>INVESTMENT UNIVERSE</th>
<th>INVESTMENT VIEW</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>NEGATIVE</td>
<td>NEUTRAL</td>
</tr>
<tr>
<td>MAIN ASSET CLASSES</td>
<td>Global Equities</td>
<td>⭕</td>
</tr>
<tr>
<td></td>
<td>Global Bonds</td>
<td>⭕</td>
</tr>
<tr>
<td></td>
<td>Money Markets</td>
<td>⭕</td>
</tr>
<tr>
<td></td>
<td>Alternatives</td>
<td>⭕</td>
</tr>
<tr>
<td></td>
<td>US</td>
<td>⭕</td>
</tr>
<tr>
<td>EQUITIES</td>
<td>Europe</td>
<td>⭕</td>
</tr>
<tr>
<td></td>
<td>Pacific (DM1)</td>
<td>⭕</td>
</tr>
<tr>
<td></td>
<td>Emerging Markets</td>
<td>⭕</td>
</tr>
<tr>
<td></td>
<td>EMU Governments Bonds</td>
<td>⭕</td>
</tr>
<tr>
<td></td>
<td>Non-EMU Government Bonds</td>
<td>⭕</td>
</tr>
<tr>
<td>BONDS</td>
<td>EUR IG Corporate Bonds</td>
<td>⭕</td>
</tr>
<tr>
<td></td>
<td>HY Corporate Bonds</td>
<td>⭕</td>
</tr>
<tr>
<td></td>
<td>Emerging Market Bonds</td>
<td>⭕</td>
</tr>
<tr>
<td></td>
<td>Oil</td>
<td>⭕</td>
</tr>
<tr>
<td>COMMODITIES</td>
<td>Gold</td>
<td>⭕</td>
</tr>
</tbody>
</table>

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

Equities have been under pressure year to date, due to a combination of fears about raising interest rates, geopolitical tensions (Ukraine) and the spreading Omicron variant.

As a result, equity volatility, which remained subdued in 2021, is back with us. The S&P500 Index Volatility spiked to 27.66 vs a 5 year average of 18.56.
The risks related to our base case scenario seem to be more concentrated in the first months of the year, where the peak of the Omicron variant contagions is expected to occur, as well as that of inflation, with the first interest rate increase by the Fed in March. In turn, rising interest rates are impacting U.S. technology stocks, which historically explain a large portion of the U.S. stock market's rise. Techs are in fact considered “long duration equities” due to their high price to earnings ratios, in other words they pay back their profits in a greater number of years vs low p/e stocks. More generally, rotation from growth stocks to value stocks has continued.

The sector composition is favoring European equities, less exposed than US equities to the technology sector and supported by the greater presence of financials and cyclicals.

### 11. SECTOR COMPOSITION: EUROPE AND US WEIGHTS

Far less Tech in Europe and a larger tilt towards cyclical areas such as Industrials, Materials, & Financials

Source: UniCredit Group Investment Strategy, Strategas
Starting from the second quarter an improvement of the pandemic can hopefully be expected, due to a greater number of vaccinations and the advent of the warm season. In addition, we see inflation getting off the peak thanks to the gradual elimination of bottlenecks on the supply side and a less penalizing comparison effect (base effect).

Accordingly, though we expect uncertainty and volatility to remain at higher levels than in 2021 due to fading monetary and fiscal stimuli (suffice it to remember that the S&P500 index closed 2021 with an increase of 26.9% and a maximum drawdown of only 5.2%), corrections in the stock market should be interpreted as long-term buying opportunities. Amid a higher uncertainty and volatility backdrop, active management is key, as well as the lengthening of the investment horizon and an increasingly ESG oriented approach.

In addition, we see corporate earnings growth to continue to support equities. Under this perspective, evidence of the 4Q-2021 earnings season is encouraging, though we are in the early stages in US.

As of January 26, twenty percent of companies in the S&P500 reported quarterly results. Eighty percent beat earnings expectations with aggregate growth of 18.5% and a positive surprise of 3.8%. The sectors that showed the greatest increase in profits were those that had been most penalized by the pandemic last year, namely Energy, Materials, Industrial, Consumer Discretionary, while the sectors that showed more modest growth were Consumer Staples, Utilities, Communication Services and Financial. In terms of revenues, 83% of companies beat expectations with a growth of 10.2% and a positive surprise of 1.7% and with all sectors showing positive growth except Communication Services.

In Europe the earnings season is going to kick-off: consensus projects +42% yoy Stoxx 600 eps growth in 4Q and +6% eps growth in 2022.

Also, a positive note is coming from the behaviour of US and European credits. While corporates bonds usually lead equity at major tipping points, this time their spreads have not heavily widened.

12. RESILIENT CREDITS

Credit spread (bp)

Source: UniCredit Group Investment Strategy
In a nutshell we continue to believe that rising inflation supports our structural underweight on global bonds, where we prefer corporate bonds and, selectively, Emerging Market bonds. We will closely monitor how much of the likely Fed’s hiking action is already discounted by the markets or better to say by the December FOMC OIS, to identify entry points.

At the same time, relative valuation and above trend global growth, lead us to stick to our strategic, positive stance on equities, taking advantage of less stretched valuations on a long-term basis. We maintain our top overweight for European equities on the back of still expansionary monetary and fiscal policies and a value tilted sector composition. We are constructive on Emerging Markets equities, where long-term investment opportunities are occurring, due to their cheaper valuation, surging commodities prices and a more advanced rates hiking cycle. In China, where inflation is falling, the PBoC is even moderately easing rates. We stay neutral US - but ready to take advantage from the current correction - and Japan equities, supported by the global recovery and a weaker yen.

**Mandate portfolios: UniCredit Group Investment Strategy Asset Allocation Stances**

**Overweight Global equities**
Decelerating but above trend global growth supports equities, despite headwinds and higher volatility from rising rates in US, the pandemic and geopolitical tensions. The recent correction makes equities valuation more appealing.

**Overweight European equities**
Monetary and fiscal policies remain expansive. Positive earnings picture, more favorable sector composition vs the US equity market and attractive dividend yields, which are well above government and corporate bond yields. Short term headwinds from pandemic and geopolitical tensions (Ukraine).

**Neutral US equities**
High growth but the Fed is now opting for a hawkish tilt. Selective buying opportunities arising from the equities markets drop and the earning 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. Attractive valuation and high weighting of value/cyclical sectors, which, however, we prefer to play in Europe.

**Underweight Global bonds**
Vulnerable to increasing inflation and rising government 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 favorable default rate scenario, as we expect above trend GDP growth in 2022. Shorter duration vs Euro Government bonds and Euro Investment Grade corporate bonds is a plus, considering the expectation of a gradual normalization of interest rates. Their lower liquidity should be taken into consideration in case of further markets turmoil.

**Underweight EMU government bonds**
We underweight core Euro governments bonds, given their high benchmark duration. We prefer peripheral government bonds, such as the Italy and Spain govies, supported by the ECB’s action and the Recovery Fund. Preferring a short duration and selectively increasing the positioning on inflation linked bonds may prove helpful to deal with the base-scenario of increasing inflation.

**Neutral non-EMU government bonds**
We expect US Treasuries yields to increase in 2022.

**Overweight Emerging Market bonds**
The search for yield support our positive stance, but we are defensive and selective considering the Fed’s tightening and inflation in EMs.

**Neutral Money Markets**
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 supply constraints.

**Positive Gold**
The price of gold should stabilize as a result of conflicting factors: to the disadvantage, the Fed’s normalization while inflationary pressures play in favor.

**Currencies**
The divergence between the Fed and the ECB monetary policies supports the USD.
Answers from Italy

“The Fed is about to hike; should we sell our bonds?”

Well, it depends. One thing that is for sure is we are confirming our long-term positive view on equities versus bonds. The current headwinds are mainly represented by the hawkish tone from the Fed, which is causing the correction in the technology sector, and the zero-Covid strategy in China, which is still affecting the global supply chain. Our view is that these factors, which are negatively impacting investor sentiment, will prove to be temporary and soon the positive drivers will take the lead again: expansionary fiscal policy, a normalisation pattern for the pandemic and economic life, and companies’ results in line or above expectations.

But we know that, in any case, a certain portion of the portfolios we manage will be invested in fixed income instruments. This is because according to the different client risk profiles, we want to target a certain level of volatility, and this is the role of the fixed income exposure: to counterbalance equity volatility and thus reduce overall portfolio risk. The fact is that through the years, this “insurance policy” has become increasingly costly, and today nominal rates are historically very low, and real returns are, for many bonds, negative.
That said, there is also a positive aspect from the recent repricing of the US money market curve. Currently, investors expect a steep hiking pattern from the Fed, with four to five rate hikes in 2022 and a similar pace in 2023. It could seem counterintuitive, but this means that if the Fed matched these expectations, 10-year Treasury bonds could be around their relative bottom in terms of price, and top in terms of yields.

Fixed income traders and investors on the long end are carefully looking at the potential target level of the Fed Funds in two years, and current 10-year rates at 1.80% is consistent with the current implied pattern. This has recently led to a massive bearish flattening of the curve, where 2-year US government bond yields have risen much more than the long end. And this could continue in the coming quarters. Another way to look at the topic is: the more the Fed is credible in its inflation-fighting rhetoric, the less longer-term bond yields need to increase, because their term risk premium will lower, or will anyway stabilize. A good way to implement this view is, for example, through positions on Emerging Market debt and global high yield asset classes, which we recently upgraded from underweight to neutral. Most of those opportunities are USD denominated, therefore the investor is buying the US curve plus the issuer spread. The average spread of a well-diversified portfolio of these instruments acts as an additional cushion in case of further increases in the US curve, or it could finance the currency hedging versus euro in case the investor does not want to increase USD exposure. So, these are examples of “good duration”, where moving towards longer maturities does imply an increase in risk (measured by duration), matched by an increase in potential return.

The story is different for the EUR curve, where investors are not expecting any relevant hiking pattern from the ECB any time soon, so the long duration bet still implies a deeply asymmetric risk-return profile. Euro governments bonds represent a good example of “bad duration”. The good news, at least, is from Italy, where the confirmation as President of Sergio Mattarella for a second seven years mandate facilitates the current government led by Mario Draghi to go ahead with the reforms and the NEXT GEN EU investment plan. Political stability will continue to support Italian BTPs, which are among our preferred investments in the euro government bonds segment.

Chairman Jerome Powell said in his last press conference on January 26th that the Fed will be “humble and nimble”. The same will apply for us in such a tough environment for fixed income investments: “humbleness and nimbleness”!
Answers from Austria

Value stocks: Why value-oriented investments are booming again

After the strong price increases across global stock markets last year, we have been experiencing a correction and higher fluctuations on the financial markets since the beginning of 2022. Concerns about a possible steeper tightening cycle by the Fed, and the high valuations of growth stocks, especially in the tech sector, are putting a strain on investors’ nerves. The euphoria around tech stocks is waning sharply as rising key interest rates are seen as a drag on highly valued high-growth companies. Over the past 15 years, since 2006, growth stocks delivered an above-average return of +384%, compared to value stocks’ return of +131% (base MSCI World Growth Net Return Index versus MSCI World Value Net Return).

The digital revolution, the omnipresence of technology in everyday life, favourable market conditions and, last but not least, the pandemic, have contributed to this brilliant development of the growth sector on stock exchanges, which, however, appears to be significantly overinvested from today’s perspective. Growth stocks are characterised above all by significantly higher estimated short-term and long-term growth in earnings and sales. Around 50% of well-known growth indices are currently allocated to the tech sector (e.g. Apple, Microsoft) or the communications sector (e.g. Alphabet, Meta (Facebook)). In contrast, the book value of value stocks is significantly lower in relation to the price than to the overall market, and the estimated earnings per share for the next 12 months appears to be more attractive.

A large proportion of value stocks are financials, which have faced headwinds over the past 15 years due to the sovereign debt crisis, low interest rates and increased regulatory requirements. In recent weeks, there has been an increased shift from growth to value stocks and we estimate that this trend will continue. In our view, value stocks need to catch up for three reasons. A look at valuations as of December 31, 2021 reveals historically exceptional discrepancies between the growth and value segments. Rising interest rates (in the US for the time being) tend to provide a tailwind for value stocks and generally put growth stocks under pressure. Another positive factor is that the majority of investors have little or no exposure to the value segment, which means that there is an absolute need to catch up. However, it would of course be wrong to lump all stocks together. There are also interesting growth stocks that justify their valuation.
However, investors will be much more sensitive in their investments in the future, because if expectations are missed, share prices could be hit harder than they have been in the recent past. In conclusion, the environment for investments in the stock market will become more challenging in the coming months and the focus will increasingly be on valuations, the quality of earnings and the long-term competitive advantages of companies. I wish us every success in 2022 in making the right investment decisions.

Answers from Germany

What is the message from the last Fed meeting?

At its last meeting in January, the US Fed left its monetary policy stance unchanged but signalled its intention to raise the key interest rate "soon". In the subsequent press conference, Fed Chairman Jerome Powell then clarified that the Fed’s Monetary Policy Committee (FOMC) was ready to implement a first rate hike at the upcoming March meeting, provided the economy performed as expected.

Powell thus confirmed the Fed’s December assessment that the ultra-loose policy introduced in the early days of the pandemic was no longer justified. According to FOMC members, the US labour market is close to full employment. The high inflation rate, on the other hand, which has been well above the Fed’s target of 2% over the medium term for months, was a cause for concern.

In his press conference, Powell did not give any binding statements on the pace of the approaching interest rate steps but left open the possibility of a more aggressive rate hike cycle than is currently expected. This could include both faster rate hikes (one rate hike at every Fed meeting instead of every second) or larger rate hikes (hikes of 50 instead of 25 basis points). On the other hand, Powell’s comments also allow for the possibility of tightening monetary policy less if downside risks suddenly emerge.

Currently, financial markets are pricing in five rate hikes of 25 basis points each this year. We currently expect four hikes, with one increase in each quarter. In the last publication of its dot plot in December, which reflects the average rate expectations of the individual FOMC members, the Fed expected three rate hikes in 2022.

Regarding the Fed’s roughly USD9 trillion balance sheet, the FOMC is now planning to take two steps: First, it is sticking to its previous timetable of ending net...
purchases of government and mortgage bonds under its monthly bond-buying programme “in early March”, which de facto means the end of “quantitative easing” (QE). This decision suggests that the Fed is no more or no less concerned about containing high inflation recently than it was in December.

Second, the FOMC signalled its intention to reduce the Fed’s stock of bonds at some point after the start of rate hikes (“quantitative tightening”). In his press conference, Powell gave no indication of exactly when this will be the case and clarified that the FOMC has not yet decided on it. He did, however, point out that the reduction will be “orderly and predictable” and that “the next meeting and at least one more” will be needed to work out the necessary details. We expect the Fed to start reducing its bond holdings in the fourth quarter of this year, although Powell’s latest comments suggest that it could start a quarter earlier.

The extent to which the aggressive forecasts for further interest rate hikes that are emerging across markets will actually materialise remains to be seen, as Powell explicitly referred to the fact that the Fed’s monetary policy stance will be “nimble”. A more aggressive timetable for rate hikes is likely to be justified if the Fed’s credibility is at risk due to increased inflation and inflation expectations. If, on the other hand, inflation moderates this year, then the need for a more aggressive rate hiking scenario should also diminish. Until then, equities will remain vulnerable, especially from the technology sector, to statements from more hawkish FOMC members.
Disclaimer

This publication of UniCredit S.p.A., Cordusio SIM S.p.A., UniCredit Bank Austria AG, Schoellerbank AG and UniCredit Bank AG (hereinafter jointly referred to as the "UniCredit Group") is addressed to an indistinct public of investors and is provided free of charge for information only. It does not constitute a personalized recommendation or consultancy activity by the UniCredit Group or, even less, offer to the public of any kind nor an invitation to buy or sell securities. UniCredit S.p.A., Cordusio SIM S.p.A., UniCredit Bank Austria AG, Schoellerbank AG, UniCredit Bank AG and the other companies of the UniCredit Group may have a specific interest in relation to the issuers, financial instruments or transactions that may be published, or have banking relations with the issuers themselves. Any estimates and/or assessments contained in this publication represent the independent opinion of the UniCredit Group and, like all the information contained therein, are given in good faith on the basis of the data available at the date of publication, taken from reliable sources, but having a purely indicative value and subject to change at any time after publication, on the completeness, correctness and truthfulness of which the UniCredit Group makes no guarantees and assumes no responsibility. Interested parties must therefore carry out their own investment assessments in a completely autonomous and independent manner, relying exclusively on their own considerations of the market conditions and the information available overall, also in line with their risk profile and economic situation.

It should also be noted that:

1. Information relating to the past performance of a financial instrument, index or investment service is not indicative of future results.

2. If the investment is denominated in a currency other than the investor’s currency, the value of the investment can fluctuate strongly according to changes in exchange rates and have an undesirable effect on the profitability of the investment.

3. Investments that offer high returns can undergo significant price fluctuations following any downgrading of creditworthiness. In the event of bankruptcy of the issuer, the investor may lose the entire capital.

4. High volatility investments can be subject to sudden and significant decreases in value, being able to generate significant losses at the time of sale up to the entire capital invested.

5. In the presence of extraordinary events, it may be difficult for the investor to sell or liquidate certain investments or obtain reliable information on their value.

6. If the information refers to a specific tax treatment, it should be noted that the tax treatment depends on the individual situation of the customer and may be subject to change in the future.

7. If the information refers to future results, it should be noted that they do not constitute a reliable indicator of these results.

The UniCredit Group cannot in any way be held responsible for facts and/or damages that may arise to anyone from the use of this document, including, but not limited to, damages due to losses, lost earnings or unrealized savings. The contents of the publication – including data, news, information, images, graphics, drawings, brands and domain names – are owned respectively by UniCredit S.p.A., Cordusio SIM S.p.A., UniCredit Bank Austria AG, Schoellerbank AG and UniCredit Bank AG unless otherwise indicated, covered by copyright and by the industrial property law. No license or right of use is granted and therefore it is not allowed to reproduce its contents, in whole or in part, on any medium, copy them, publish them and use them for commercial purposes without prior written authorization from respectively UniCredit S.p.A., Cordusio SIM S.p.A., UniCredit Bank Austria AG, Schoellerbank AG and UniCredit Bank AG save the possibility of making copies for personal use only.