UniCredit
Wealth Management

Monthly Outlook

June 2021

Coming Back to Life

Table of contents

Coming Back to Life

CIOs Letter

Coming Back to Life

In Europe, the vaccination campaign is progressing rapidly and the mood is brightening noticeably. For example, the German Ifo and Italian ISTAT indices posted strong gains. Both the ISTAT and the expectations component of the Ifo index, which is important for forecasting purposes, have already returned to their cyclical highs from 2017. Earnings expectations are also continuing to climb. Since the end of April alone, consensus earnings estimates for European and US equities for the current year 2021 have risen by over 3%. Earnings estimate revisions also point significantly upwards for subsequent years.

In the EU, around 20% of the population is now fully vaccinated, compared with around 40% in the US and the UK. However, the weekly vaccination rate in Europe is now significantly higher than in the US. On this side of the Atlantic, vaccine doses in the range of 5% to 6% of the population are administered per week. In the US, this figure has fallen from a high of nearly 7% in April to 2% currently. The pace of vaccination, combined with the lockdown measures of recent months, is also reflected in incidence rates, i.e., the rate of new infections in the last seven days per hundred thousand inhabitants. In Europe, this has recently fallen to below 50, which has led to further relaxation of contact restrictions.

Many citizens – us included – have been able to go out to eat in recent weeks for the first time since the second Covid-19 wave began last fall. It's a liberating experience that lifts spirits. The low infection rates also give hope for vacation travel this summer. On the one hand, this is important for the travel industry and the countries whose economies depend heavily on tourism. On the other hand, it also conveys a sense of increasing normalisation and the prospect of being able to put the pandemic behind us, as soon as possible.

However, there is still a long way to go before we are out of the woods. A large part of the population, including in Europe, has not yet been vaccinated at all, and in the UK, infection rates are currently rising again, although the country has the highest vaccination rates in Europe. According to media reports, this could have to do with the emergence of virus variants. So one should not neglect such risks. In emerging countries, where vaccination rates are still very low, we keep hearing about frightening new waves of infection. This applies equally to Latin America and Asia. Clearly, more efforts are needed, even in the so-called developed world, until the pandemic is finally defeated.

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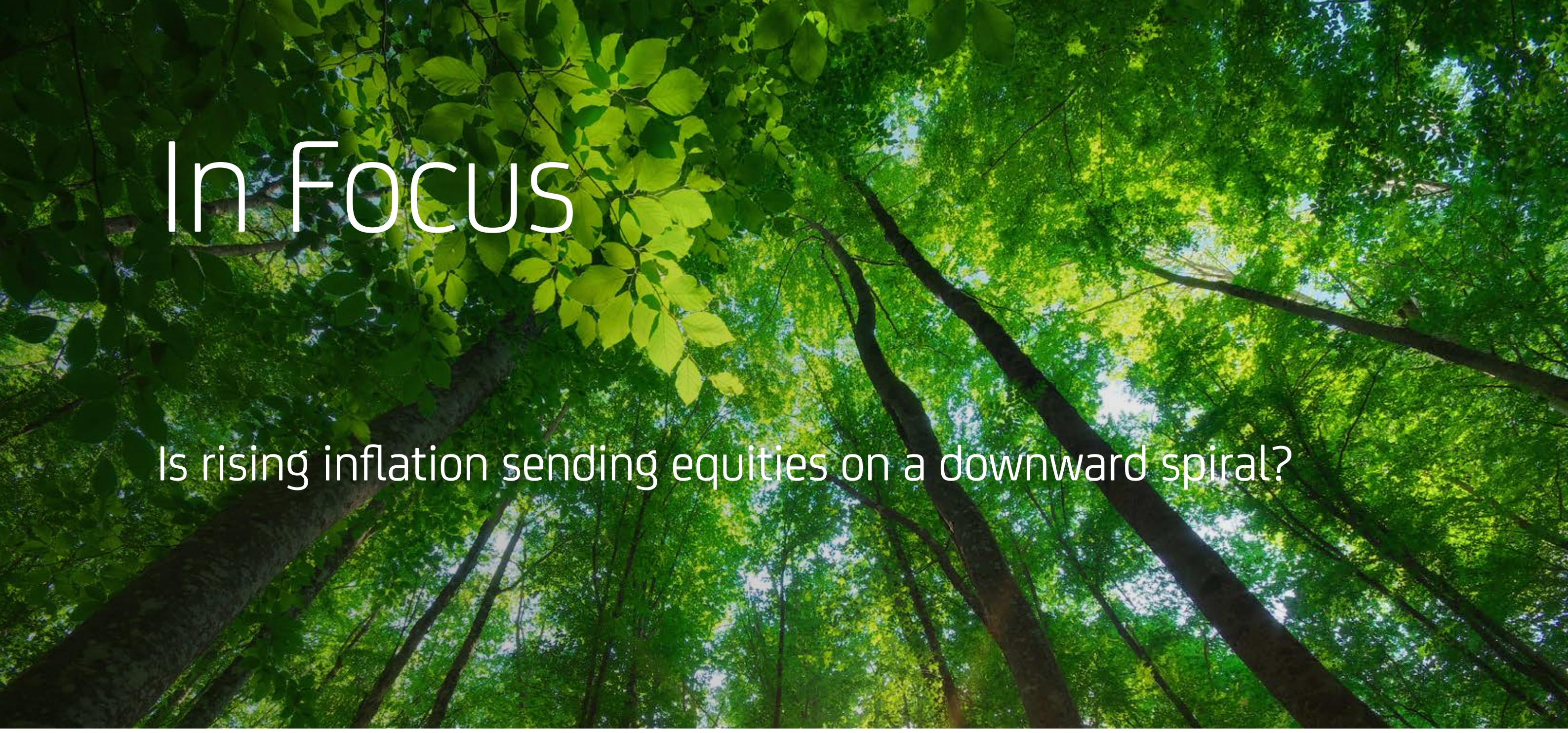
In this market environment, share prices have recently continued to rise, in Europe even somewhat more strongly than in the US. The STOXX Europe 600 rose by 4.1% since the end of April, while the S&P 500 (in USD) rose by only 1.1%. Yields on European government bonds were quite volatile in May. For example, the yield on 10-year German government bonds rose temporarily to -0.1%, but then eased again and closed the month virtually unchanged at around -0.20%. One factor that strongly influences the interest rate markets in Europe is inflation. The so-called headline inflation rate across the EMU recently rose to 2.0% year-on-year. However, if we look at the core inflation rate (excluding the volatile components of energy and food), which is more important from a monetary policy perspective, it is still stuck at levels below 1%. A sustained surge in inflation cannot be credibly deduced from these data at present. Moreover, inflation expectations derived from the inflation swap markets at least show that this is unlikely to happen in the coming years either. The corresponding expectations for headline inflation rates remain well below the European Central Bank's (ECB) target of 2% for the euro area.

As a result, the defining issues for the capital markets as we enter the summer months remain the economic recovery and the associated rise in inflation, and thus in yields. As we explain in the current In Focus section, the experience of the last 40 years suggests that an environment of rising yields does not necessarily pose a problem for equity markets if they are driven by an economic upturn. We expect this scenario to hold in the months ahead. However, it is to be expected that most of the recovery rally is already behind us and therefore a rather sideways sideways stock market and phases of increased volatility should definitely be expected over the summer period. Nevertheless, equities remain interesting in such an environment, both for fundamental reasons, as an economic recovery implies further increases in corporate earnings, and from a relative perspective, as rising yields are a direct burden on fixed income investments.



In Focus

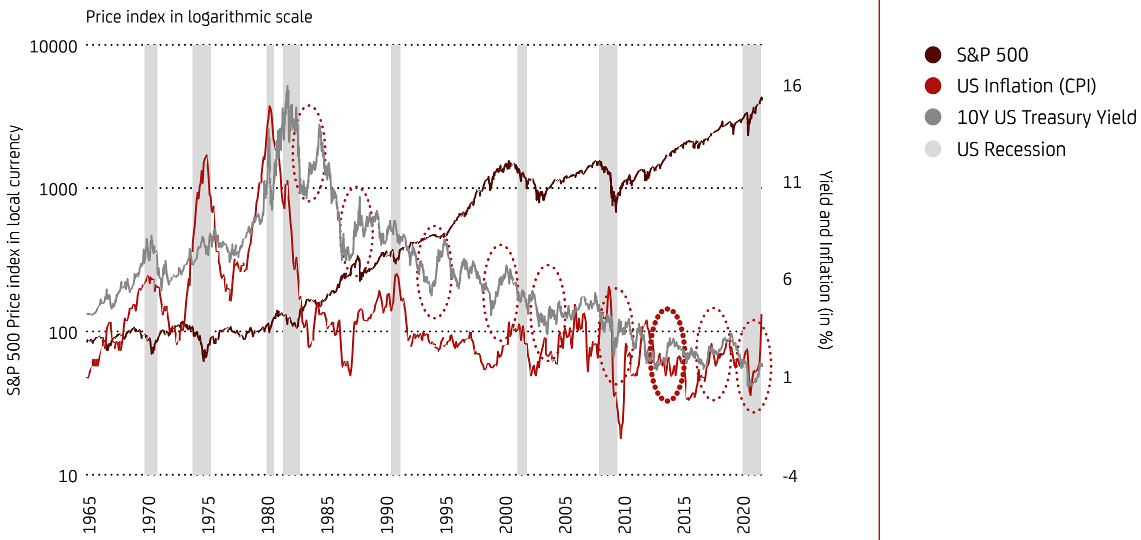
Is rising inflation sending equities on a downward spiral?

The successes in combating the pandemic in Europe and the US have boosted both the economic outlook and stock markets in recent months. Quite a few important stock indices were able to reach new all-time highs during this phase. These gains were accompanied by a significant recovery in (expected) corporate earnings. However, the price gains were higher than the increase in earnings expectations. This means that valuations, i.e. the price/earnings ratio (P/E), also made a significant contribution to the strong performance. At the same time, this rise in the P/E ratio is related to the significant drop in interest rates during the pandemic, as central banks aimed to stabilise the economy with interest rate cuts and massive bond-buying programmes. With the increasing economic recovery and the resulting rise in inflation, yields have already risen significantly in some cases, although central banks are continuing their support programmes unabated. The further rise in yields coupled with occasionally quite high stock valuations (P/E ratio) are causing uncertainty among investors, at times. Investors are worried that rising interest rates and yields could spoil the mood in the stock markets.

In the following analysis, we want to highlight a few key facts about the relationship between rising yields and stock performance. But let us make one thing clear right from the start: historically, market phases with rising yields are not necessarily bad for stocks. On the contrary, in the 10 periods of significantly rising yields in the US market since the early 1980s, equities have risen more, on average, than over the entire period under review. However, after nearly 40 years of falling returns, the US and European economies may be at the beginning of a new trend. A differentiated view is therefore advisable.

For our analysis, we focus on the US market, as it provides a sufficiently long time series for stock indices, yield levels and inflation to be able to substantiate corresponding statements over a longer period of time. In addition, the greatest concerns regarding the current level of yields and inflation are also concentrated in the US. We look at data from 1965 onwards, which is why we use the price index of the S&P 500 index in this analysis and not the total return index (i.e. including dividends), as this has only been available since the end of the 1980s. However, when looking at stock market performance over several decades, the inclusion of dividends would be worth considering nevertheless. In the following chart 1, we plotted the stock index on a logarithmic scale. We compare it with the yield on 10-year US Treasuries, the corresponding inflation rate and the recession phases in the US.

1. US: STOCK INDEX, 10Y TREASURY YIELDS AND INFLATION



Source: Refinitiv Datastream, UniCredit Wealth Management. Please note: Past performance and forecasts are not reliable indicators of future performance. The indices may not be purchased and therefore do not include costs. When investing in securities, costs are incurred which reduce the performance.

The period shown can be roughly divided into two phases – a phase with significantly rising yield levels, which encompasses the two oil price crises and culminated in the US savings and loan crisis in the early 1980s, and the phase thereafter, which was accompanied by a successive decline in yield levels.

In contrast, the phase up to the early 1980s was characterised by high inflation rates (in the double-digit percentage range), which were also partly caused by the oil price crises and sent the US economy into recession in each case. At that time, stock markets as a whole tended to move sideways.

From the mid-1980s onward, the US stock markets began to soar, a trend that has continued to this day, interrupted only temporarily by the well-known major crises including the dot-com bubble, subprime crisis and Covid-19 pandemic. However, the last four decades have also been characterised by a gradual decline in yield levels from around 15% in the mid-1980s to below 1% last year.

However, this long-term decline in yields was repeatedly interrupted by phases of rising rates. And it is precisely these phases that we want to analyse in more detail. Between 1983 and the current edge, we have identified 10 phases with significantly increased yields and marked them with dashed lines (between 2016 and 2018, two such phases are marked together in one oval). In all phases, the yield level on 10-year US Treasury bonds increased by at least 100 basis points (bps, or 0.01 percentage points) within a few months. The phases in the 1980s resulted in yield increases averaging about 350 bps within an average of 10 months. In the 1990s, yield increases averaged 250 bps (within an average of 15 months). Since the 2000s, yield surges have averaged only slightly less than 150 bps with an average duration of eight months. The 2013 yield spike (the so-called taper tantrum, marked in red) deserves special attention. This rise in yields (between May and September 2013, yields rose by 135 bps) was triggered by the US Federal Reserve's (Fed) announcement that it will scale back its bond purchases. The conditions back then are similar to those in the present day.

The high-inflation phase was brought to an end during the term of office of then Fed President Paul Volcker through massive interest rate hikes (at times the key rate was 20%), thus bringing inflation under control.

Interestingly, stock markets performed well overall during these 10 phases. On average, the S&P 500 index rose by 10.7% within the spurts of rising yields (with an average duration of 10 months). Incidentally, that is noticeably more than the average 8.8% price appreciation per year over the entire period from 1983 to the present. And in only two of the 10 periods has the S&P 500 index fallen. Between May 1983 and June 1984, the 10-year yield rose from 10.1% to 13.8%, while the S&P 500 index fell 6.2%. And between October 1993 and November 1994, yields rose from 5.2% to 8.0%. At the same time, the stock index declined 2.4%. In all other periods, the stock index has risen, sometimes sharply, including during the recent rise. During the taper tantrum in 2013, the S&P 500 index still rose by 4.6%.

Between August 2020 and May 2021, yields on 10-year US Treasuries rose from 0.5% to 1.7%. Over the same period, the S&P 500 index climbed by almost 23%.

Rising stock markets during a noticeable rise in yields are therefore nothing unusual and are also economically well justifiable, as yields rise in phases of economic recovery. Such an economic environment naturally also boosts corporate profits and thus drives stock markets.

However, there have also been examples to the contrary in Europe in the recent past. During the financial and sovereign debt crisis, the yields of hard-hit countries in the European periphery rose, in some cases massively. This development was accompanied by a significant decline on the stock markets. However, the rise in yields was due to an increase in the risk premium (the so-called risk spread) compared with safer EUR government bonds. From these examples, it can be concluded that it is of central importance why yields point upward. If they rise because the economic environment is brightening, then rising yields may well go hand in hand with rising equity markets. However, if they are rising because the risk premium (or inflation premium) is swelling, then rising yields may well be associated with equity price discounts.

The phase up to the beginning of the 1980s also shows that massively rising interest rates can be problematic for equities. However, this phase was characterised by stagflation, i.e. inflation coupled with weak growth. In the current environment, however, neither a scenario such as the financial and sovereign debt crisis nor a long-term stagflation scenario appears to pose a key risk. Yields are rising because the global economy is recovering strongly after the Covid-19 shock and this will ultimately lead to only moderately rising inflation rates. It currently seems rather less likely that consumer prices will remain above the target corridor of the leading central banks (mostly around 2%) on a sustained basis in the coming years.

For investors, therefore, equities remain the most interesting asset class. For fundamental reasons – a growing economy leads to rising corporate profits – as well as from a relative perspective. Rising yields are a direct burden on bond markets. Nevertheless, it is not unlikely that a large part of the recovery rally is already behind us and that the markets are now entering a phase of volatile sideways movement – in which there may well be setbacks. However, these are more likely to be buying opportunities rather than reasons to sell.

Macro & Markets

Europe: Getting ready for a growth spurt

Europe is catching up! While it was initially China that pulled the world economy out of the Covid recession, followed by the US that became the global growth champion towards the end of 2020 thanks to its gigantic fiscal programmes, it is now recession-plagued Europe that is blowing the whistle to catch up. Real GDP is set to grow at double-digit rates soon.

Within striking distance to the US

The reason for the EMU growth spurt towards the end of spring is the number of success stories in the fight against the pandemic. In particular, the third Covid-19 wave seems to have been broken. The long-lasting, sharp lockdown measures and the warmer weather are starting to bite, and incidence figures are falling. At the same time, an ever-increasing number of people are being vaccinated against Covid-19 (see chart 2). Around 45% of Europeans have now received their first dose. The Anglo-Saxon lead in vaccinations compared to the euro area almost halved in May.

The number of new infections per 1 million people in Italy and Germany has now even slipped back below that of the US – although the country was spared the third Covid-19 wave.

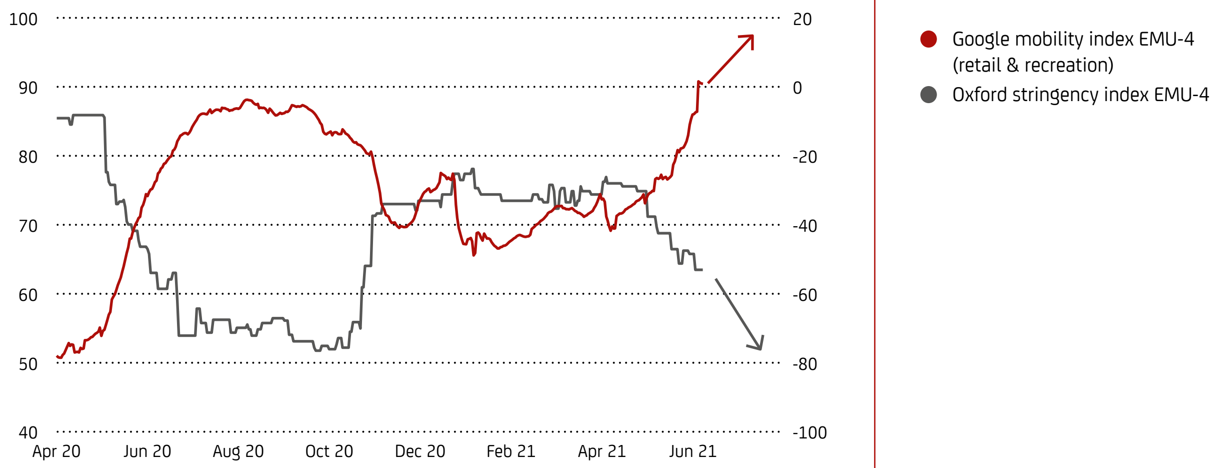
2. EMU: SUSTAINED PROGRESS IN FIGHTING COVID-19

Source: www.ourworldindata.org, UniCredit Wealth Management

Both trends increasingly allow more European countries to loosen their restrictions and gradually re-open up their economies. For the first time since October last year, the renowned Oxford Stringency Index measuring the degree of lockdowns has declined significantly (see chart 3). At the same time, mobility indicators are picking up. Here, too, the gap to the US has started to narrow substantially.

In early April, the Google Mobility Index for retail & recreation in the euro area was still around 40% below its pre-Covid level; in the US, by contrast, it was only 17%. The difference has since shrunk to just 5.5 points.

3. EMU: LOCKDOWN MEASURES LOOSENED, MOBILITY INCREASING AGAIN



Source: www.ourworldindata.org, UniCredit Wealth Management

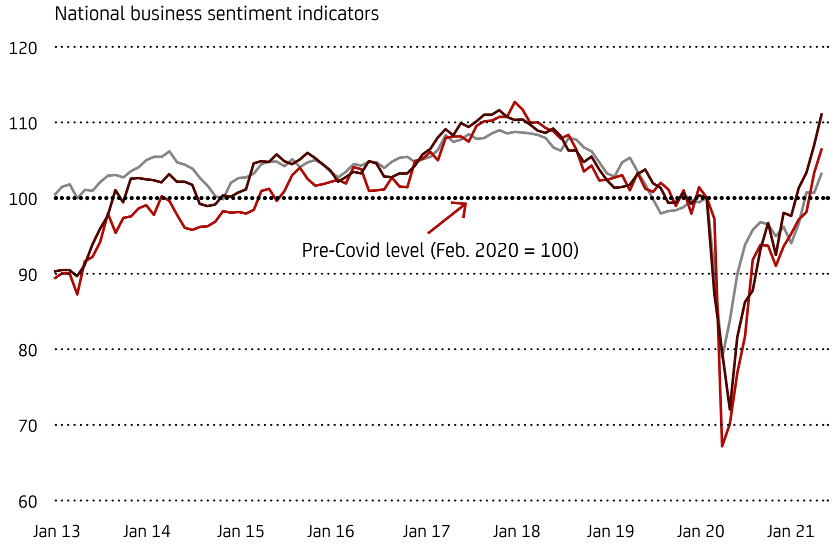
Against this background, it is hardly surprising that confidence among households and companies has increased rapidly. In May, the EMU-wide composite purchasing managers' index, one of the most reliable leading economic indicators, climbed to its highest level in more than three years. Unlike in previous months, the strong increase this time was driven solely by the services component, which has been badly hit by lockdown measures. The sector is now benefiting most from the re-openings. Its manufacturing counterpart, on the other hand, only rose marginally, but nevertheless marked a new all-time high.

Last month, the composite purchasing managers' index rose unexpectedly strongly by 3.1 to 56.9 points. The level is way above the critical value of 50 separating economic expansion from contraction.

Notably, the development within the EMU is becoming increasingly balanced not only in sectoral, but also in regional terms. France, Italy and Spain are increasingly catching up with Germany, which has led the group so far. They have even passed Germany in the closely watched national business climate indices (see chart 4). What they have in common is that they already left their pre-Covid levels behind and are all pointing steeply up.

Business climate indices were driven primarily by their expectation components. However, the assessment of the current situation has also improved markedly.

4. BUSINESS CLIMATE FIGURES SIGNALLING GROWTH SPURT

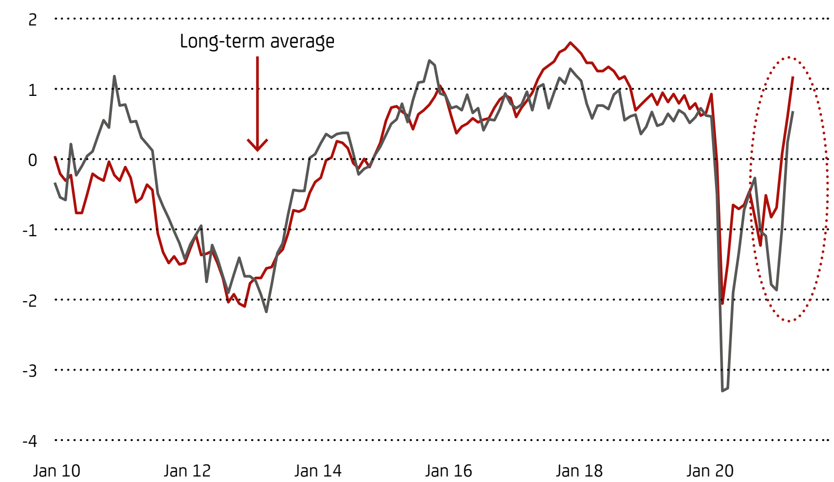


Source: Refinitiv Datastream, UniCredit Wealth Management

The latter also applies to consumer confidence. After months of languishing and even declining for a while, consumer sentiment has really skyrocketed in recent weeks (see chart 5). The previous cyclical high in early 2018 is within striking distance. In the slipstream of consumer confidence, the business climate in the retail sector surveyed by the EU Commission has also brightened considerably.

The EU Commission's comprehensive Economic Sentiment Indicator (ESI) for the euro area rose by an impressive four points in May and, at 114.5 points, is no longer far from its all-time high (Dec. 2017: 115.2). Drivers were the service sector and retail trade. The employment outlook has also brightened noticeably.

5. RISING CONSUMER CONFIDENCE FUELLING RETAIL SECTOR



Source: Refinitiv Datastream, EU Commission, UniCredit Wealth Management

As the majority of the hard data only reflects the development in April due to the publication lag, the latest surge in sentiment cannot yet be seen in these figures. However, the May and June numbers for retail sales and production, which are due to be published in the coming weeks, should show a strong acceleration.

The partially tightened lockdown measures caused EMU-wide retail sales to fall by 3.1% in April compared to the previous month. The contractions were particularly strong in France and Germany.

This also implies that our growth projections for the current quarter were probably too cautious. Originally, we assumed that the euro area would not be able to make up much more than the first quarter's losses in spring. Now, however, it appears that EMU-wide GDP could increase by considerably more than 5% annualised. This would also mean that the US growth lead this spring would narrow considerably more than previously projected – even though the booming US economy has been able to pick its pace of economic expansion to roughly 10%.

Summer will be hot: Consumption surge seems to have started already

However, this is not the end of the recovery road in the euro area. We even expect real growth to spurt this summer. Real GDP growth in annualised terms should not only reach double digits, but also outpace that of the US economy. More importantly, unlike a year ago, the summer rebound should turn out to be not just a flash in the pan, but sustainable. The euro area economy will most probably continue to grow above average in the following quarters, even if quarterly GDP rates will gradually slow down, i.e. normalise.

Last summer, extensive easing of the Covid-19 restrictions caused EMU-wide GDP to grow by 12.7% qoq (non-annualised!). However, the third Covid-19 wave caused a severe setback (Q4/20: -0.7%, Q1/21: -0.3%).

Our confidence is supported by plenty of evidence. As Chart 3 implies, there is still ample room for improvement in terms of re-opening and mobility until normality is back. At the same time, as vaccination numbers continue to rise, the correlation of these indices with Covid-19 case numbers is increasingly weakening and is likely to collapse altogether as herd immunity sets in (unless new, more dangerous mutations emerge).

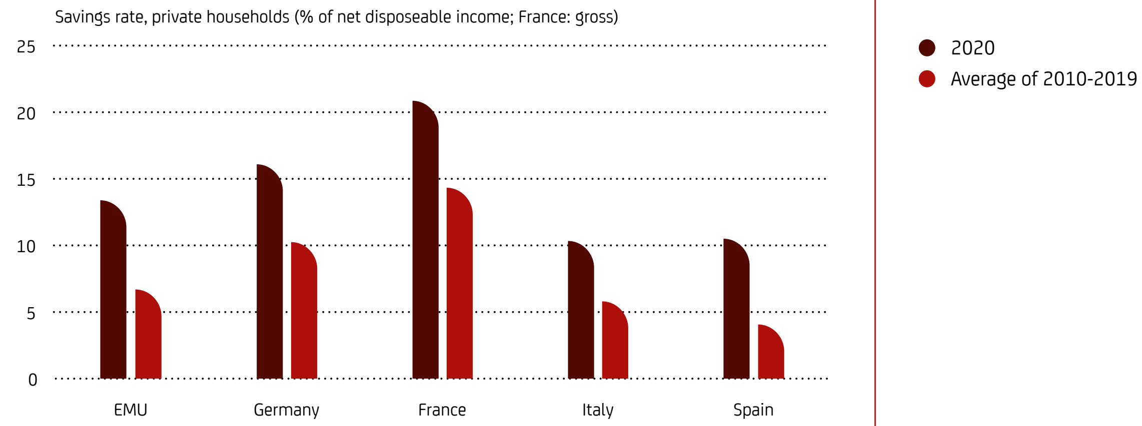
Therefore, even if the Covid-19 case numbers are likely to rise again this autumn with the colder weather (a fourth wave), there should no longer be any noticeable lockdown measures or mobility restrictions in view of herd immunity. The current development in Latin America and Asia is quite different to this. There, new lockdown measures have to be executed due to a lack of sufficient progress in vaccinations.

As a result, the decisive obstacles to output in the service sector are gradually disappearing. For the coming months, we therefore expect a genuine growth spurt in the previously hard-hit retail trade, personal services, leisure and recreation, and cultural activities. But we see continuing upside potential for the manufacturing sector as well, although this has been largely spared from restrictions more recently. Quite a few companies, above all the car industry, had to struggle with supply chain problems for auto parts and, even worse, for semiconductors up until recently. The latter also affects almost the entire manufacturing sector. In addition, the construction industry is also increasingly running short of inputs. No wonder that delivery times have become longer and longer. However, the increasing revival of the global economy should ease the situation step by step.

How powerful the catch-up potential will evolve in the coming quarters can be seen on the demand side, primarily private consumption. EMU consumer sentiment may have risen again to pre-Covid levels, but spending was still 10% lower at the end of last quarter. This was primarily due to angst saving during the pandemic. In the euro area, savings rates, i.e. savings in relation to (net) disposable income, have simply doubled over the past year (see chart 6) and, if Germany remains the guidance, are likely to have risen even further by the end of March.

According to the Bundesbank, the savings rate in Germany rose by around 4 points to 20.1% in the first quarter of 2021.

6. COVID-19 BOOSTED PERSONAL SAVINGS

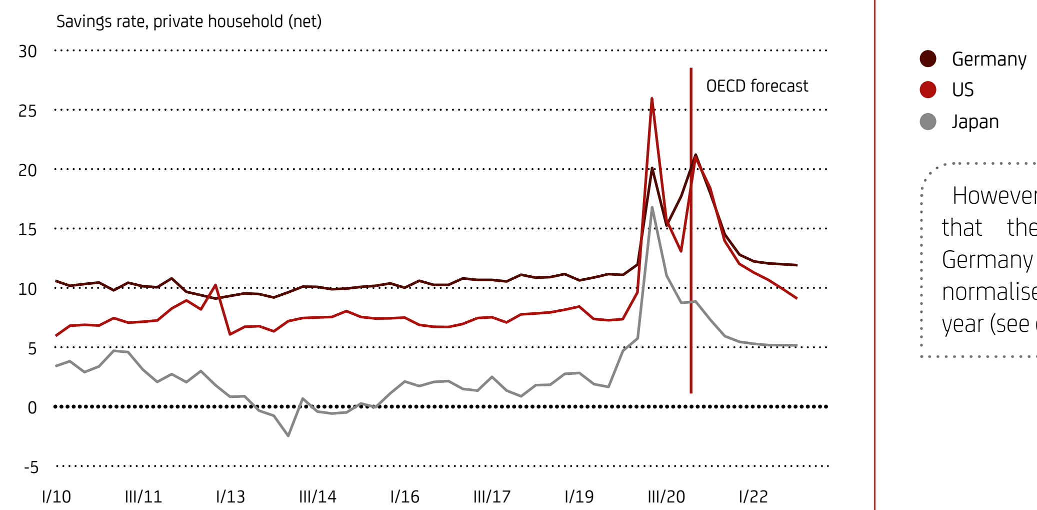


Source: Organisation for Economic Cooperation and Development, UniCredit Wealth Management

Accordingly, private households put away about EUR150 billion more in 2020 than in the previous year. That is around 1.25% of EMU-wide annual or a good 5% of quarterly GDP. Of course, pent-up consumption is unlikely to be unloaded within a quarter. However, last summer's development fuels hope for a veritable surge in consumption. Falling incidence figures combined with extensive re-openings at that time caused the savings rate to tumble by about ten percentage points. At the same time, private consumption shot up by 14% – not annualised, mind you! Therefore, a strong increase in consumption is also warranted this summer.

The catch-up effect of consumption will be joined by rising employment and growing incomes. According to the EU Commission, those expectations of companies and households are clearly pointing upwards (link).

7. SAVINGS RATES COULD NORMALISE QUICKLY



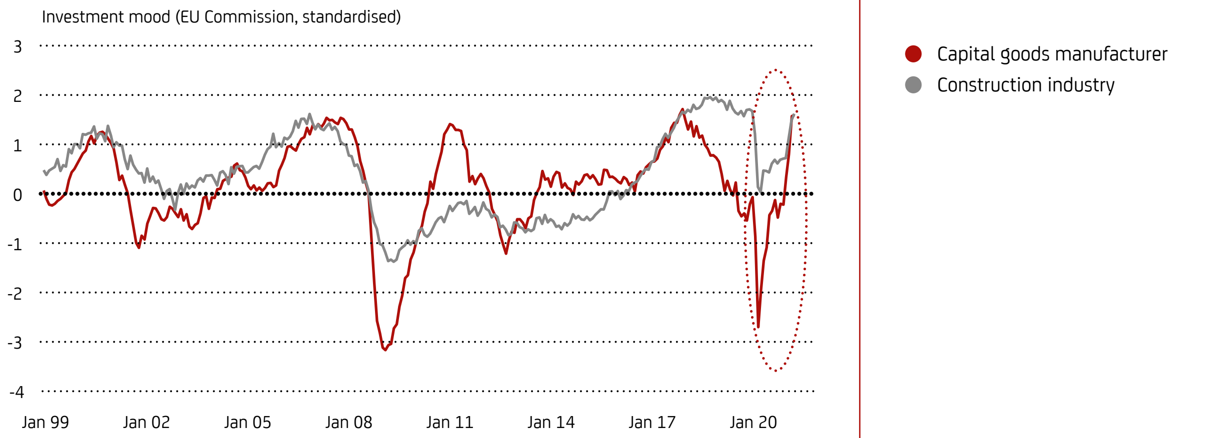
Source: Organisation for Economic Cooperation and Development, UniCredit Wealth Management

However, the OECD assumes that the savings rate in Germany will have largely normalised by the end of the year (see chart 7 and this link).

Beyond consumption, we also expect support for overall GDP growth over the coming months from brisk investment activity, so that the swelling demand can ultimately be met. At any rate, the industrial inventories are currently empty. At the same time, confidence among capital goods manufacturers and across the construction industry (investment of structures) could hardly be higher (see chart 8).

The inventory sub-index of the Purchasing Managers' Survey has recently fallen further and is approaching its all-time low of May 2009, when the euro area economy started to grow out of the financial market crisis.

8. EMU SERVICE SECTOR SENTIMENT STILL SUBDUED



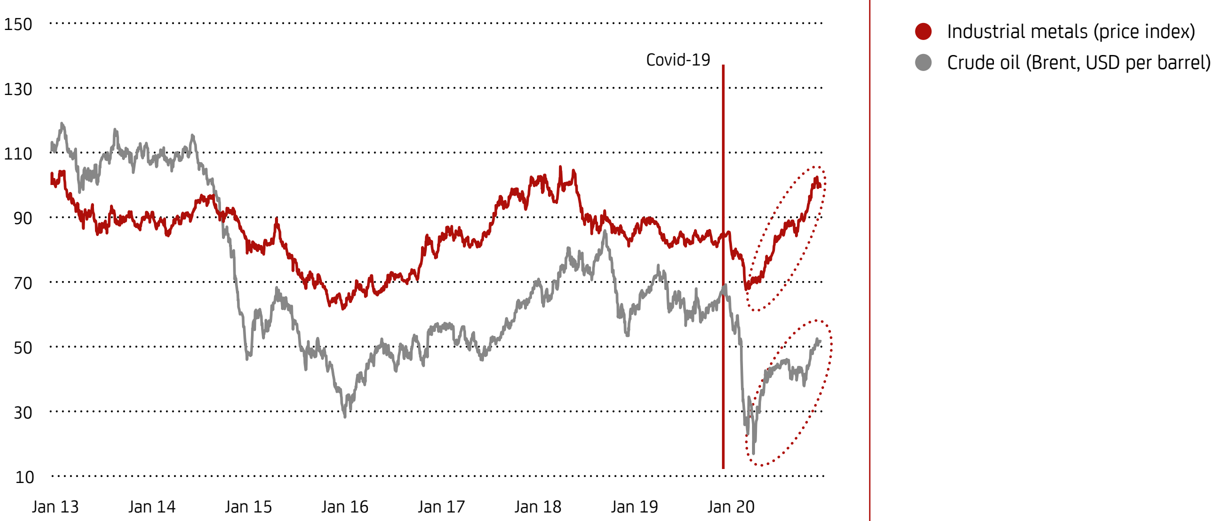
Source: Refinitv Datastream, EU Commission, UniCredit Wealth Management

Given that the export-heavy economy in the euro area is also benefiting from the global economy picking up speed, we can easily stick to our message outlined in previous months: in the second half of this year, Europe should replace the US as the global growth champion.

Inflation to pick up, but risks remain manageable

However, the surge in demand also has its downsides, as it pushes inflation above levels that can usually be expected after a global recession is over, when commodity and energy prices are rising strongly. This is no different now (see chart 9).

9. CRUDE OIL AND INDUSTRIAL METAL PRICES SHOT UP



Source: Refinitv Datastream, UniCredit Wealth Management

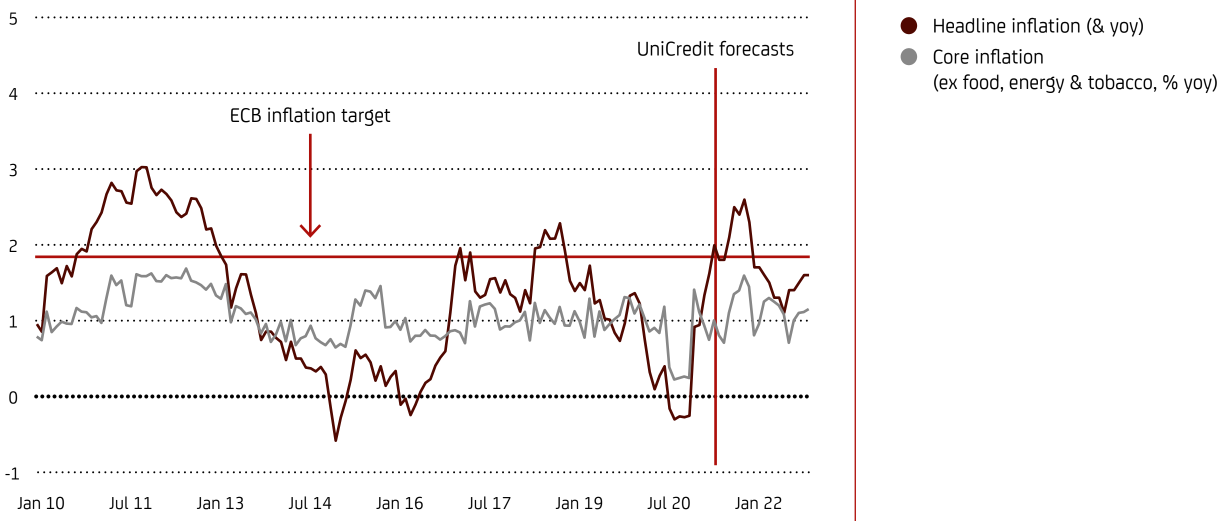
However, the core rate, i.e. the inflation rate excluding the volatile components of energy and food, should also rise noticeably this time. The reason for this is the genuine surge in demand for services (pent-up consumption), which is opening up scope for companies to pass on higher prices which they are likely to exploit after the long Covid-19 drought. The same applies to the manufacturing sector. Here, soaring delivery times and rising input prices should help to send both headline and core inflation noticeably higher over the coming months. According to our colleagues at UniCredit Research, headline consumer price inflation should shoot up above the ECB's target towards the end of the year – but only temporarily (see chart 10).

However, an increase in inflation only becomes problematic when there are second-round effects – because wage demands surge and/or capacities (capital stock as well as the labour force) are already fully utilised. That is unlikely to happen in Europe this time. For one thing, pent-up consumption should unload relatively quickly and then return to normal levels. Secondly, there is still plenty of spare capacity. Real GDP is still well below its pre-Covid-19 level (economic slack), unemployment or underemployment (short-time work) is still comparatively high and the capital stock under-utilised. In addition, increasing investment activity is already causing it to grow again.

Core inflation is economically considered the superior inflation measure because (seasonal) fluctuations in food and energy prices are excluded from the headline inflation rate to prevent short-living, false signals.

If inflation rises as a result of excess demand, economists are speaking of demand pull inflation. In contrast, cost push inflation is due to rapidly rising wages or input prices.

10. EMU: INFLATION TO PICK UP FURTHER, BUT ONLY TEMPORARILY

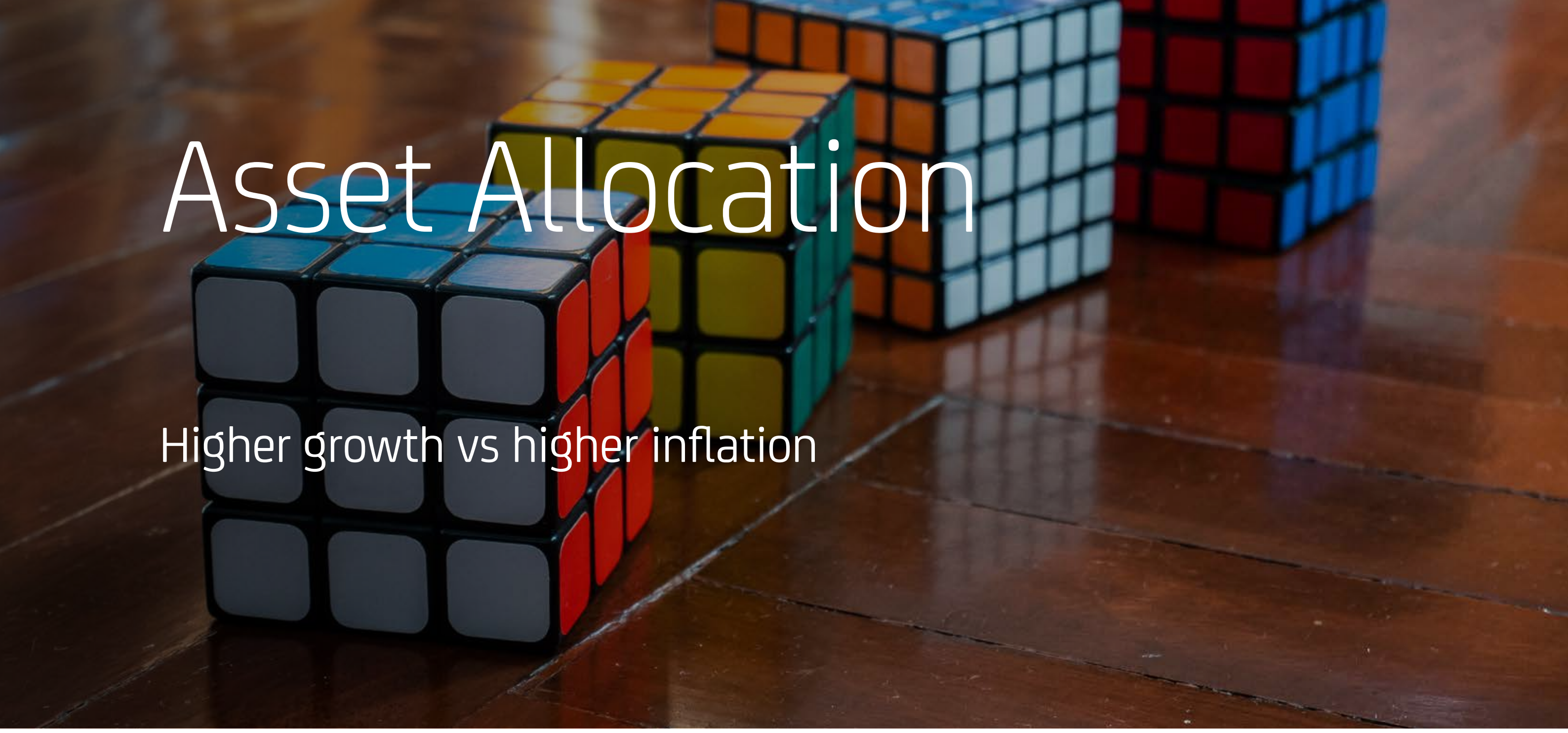


Source: Refinitv Datastream, UniCredit Wealth Management

These are reasons enough for the ECB to stay relatively relaxed and having ramped up its pandemic purchase programme as a hedge against downside risks. However, if, in the course of the coming year, inflation settles closer at the ECB target than to the more dangerous zero line (deflation risks), a hyperexpansive monetary policy will no longer be necessary. This will be the starting point for the ECB to reduce its purchases of securities. But the ECB will wait even longer before raising its key interest rates (not before 2023).

In the US, however, the inflationary environment is more tense. There is no longer any economic slack to be seen. The overall economy has already returned to its pre-Covid level. At the same time, the labour market is booming. Moreover, the inflationary pressure on the preliminary stages is much higher than in the euro area. No wonder therefore, that the Fed's preferred inflation measure, the personal consumption expenditure deflator, is already well above its 2% target at 3.6% for the headline and 3.1% for the core rate. The Fed may already have made it clear in 2020 that it will tolerate a temporary overshoot. But to avoid second-round effects, it will probably be forced to start the tapering debate on scaling back its securities purchases as early as this summer, announcing the decision in autumn and gradually reduce securities' purchases from the turn of the year on. The Fed will also wait several quarters before finally raising interest rates, but its tightening cycle will most likely start well before that of the ECB..

After the disappointment in April, almost 500,000 new jobs were created again in May.



Asset Allocation

Higher growth vs higher inflation

ASSET		INVESTMENT UNIVERSE	INVESTMENT VIEW		
			NEGATIVE	NEUTRAL	POSITIVE
MAIN ASSET CLASSES		Global Equities	○	○	●
		Global Bonds	○	●	○
		Cash	●	○	○
		Alternatives	○	●	○
MAIN ASSET CLASSES IN DETAIL	EQUITIES	US	○	●	○
		Europe	○	○	●
		Pacific (DM[1])	○	●	○
		EM[2]	○	○	●
	BONDS	EMU Governments	●	○	○
		Non-EMU Government Bonds	○	●	○
		EUR IG Corporate Bonds	○	○	●
		HY Corporate Bonds	●	○	○
		EM Bonds	○	○	●
	COMMODITIES	Oil	○	●	○
		Gold	○	○	●

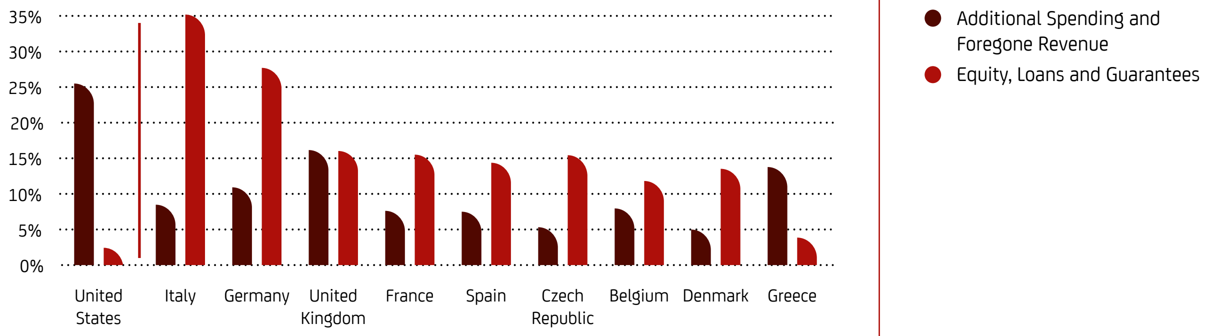
[1]DM = Developed Markets (Australia, Japan, Hong Kong, New Zealand, Singapore)
[2]EM = Emerging Markets

Risky assets continue to be supported by the global recovery, with global GDP growth projected at 6% for 2021 and 4.4% for 2022 (Bloomberg consensus), thanks to normalising economies, monetary stimulus and very expansionary fiscal policies.

The overall post-pandemic direct fiscal stimuli have been impressive in the US, amounting to 25% of the GDP – more than double the stimuli in European Countries– and have mostly focused on direct payments to citizens. Meanwhile, in Europe, fiscal action has been developed through equity, loans, guarantees and the maintaining of employment levels.

11. DISCRETIONARY FISCAL RESPONSES TO THE COVID-19 CRISIS, AS A PERCENT OF GDP

Includes measures announced through March 2021. European countries listed in order of total and only shown if responses exceed 15% of GDP.

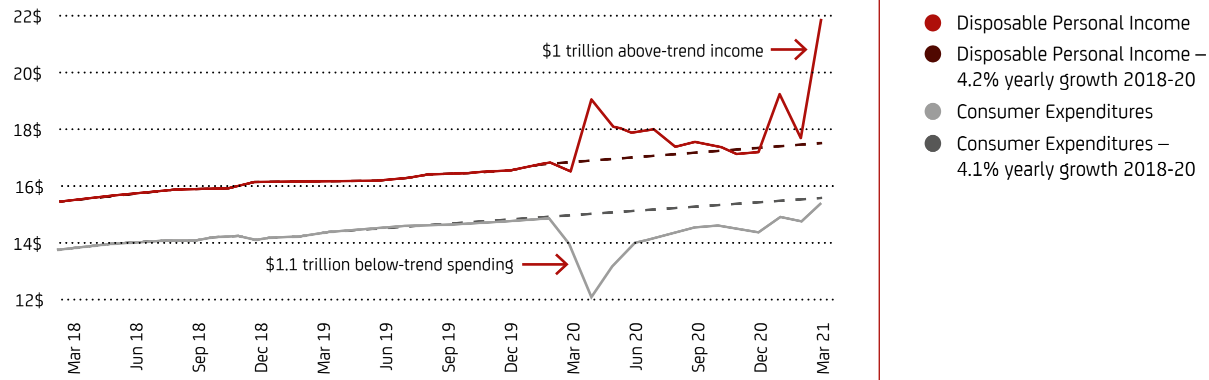


Source: IMF Fiscal Monitor Database

However, the overall USD6 trillion US fiscal stimulus poses high inflation risk, as it is too big compared to the US output gap. On top of the current supply side/ commodity driven inflation, a "dry powder" of USD2.1 trillion excess demand has built up, thanks to the stimulus checks and pent up demand.

12. DISPOSABLE PERSONAL INCOME AND CONSUMER SPENDING COMPARED TO PRE-COVID TRENDS

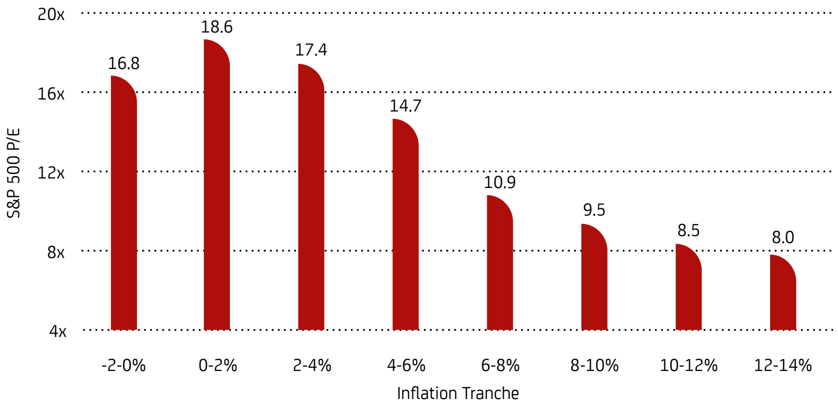
"Dry powder" – $2.1 trillion, including £380 billion added in March 2021



Source: US Bureau of Economic Analysis, Keybridge. Based on a framework by Jason Furman.

For these reasons, an inflation overshooting, up to the 4-6% level, while not being our base case scenario, is a material risk and deserves to be closely monitored. In fact, historically, P/E multiples start shrinking when the inflation rate is above 4% (see below chart).

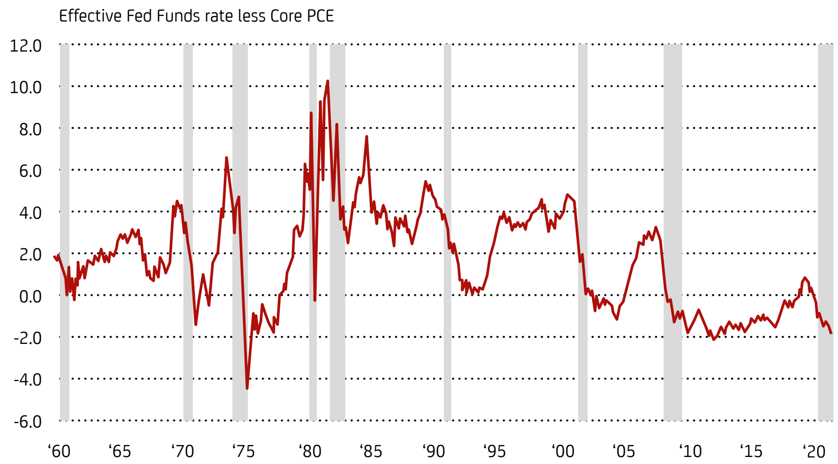
13. AVERAGE S&P 500 P/E BY CPI INFLATION Y/Y TRANCHE



Source: Strategas, UniCredit Wealth Management.

Concerns for equities are related to the considerations that higher inflation may imply more restrictive monetary policies leading to higher interest rates (at which companies' cash flows are discounted) – and companies may not have enough pricing power to cope with higher production prices, resulting in pressure on their margins. However, it's important to point out that real short- and long-term rates remain in negative territory, suggesting that support for equities continues to be compelling.

14. REAL FED FUND RATES GO DEEPER INTO NEGATIVE TERRITORY



Source: Strategas, UniCredit Wealth Management

A somewhat higher inflation environment implies that equity markets will likely be more volatile and reliant on earnings per share growth, as the monetary policy will become gradually more restrictive.

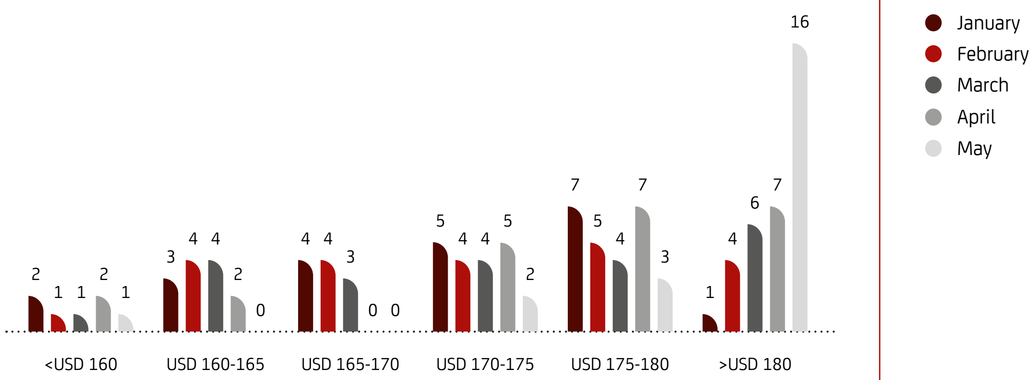
In Developed Markets (DM), we expect the Fed to announce tapering in Q3, while the ECB may be tempted to gradually slow the pace of the PEPP over the coming months.

In Emerging Market (EM) countries, a cycle of rate increases has already begun and is expected to continue and extend to other countries. In addition to Russia, Brazil and Turkey, which have already raised official rates and will likely continue to do so, South Africa, Colombia, Chile, Hungary, the Czech Republic and Poland are also expected to raise rates within the year. The central banks of the EM countries must in fact face rising inflation and act in advance of the Fed in order to avoid devaluation of their currencies. In addition, China, although not fully pursuing a restrictive monetary policy, is prudently managing a tightening of credit. Under this perspective, the Q1-21 earnings season has been encouraging.

The final phase of the reporting season confirms the trend of significant earnings growth thanks to the acceleration of the economy and the favourable comparative basis, despite high expectations. Results continued to surprise positively in both the US and Europe with the percentage of companies beating earnings expectations reaching the highest level in the last 10 years. Specifically, in the US, 86% of companies beat expectations with earnings growth of 50% and a positive surprise of 24%. Consumer discretionary, financials and materials continue to be the main contributors to strong earnings growth airlines (the industrials component) remains the only sector with negative growth, while utilities was flat, with eight out of 11 sectors showing double digit growth. Revenue growth was also significant, standing at 10% with a positive surprise of 4% and with 10 out of 11 sectors showing growth. In Europe, 70% of STOXX Europe 600 companies that have already reported beat expectations with earnings per share growth of 42% and a positive surprise of 22% and with seven out of 11 sectors showing double-digit growth. Materials, discretionary, technology and financials led growth while staples, healthcare and utilities were weaker. At the revenue level, 63% of companies beat expectations with 5% growth and a positive surprise of 3% and with seven out of 11 sectors reporting revenue growth.

Looking ahead to the coming quarters, estimates in the US show that earnings growth expectations for the second quarter are significantly higher than in the first quarter. The good results of the first quarter have in fact led to an upward revision of expectations for the coming quarters, but a downward revision for the first quarter of 2022, whose comparable basis now appears more challenging. Overall for FY 2021, analyst consensus now expects SP&500 earnings per share to be above USD180.

15. STRATEGIST FORECAST FOR 2021 S&P EARNINGS PER SHARE LEVELS

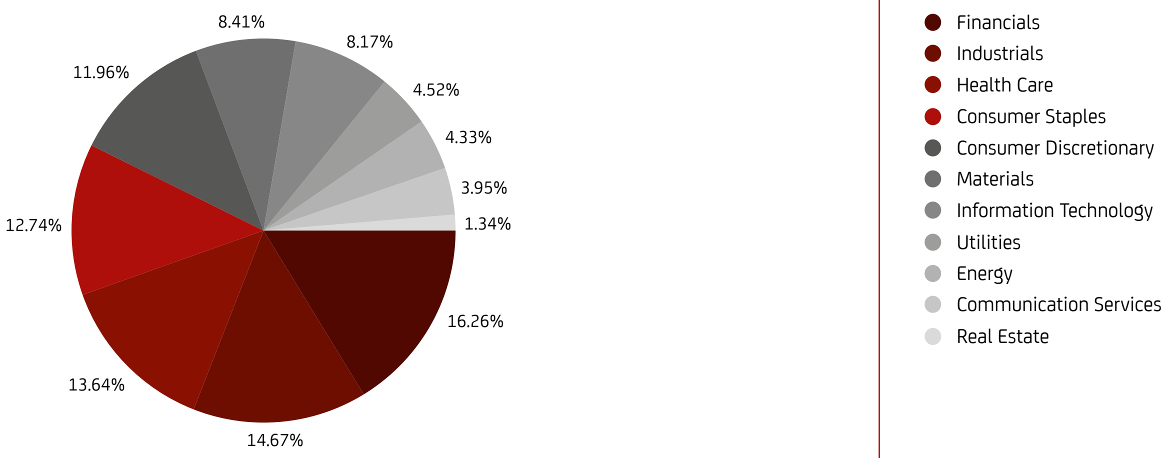


Source: UniCredit Wealth Management on consensus data.

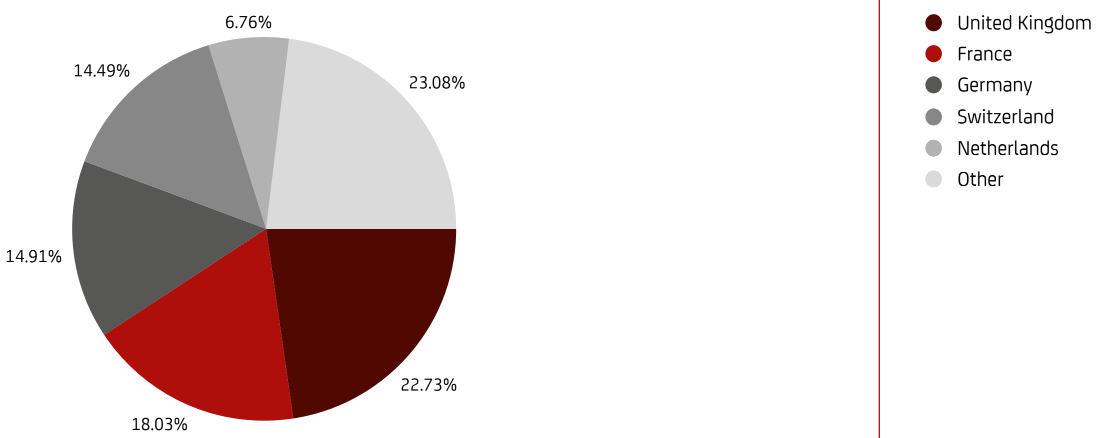
In Europe, the improvement of the earnings growth momentum as well as of the macro momentum, as testified by leading indicators such as the PMI and IFO, is supporting our overweight positioning. European stock markets benefit from a high weighting of cyclical and value sectors. Also, in the Green Economy, which is going to benefit from the first disbursements related to the Next Generation EU program, Europe is gaining global leadership positions.

16. MSCI EUROPE INDEX (EUR)

Sector weights



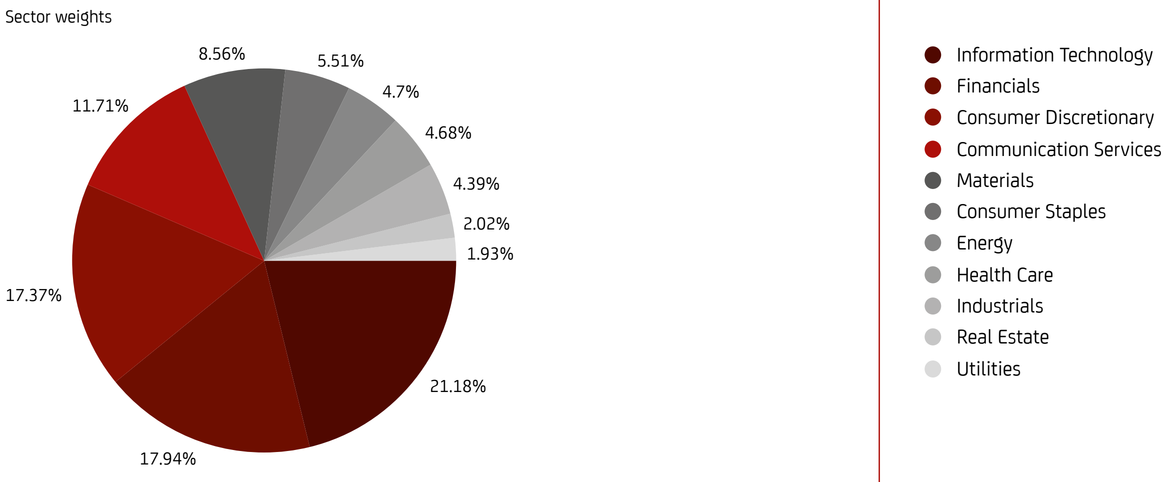
Country weights

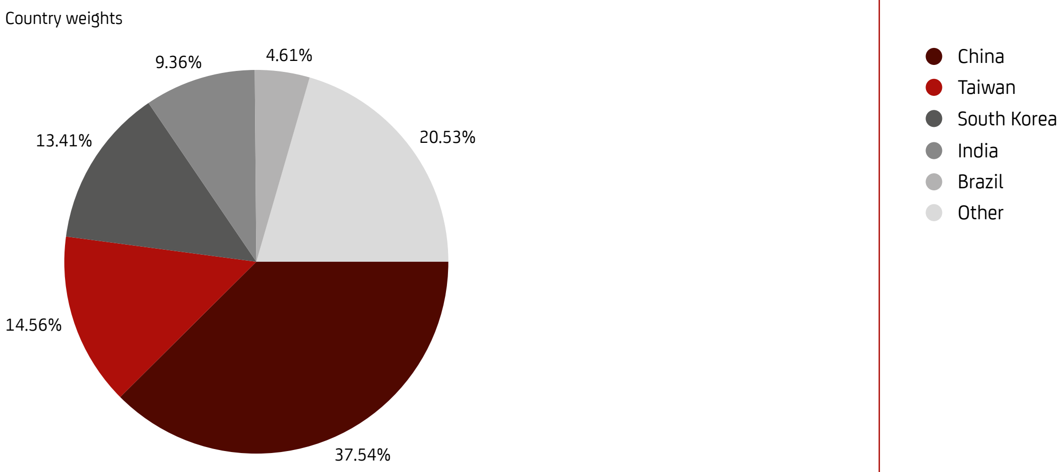


Source: MSCI, UniCredit Wealth Management

We maintain our overweight positioning on EM equities supported by global growth and the pick-up of the commodities cycle. However, in comparison with European equities, EM equities have been affected on the macro side by rising interest rates and, on the micro side, by the higher weightings of the technology sector. Also, the low vaccination rate of many EM countries, especially across Asia, and the Covid emergencies in Brazil and India, are making the pandemic situation in EM worse than in Europe. Last but not least, we expect the confrontation between the US and China to remain tough during the Biden Administration, although brought within the framework of a multilateral approach.

17. MSCI EMERGING MARKETS INDEX (USD)





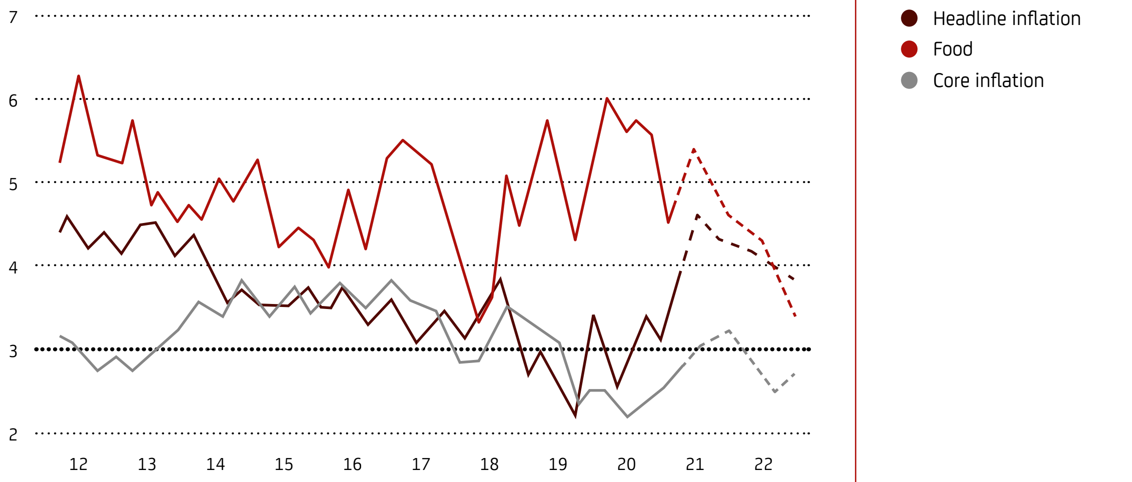
Source: MSCI, UniCredit Wealth Management

We confirm our prudent stance on global bonds, as bond portfolios returns, net of fees, will merely cover inflation, with real returns at zero or negative levels. This suggests to shift from bonds into equities.

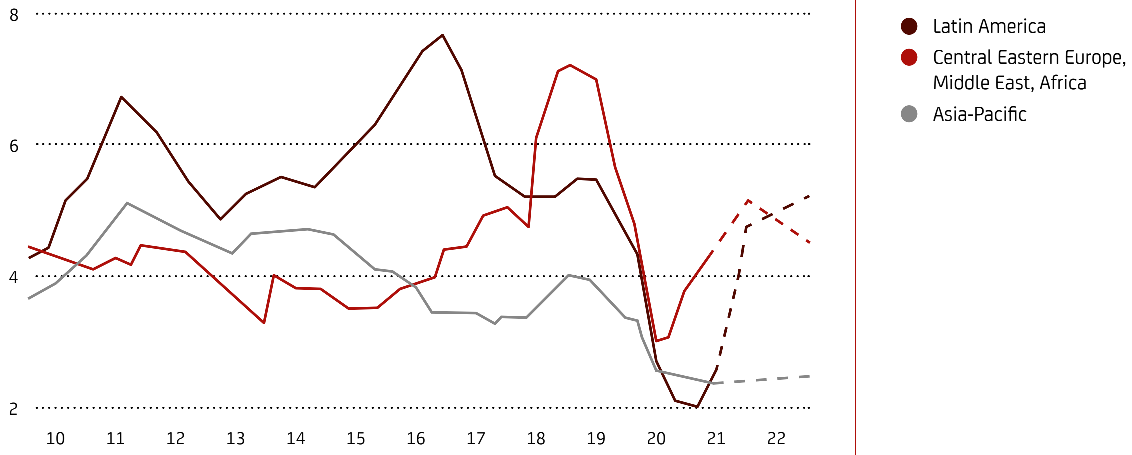
We remain underweight core EMU governments bonds, with a strict duration control and preferring peripheral government bonds. We keep our focus on inflation-linked bonds as we expect inflation to pick-up over the coming months. As for credit, we remain overweight EUR investment grade corporate bonds, given the ECB's support, but we are more aware of their lower spread buffer and of the possibility of a slower pace of the PEPP–related purchases. As for EM bonds, the expectation of further rising US Treasury yields, higher inflation and the starting of the rates hiking cycle in EM countries make us more defensive, reducing both rates and duration risk, and more selective, avoiding countries with fiscal imbalances and high political risk.

18. EM INFLATION AND KEY RATE DEVELOPMENTS

EM inflation rise (in % y/y) set to extend further into H2, hit core inflation



Policy normalisation to gain pace over the coming months in EM (key rates in %)



Source: National Statistics bureaus, Macro Bond, BNP Paribas forecast (dotted lines), UniCredit Wealth Management

UniCredit GWM Asset Allocation Stances Summary

Overweight Global equities
The combination of massive fiscal and monetary action and a strengthening global recovery supports equities, despite uncertainty due to the pandemic.

Overweight European equities
Monetary and fiscal policies are highly expansive. Macro momentum is building up, as also suggested by leading indicators. Higher weighting of value and cyclical sectors versus the US equity market and attractive dividend yields, which are well above government and corporate bond yields.

Neutral US equities
Improving growth outlook due to Biden's very expansionary fiscal policy and better health conditions, but less attractive valuation versus non-US areas.

Overweight Emerging Market equities
Growth play, we prefer China and more generally Asian countries where the growth rate is higher. Countries and sectors selectivity among the EMs is strongly recommended. Covid resurgence in Brazil and India is a source of concern.

Neutral Pacific equities
Japan is supported by the global recovery and the high weighting of value/ cyclical sectors, but the pandemic situation is now worsening due to the low vaccination rate.

Neutral Global bonds
Global bonds are supported by central banks' expansive monetary actions, but their valuation, especially for DM government bonds, is not attractive.

Overweight on Euro investment grade corporate bonds
Still supported by the ECB's purchases but their tighter spread buffer makes them more vulnerable to rising rates. We prefer financial subordinated debt, given the increased capital buffer of European banks.

Underweight high yield corporate bonds
Among the risk assets class we currently prefer equities as the lack of market liquidity remains an issue for high yield bonds.

Underweight EMU government bonds
The ECB's monetary policy is highly expansive, but valuations of core government bonds are currently not attractive. We prefer peripheral government bonds, such as the Italian BTPs, supported by the ECB 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 a temporary and moderate increase of inflation.

Neutral on non-EMU government bonds
A short-term, tactical move given the high level already reached by US Treasury yields.

Overweight Emerging Market bonds
The search for yield supports a selective buying opportunity but we are now more defensive and selective given the expectations of a long-term rise in long-term US Treasury yields.

Underweight Money Markets
They are not attractive, to be used mostly as hedging for uncertainty.

Neutral Alternatives
They offer portfolios decorrelation opportunities.

Commodities

Positive Gold

The price of gold is sustained by accommodative central banks' monetary policies and, looking forward, by its role of inflation hedging.

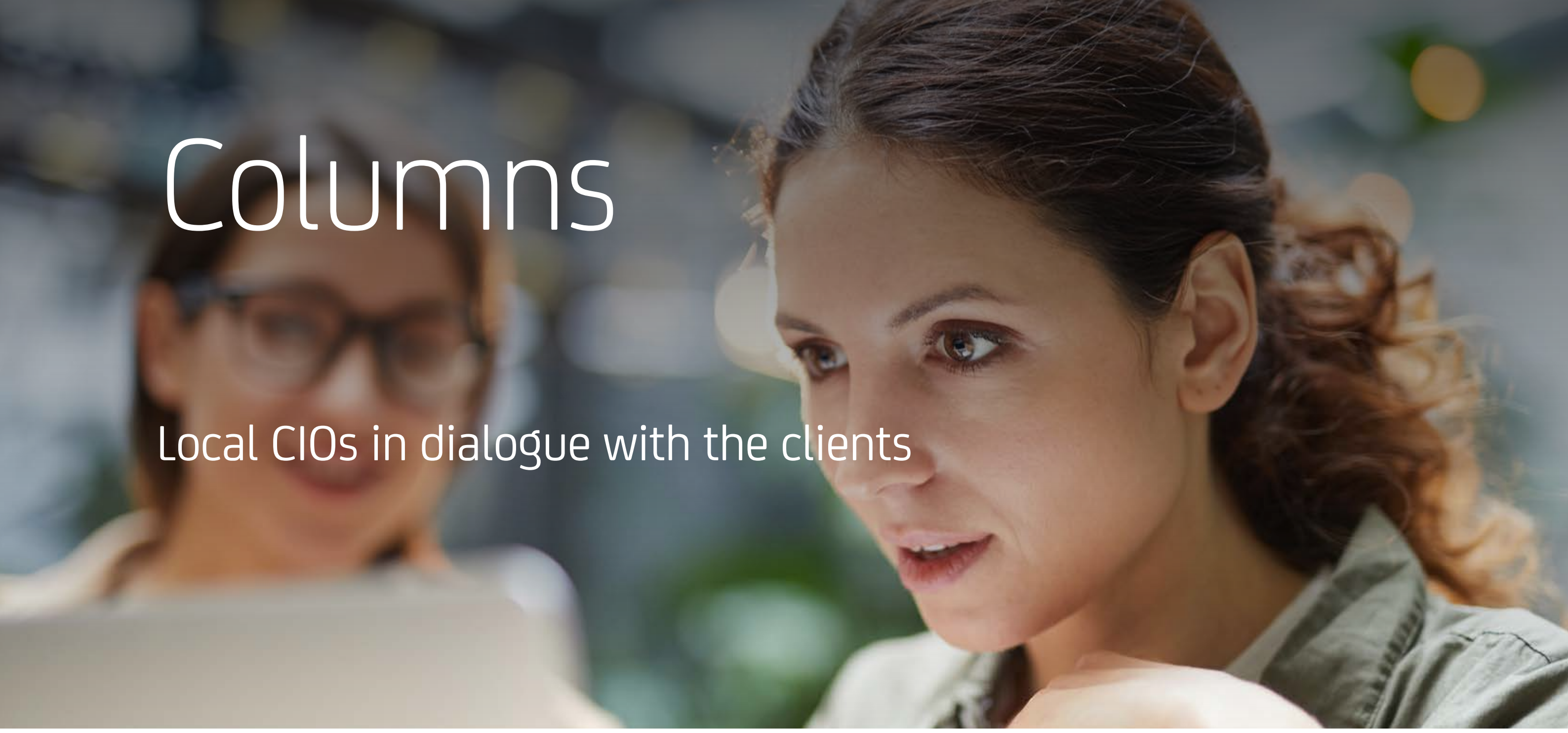
Currencies

EUR/USD

The dollar has recently weakened against the euro due to the prospects of economic recovery in the Eurozone following the speeding up of vaccination campaigns. In the longer term, the US dollar is expected to remain weak due to the so-called twin deficits, trade and fiscal, of the US.

Columns

Local CIOs in dialogue with the clients



Answers from Italy

What is the impact of the recent G7 statement on the global corporation tax?

On June 5, during the G7 summit held in the UK ("Build Back Better"), Finance Ministers of the US, Canada, Japan, UK, Germany, France and Italy agreed on a deal to establish globally coordinated corporation tax rules. While many of the details still have to be discussed and defined, some pillars have been made public.

The first pillar states that the largest multinationals, specifically those with at least a 10% profit margin, will see 20% of the profits above that threshold, reallocated to those countries where they operate. Those countries could then apply domestic corporation tax rates. So, the headquarter approach alone will not apply anymore. The second pillar states that a 15% global minimum corporation tax will be operated on a country basis, thus creating a more level playing field.

These points are particularly relevant since they weaken the purely formal fiscal domicile principle applied to companies. This is a quite "traditional" one, less and less aligned with the current financial and economic environment where the remote and digital economy is gaining ground. In the current set up, huge distortions have risen, and some multinationals pay an effective tax rate lower than many small and medium enterprises.

Besides very positive official comments from G7 members (some have stated it is as a "historic agreement"), there have already been some less enthusiastic comments. Some argue that a 15% minimum tax rate is not that impressive, since it is aligned to the tax rate of fiscal legislation of some countries already considered a "tax haven", whereas a 21% rate would have been much more effective (this last one seems to have been the

Our experts:

Alessandro Caviglia

CIO
Cordusio Sim (Italy)

initial proposal, lowered during the negotiation to achieve a larger consent). Others are worried by the fact that more extensive international acceptance has still to be gained, so for example the next step is the approval by G20. Moreover, national fiscal laws need to be amended and, for example, in the US the approval from both houses of the Congress should not be given for granted. Nevertheless, we want to highlight some additional positive aspects which carry benefits to the entire macro and micro economic environment.

Firstly, the US has been one of the main sponsors of the project: another strong sign of the return to the multilateralism and international cooperation, notwithstanding the fact that most of the "well known suspects" are US technology giant companies.

Secondly, the new century has seen a dramatic rise in wealth concentration within countries in association with a rise in political extremisms and indeed, the unfair fiscal competition has contributed to disparities. A more balanced approach between wealth creation and its distribution signal the strong will to seed more sustainable growth over the long term.

Finally, for the first time in recent history, fiscal stimuli have been synchronous on a global level, producing a huge and unprecedented reaction to heal the pandemic wounds. Obviously, this has been associated with an increase in budget deficits and public debt levels. The risk is that in the coming years, in the same synchronous way, main world economies could find themselves obliged to operate a "fiscal tapering" (gradual removal of fiscal expansionary measures, something we already know on the monetary policy side). This could have global recessionary impacts. The fact that governments are already trying to move in a coordinated way, to find resources to finance their long-term spending and investment projects, lowers the risks of this scenario. In conclusion, it is a long and hard way forward, and many steps lie ahead, but the first one is always the most important and it seems to be in the right direction!

Answers from Austria

China – the emerging giant

Since the beginning of the year, the performance of Chinese equities has lagged behind European equities and American stocks, which is why I get a lot of questions in client meetings about China and Asia's future prospects.

Although this year, the established industrialised countries, especially the US, are outpacing China in terms of economic growth, China's slowdown is not a disappointment, but merely the expected normalisation after the rapid catch-up pace last year. The Chinese economy had already made up for the slump at the beginning of last year in the previous spring. However, under China's leadership, the Asian continent will play a much more important role economically in the coming decade than it does today, which is likely to translate into sustained high growth rates.

The trade agreement reached in the region last year will certainly be supportive: the Regional Comprehensive Economic Partnership (RCEP), the largest trade union in the world, was recently formed in Asia – without the participation of the US and the EU. The free trade zone comprises 15 member states including China and thus more than 2.2 billion people or 30% of the world's population, accounting for 30% of world economic output and 28% of world trade. At first glance, the agreement may seem unspectacular for the member states. Unlike most other trade agreements, barriers between the partners have already been largely eliminated. With the exception of Japan and China and Japan and South Korea, various trade agreements already exist between all 15 member states. Even though trade barriers to reciprocal trade have been low to date, the individual agreements in force so far pose a challenge for exporters. Each trade agreement had different bureaucratic rules that had to be adhered to in order to obtain the respective market access. RCEP creates a significant relief here and an even stronger economic interdependence between the individual countries is pre-programmed.

Another argument in favour of China and the Asian Emerging Market countries is certainly the gradual increase in weightings in global indices by global index providers such as MSCI and FTSE. China's economic engine already accounts for about one-fifth of global output, while foreign investors currently own only a fraction of the shares (about 4%) in mainland markets due to years of restrictive Chinese investment policies. Accordingly, it can be expected that investors will

Oliver Prinz

Co-CIO Bank Austria and Schoellerbank (Austria)

increasingly invest in this asset class and that the Chinese equity market will thus gain in importance in the medium term.

We remain positive on the Asian emerging market countries in our outlook and primarily prefer investment solutions that allow good risk diversification. EMs have become an important part of the portfolio for many investors and will continue to gain importance by increasing weightings in global indices.

Answers from Germany

Bitcoin has caused quite a stir recently. Should investors consider cryptocurrencies?

In April, Bitcoin, the most prominent representative of cryptocurrencies, reached values above USD60,000, but then fell back below USD35,000 – clearly, the price of Bitcoin is extremely volatile. In fact, it is similar for many other cryptocurrencies, suggesting that for investors, such investments are very risky. High risk means that investors must also expect a high risk premium for corresponding investments. And at this point, at the latest, it gets quite complicated.

Unlike, say, stocks, bonds or even gold, Bitcoin has no intrinsic value, nor does it offer investors future cash flows such as dividends in the case of stocks or interest in the case of bonds. With price fluctuations like those in the past, however, Bitcoin & Co would have to offer risk premiums that exceed those of stocks. But it seems extremely doubtful whether this can be guaranteed on a sustainable basis. For this, the demand for such cryptocurrencies would have to grow continuously and ensure price increases that exceed the total return of stocks (i.e. price increases plus dividends) on a sustainable basis due to the high risk premium. However, the performance of stocks on average even exceeds nominal economic growth. It seems very questionable how the demand for Bitcoin & Co can generate such growth rates on a sustained basis. Thus, this risk profile does not seem very interesting for long-term oriented investors.

At the same time, short-term investors should also be aware of the risks. More than 40% of all Bitcoins, for example, are held by less than 0.01% of existing Bitcoin accounts. The activities of such large accounts – which are often referred to as whales – therefore have a considerable influence on short-term price developments. In addition, regulators around the world have recently been focusing on the cryptocurrency market, not least because of illegal activities such as

Philip Gisdakis

Co-CIO of Group Wealth Management and CIO UniCredit Bank AG
(HypoVereinsbank) (Germany)

money laundering and the like. And one more thing: investors should also keep an eye on the climate impact in terms of sustainability. The generation of new Bitcoins, i.e. the mining process alone, consumes more energy than the whole of Sweden, for example – energy that would be better spent on sensible investments. This also applies to the enormous demand for IT components such as graphics cards, which are essential for the increasingly complex computing operations involved in mining.

However, this critical view of Bitcoin does not mean that all investments based on the blockchain technology underlying cryptocurrencies must be viewed with similar suspicion. On the contrary, blockchain technology has great innovation potential and will probably cause and accompany disruptive changes in many industries, especially in the financial industry – the extent of which would go beyond the scope of such a column. However, in order to be able to make appropriate investment decisions, a great deal of detailed and expert know-how is required.

A blockchain is a type of data storage in which blocks of data build on each other and are cryptographically secured. This means that unnoticed manipulation is no longer possible. Decentralised data storage eliminates the need for a central administrative office, as is currently required for securities, for example. The blockchain principle can be applied in many ways and is not limited to cryptocurrencies. Likewise, the process can be used for contract documentation, for general securitisation of property rights, in logistics and for many other purposes.

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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.

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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.

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