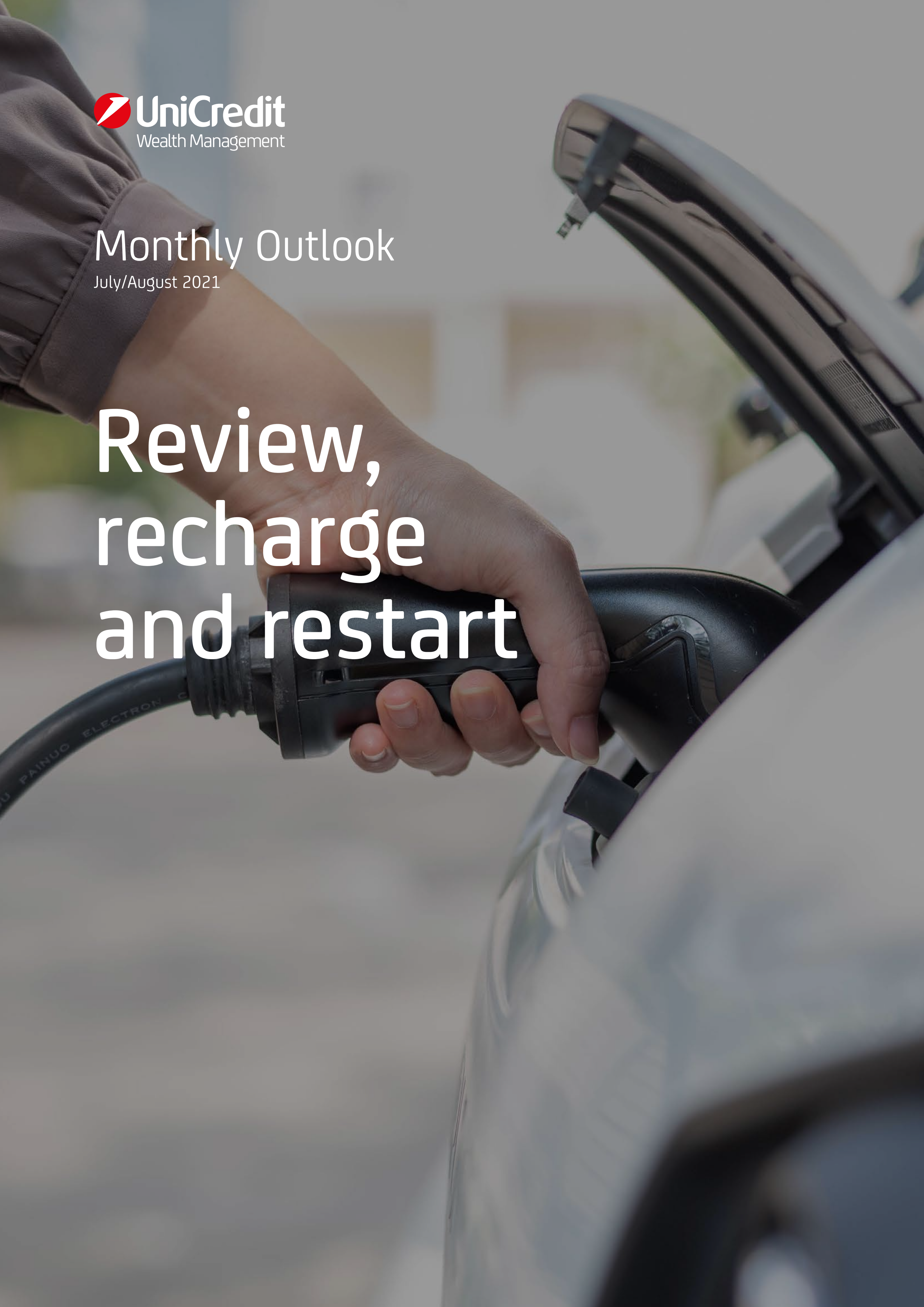

UniCredit
Wealth Management

Monthly Outlook

July/August 2021

Review, recharge and restart

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CIOs Letter

Review, recharge and restart

The first half of the year is now behind us, which provides a welcome opportunity to take a look back. Many hopes that we had cherished, following the terrible year of 2020, have come true in recent months. We don't want to sound too euphoric and we know that there are still many uncertainties, problems and wounds that still need to heal. But let's first look at the positive developments.

The medical solution to the pandemic that we all long for in the form of widely available vaccines is approaching, even if – perhaps a major drop of bitterness – this is initially only for the industrialised nations. While disappointment at the slow start to the vaccination campaign prevailed in continental Europe at the beginning of the year, the campaign is now in full swing. Vaccine doses in the range of 5%-7% of the population are currently being administered per week. By mid-year, about 40% of the population in the EU was fully vaccinated.

Due to the success of the triad of vaccination, testing and spacing, incidence rates have dropped significantly in many countries in Europe and North America. Restrictions have been scaled back. The economy is now benefiting from this. While gross domestic product in the euro zone contracted slightly in the first quarter, the economy picked up considerably in the spring and is expected to grow strongly in the current quarter. Capital markets welcomed this and staged a rally. In the first half of 2021, the leading stock indices in Europe and the US gained around 15%. For a long period, European stocks led the way – an experience that equity investors had not had for some time. However, as the economy recovered, inflation also picked up, driven by catch-up and base effects, but also due to capacity and supply bottlenecks. But central bankers believe that these effects will only push inflation up temporarily and that it will gradually return to normal. While we share this view, confirmation is still pending.

As already mentioned, however, there are still some clouds in the sky. The most important question is: how will the pandemic progress? And, how effective are the approved vaccines against virus variants? Is vaccination readiness high enough to achieve herd immunity as soon as possible? Might even more aggressive variants emerge that challenge previous successes? We do not know the answers to these questions, but we are convinced that the above triad – vaccinating, testing, and, where necessary, spacing out – is the right way to bring the pandemic under control. And even in the event of a less favourable scenario, we know that the resources and measures available to us will be sufficient to

Manuela D'Onofrio

Head of Group Investment Strategy and CIO Group Wealth Management

Philip Gisdakis

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

meet further challenges. Work is already underway on vaccine modifications. We are convinced that science will provide the answer to the challenges.

In the stock markets, the majority of the post-pandemic rally is likely already behind us. But that does not mean that the recovery is over. Normalisation also means that problems and challenges that existed before the pandemic, and were pushed into the background during it, will once again emerge on investors' radars. Climate change is one of the most important ones. But here, too, we are convinced that the answers to the associated problems and risks represent more of an opportunity for the European economy. As in the pandemic, science, innovation and, above all, targeted investment, will make up a weighty part of the solution. But innovations and investments mean more growth and prospects for employees and companies alike.

For this reason, we prefer equities to fixed income securities and, in the case of the former, focus in particular on European stocks. Our fundamentally oriented approach to individual stock selection, which places particular emphasis on the quality and stability of companies, has proven its worth during the crisis. Initially, we focused on defensive sectors, especially healthcare and information technology. In the recovery, more cyclical sectors are coming to the fore, which can benefit particularly from growth. We are also particularly pleased with the performance of our sustainable investment strategies. They showed once again that taking into account so-called ESG criteria (environmental, social and governance) does not have to impair the prospects of the success of investments, but on the contrary can even increase them. European companies played a key role in the development of the vaccine. This underscores the competitiveness and innovative strength of our economies. That's why we have no fears about future challenges.

Macro & Markets

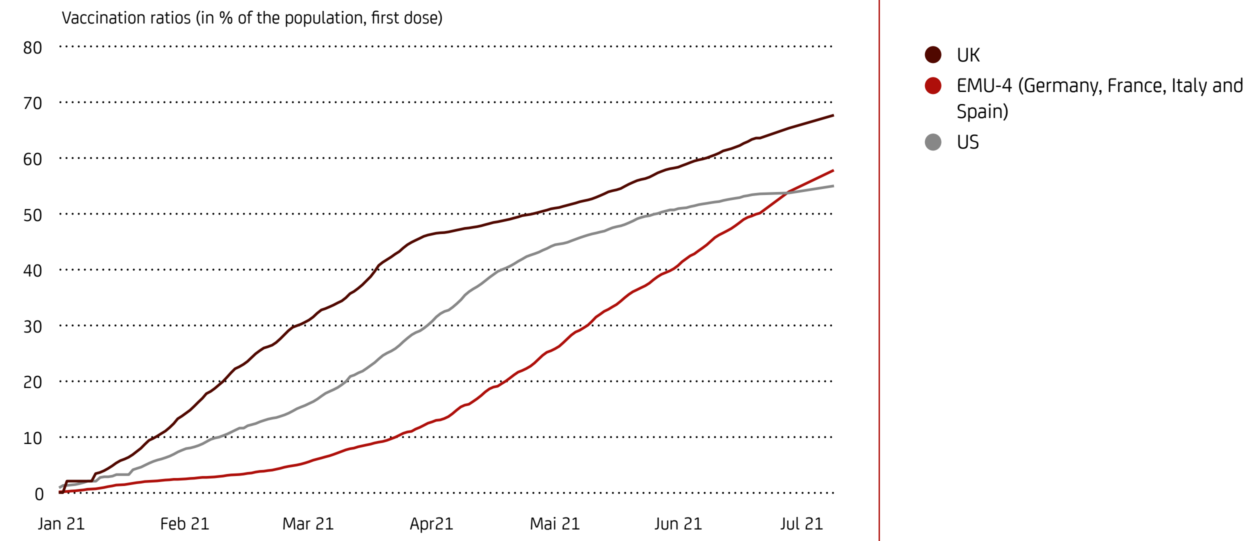
On the way back to normality

Vaccination success gives hope

Covid has kept the world on its toes for a year and a half. Each wave of the virus not only caused millions of people to suffer, but also sent economies into a tailspin – because up until recently, infection numbers could only be brought under control with severe lockdowns and mobility restrictions. In each trough, however, the economic engines started up again. Pent-up demand combined with massive monetary and fiscal policy stimuli fuelled a rapid recovery process – before weakening discipline and colder weather drove infection figures up again.

While businesses were closed almost across the board in the first wave, only the service sector was affected afterwards.

1. FAST PACE OF VACCINATION IN EUROPE



Source: www.ourworldindata.org/covid-vaccinations, UniCredit Wealth Management

This seesaw movement was most pronounced in Europe, which has already had to cope with three Covid waves and two recessions (double dip). However, it seems that at least the economic zig-zag course is coming to an end, as the initially close correlation between the infection, lockdown and economic growth

has loosened noticeably and should break down completely this autumn.
The main driver of this is the rapid progress in vaccinations. In terms of first-dose vaccination, the euro area has recently surpassed the US (see chart 1). Extrapolating the pace of the past few weeks, herd immunity could likely be reached before winter, with about 80% of the population fully vaccinated.

However, the more contagious a viral mutation, the higher the percentage of vaccinated people is required to achieve herd immunity.

But this is still no reason to sound the all-clear. In fact, the road to herd immunity remains rocky. The rapid spread of the highly infectious Delta variant underscores the risk of rising infection rates again. At the same time, the willingness to vaccinate could potentially dwindle. And even herd immunity does not mean the end of Covid (albeit that of the pandemic). In an analogy to the influenza flu, there are likely to be recurrent Covid waves, especially during the winter months – and the fourth one is already pre-programmed.

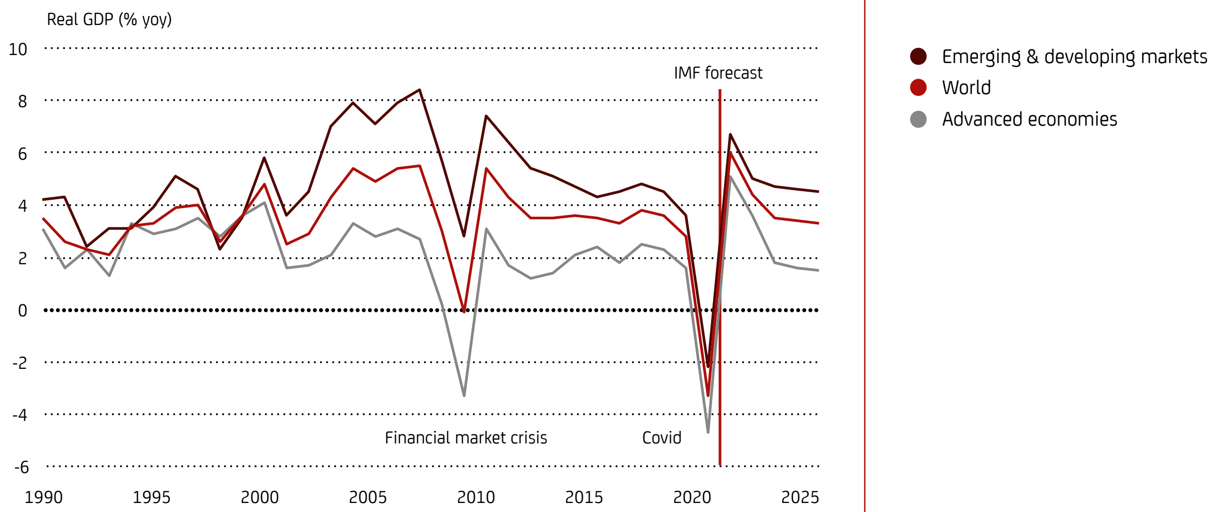
However, it should be possible to keep infection numbers in check through (booster) vaccinations. Above all, infection numbers should no longer endanger our health systems and thus make new, far-reaching lockdowns necessary. The development in the UK gives hope. There, incidence figures are rising sharply again, but the number of hospital admissions and deaths is increasing only modestly – even though, with a good 50% of people fully vaccinated, herd immunity has not yet been achieved. The end of the pandemic in Europe and North America is thus coming closer – as long as mutations resistant to current vaccines do not arise. However, this is only a risk and not our baseline scenario.

In Asia and Latin America it will take longer before herd immunity is achieved. There, the vaccination campaign is progressing very slowly. In addition, due to mutations and seasonal factors (winter in the southern hemisphere), the infection number has risen noticeably again in the meantime.

Economically, too, the prospect of herd immunity before winter is good news. The revival of the global economy that began in the first half of this year is not only likely to accelerate, but more importantly become steadier. A setback like last year, when the summer growth spurt came to an abrupt end last autumn, is unlikely to happen again. Real GDP worldwide is set to continuously grow at an above-average rate into the year after next – even if rates should gradually flatten out and return to their potential path (normalisation, see chart 2). But let's take it one step at a time!

We expect inflation to show a similar development to that of growth.

2. GLOBAL GROWTH TO RETURN TO TREND PATH IN MEDIUM-TERM



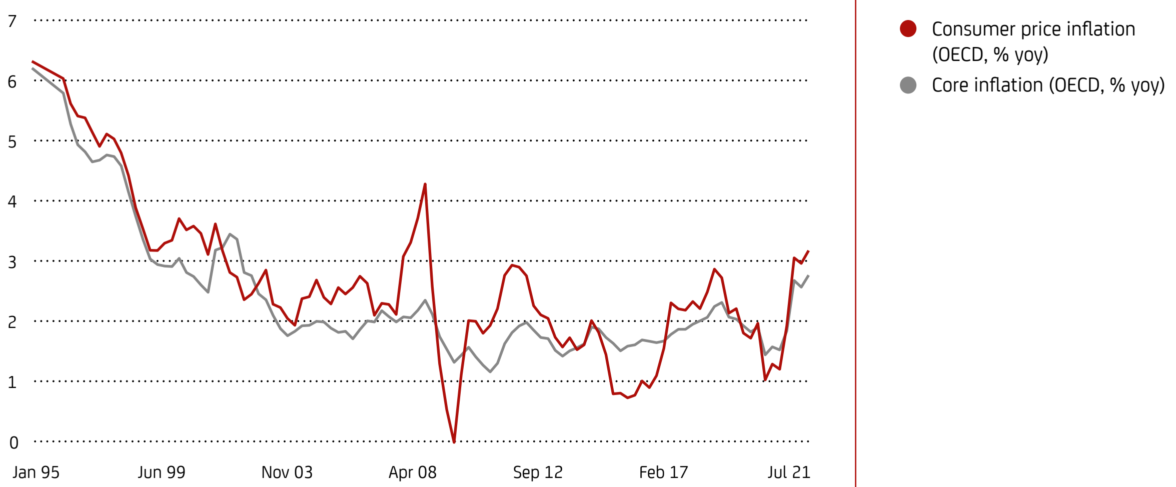
Source: Refinitiv Datastream, IMF, UniCredit Wealth Management

Global growth: Pick up in first half of 2021...

After a bumpy start, the global economy picked up considerably in the first half of the year – although worldwide infection rates only peaked in April. With an annualised increase of 4.5%, global GDP in the first six months is likely to have grown a good one percentage point faster than the long-term average. This is significantly more than originally expected, too. However, inflation also surprised on the upside. The surge in demand combined with sharply rising commodity prices and transport costs as well as supply bottlenecks for important intermediate goods (e.g. semiconductors) caused global inflation to rise unexpectedly quickly to a multi-decade high (see chart 3). This also applies to core inflation, i.e. inflation excluding the volatile components of energy and food.

Official data are not available yet. Second quarter GDP reports will not be published before the end of July. However, the timely economic data allow first projections (nowcast).

3. CORE INFLATION RISES TO HIGHEST LEVEL IN ALMOST 20 YEARS



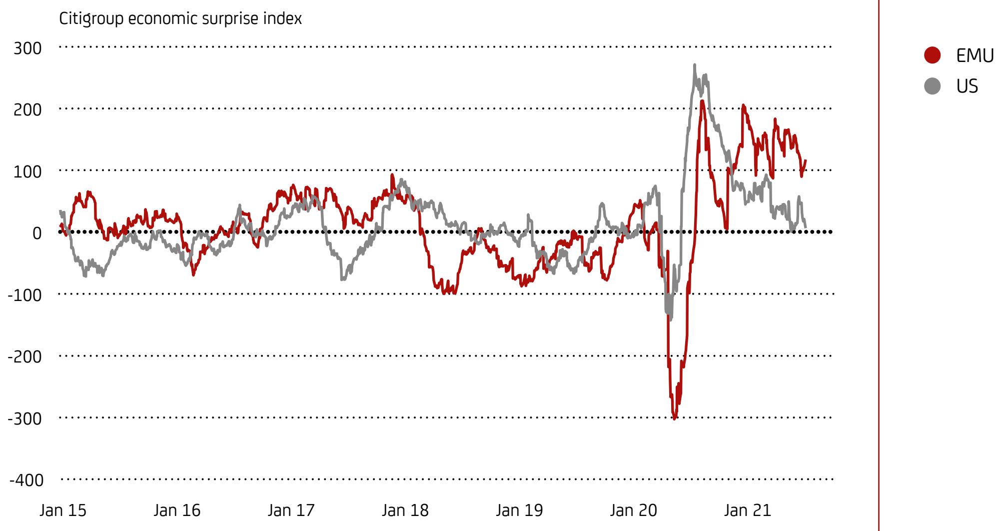
Source: Refinitiv Datastream, OECD, UniCredit Wealth Management

However, the economic recovery in the first half was very uneven across regions. This was primarily due to the varying extent of economic policy stimuli and a diverging pace of vaccinations. The trillion-dollar fiscal programmes (some of which have only just been announced) caused the US economy to boom in the spring, with annualised growth of just under 10%. The US thus overtook China as the global growth champion – although the growth potential in China is far higher (5.5% vs. 1.75%). There, the unwinding of fiscal and credit policy stimuli pushed growth below potential, albeit temporarily. The absence of the third Covid wave and the initially rapid progress in vaccinations also contributed to the superior performance of the US in H1 2021.

In the first three months of his term in office, US President Biden has launched fiscal programmes amounting to USD6 trillion (Rescue Plan, Jobs Plan and Families Plan) – in addition to the USD900 billion that was released last December under Trump. Even if the measures are spread out over several years, they already mean enormous stimulus and announcement effects.

By contrast, the EMU slipped into a double-dip recession at the turn of the year due to the pandemic and was only able to pick up speed again in the course of the spring – but then strongly. Our originally expected +5% annualised growth for the second quarter may soon prove to have been too cautious. Economic data continue to surprise on the upside (see chart 4).

4. THE EMU CONTINUES TO SURPRISE ON A POSITIVE NOTE



Source: Refinitiv Datastream, UniCredit Wealth Management

Asia and Latin America have been the weakest links in the global economy recently. Rising infection numbers and renewed lockdowns, a sluggish pace of vaccination, travel restrictions as well as the limited potential of economic policy countermeasures – weaker currencies have already forced some central banks to raise key interest rates – put their economies back in the stranglehold of the virus. Economic growth of Emerging Markets is likely to have stagnated in Q2 2021 – and even to have shrunk noticeably when excluding China.

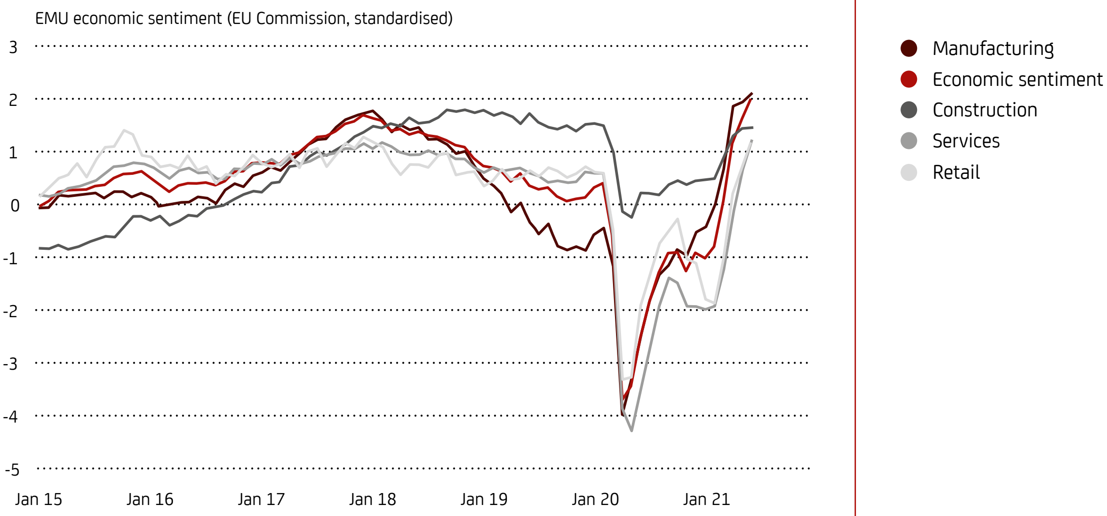
India, Argentina, Peru, Colombia, Malaysia and Singapore were hit the hardest. Real GDP is expected to have declined by an annualised 5%-25% in Q2 2021.

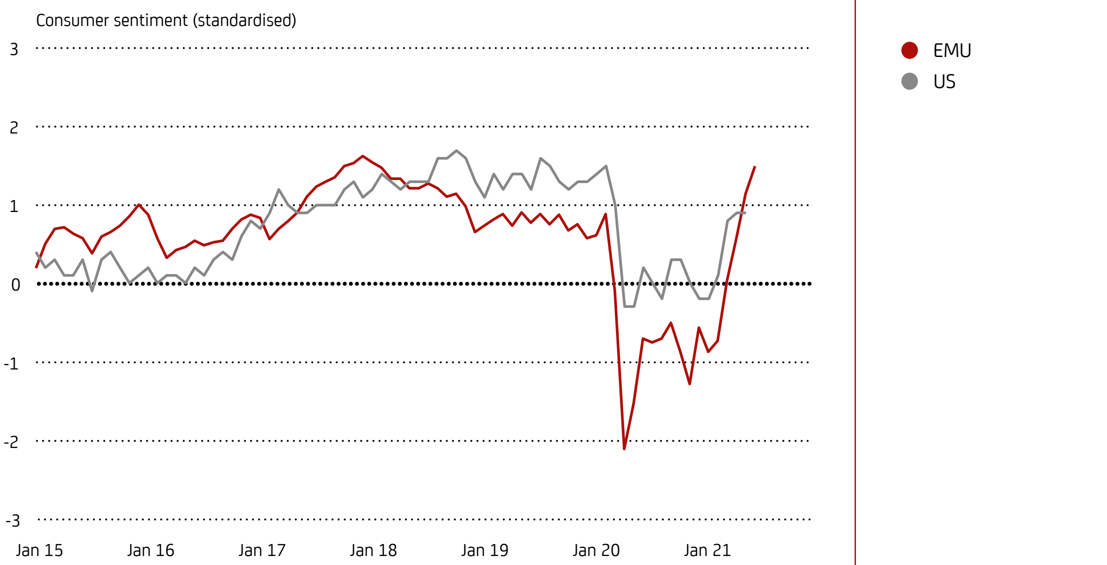
... followed by a spurt in the second half of the year

Over the short-term horizon, weak growth in Emerging Markets may persist. Nevertheless, there are indications that are pointing to a recovery ahead. Their economies should gradually strengthen in the course of H2 2021 (base and catch-up effects). In addition, the region is benefiting from the growing demand of industrialised countries for raw materials, intermediate and technology goods.

However, we expect to see the strongest momentum in Europe. The EMU area started the second half of the year with plenty of momentum. Growing vaccination rates, further easing of restrictions and rising mobility indices lead us to expect real growth to spurt in the current quarter. Consumer and business sentiment could hardly be better. The indicators have now not only left their pre-Covid levels behind, but even reached new cyclical highs recently (see charts 5).

5. HIGH-FLYING MOOD IN EUROPE





Source: Refinitiv Datastream, UniCredit Wealth Management

Private consumption will become the economic locomotive. The prospect of herd immunity and the re-opening of the services and retail sectors, which have been so badly battered by Covid, should lead to a genuine unloading of the pent-up consumer demand in the summer. If the savings rate normalises in the course of the second half of the year, as forecasted by the OECD, this alone will generate additional private consumption of 5% of a quarterly GDP. High-flying consumer demand will be flanked by rising investment and export activity. At least this is the message of the corresponding leading indicators such as sentiment or new order figures.

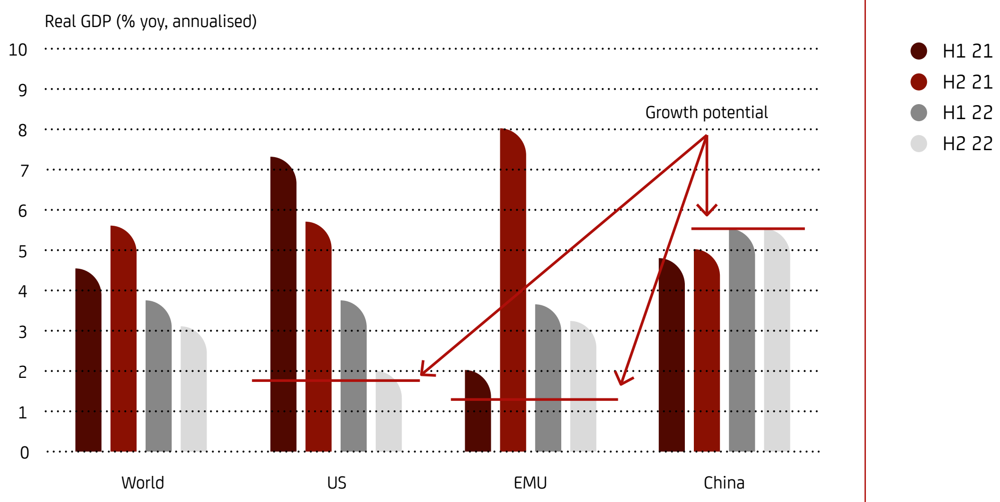
No wonder, therefore, that growth expectations for the euro area have been raised in recent weeks. Quite a few analysts now expect double-digit annualised GDP growth for Q3. And because the underlying momentum is likely to increase, or

At the beginning of spring, the savings rate in Germany was 20%. According to the OECD, it should fall to just over 12% by the end of 2021. The long-term average is just under 11%.

at least remain high beyond base effects, EMU-wide economic output should be able to grow by around 8% overall in the second half of the year. Thus, the euro area will take over global growth leadership (see chart 6) and should still leave the US behind in the coming year. Consequently, the respective Covid gaps should close more quickly than previously projected.

The static pre-pandemic GDP level could now already be reached at the turn of the year, while the underlying pre-pandemic potential path (dynamic) should be achieved by the end of 2022.

6. EURO AREA SET TO OUTPACE THE US



Source: Refinitiv Datastream, UniCredit Wealth Management

A stepwise normalisation in the coming year

Of course, growth dynamics are always driven by base effects. What falls deeper into a crisis can also grow stronger out of it. Moreover, the slowing pace of expansion in the US is anything but a disappointment. For one, GDP growth is expected to remain above potential until the end of next year. The underlying strength of the US economy is beyond doubt. This is shown by the whole spectrum of economic indicators – from the leading and sentiment indices to coincident indices such as production and retail sales to lagging labour market figures. All of them are pointing clearly upwards beyond temporary related setbacks ("too much, too soon") and have mostly left their pre-Corona levels behind – or even reached new cycle highs.

However, this assessment only applies if the crisis was the result of an external shock such as a natural disaster or a pandemic. But, if a recession is the result of accumulated structural rigidities, experience shows that the recovery after the recession is not only weaker but also more protracted.

Secondly, the slowdown in the US economy is merely an indication of an incipient, healthy normalisation after the strong catch-up process that preceded it – as base effects are fading and the impact of economic policy impulses is gradually diminishing. Moreover, the US economy is running ahead of the European economy. The GDP gap on the other side of the Atlantic was already closed in the spring, and the underlying US trend GDP path should be reached again towards the end of the year. What is now happening in the US (and already happened in China), a gradual return to potential, is likely to take place with a time lag in Europe and Emerging Markets as well. After two years of sharp swings, 2022 should mark the beginning of normalisation in economic terms.

This June, 850,000 new jobs were created. This is the strongest monthly increase since August last year.

What, however, are the risks to our rather optimistic global economic outlook? In the short term, it is the virus mutations that could cloud the picture. With each vaccination, however, the downside risks will lessen. Pressures could also result from even longer-lasting supply bottlenecks for primary products such as semiconductors. If, on the other hand, pent-up consumer demand unloads unexpectedly quickly and violently, the growth spurt in the summer could be even stronger.

Monetary and fiscal policy - from tailwinds to headwinds?

And beyond the short term? In view of the rapid increase in inflation and public debt, is there not a threat of a strong monetary and fiscal headwind starting next year, which could slow down or even stop the global economic recovery? In a nutshell, we do not expect this to happen! In fact, much more than the start of economic policy normalisation is not to be expected for 2022.

Why not? For one thing, the rapid rise in inflation should prove to be temporary and price increases should gradually fall back to or below central banks' targets – once pent-up demand has been worked off, the increased raw material and transport costs have dropped out of the year-on-year rates and the supply bottlenecks have been removed. There are no signs of a wage-price spiral either. Central banks can therefore look through the current price pressure without worrying, especially since the medium-term inflation expectations of market participants appear to be firmly anchored (see chart 7).

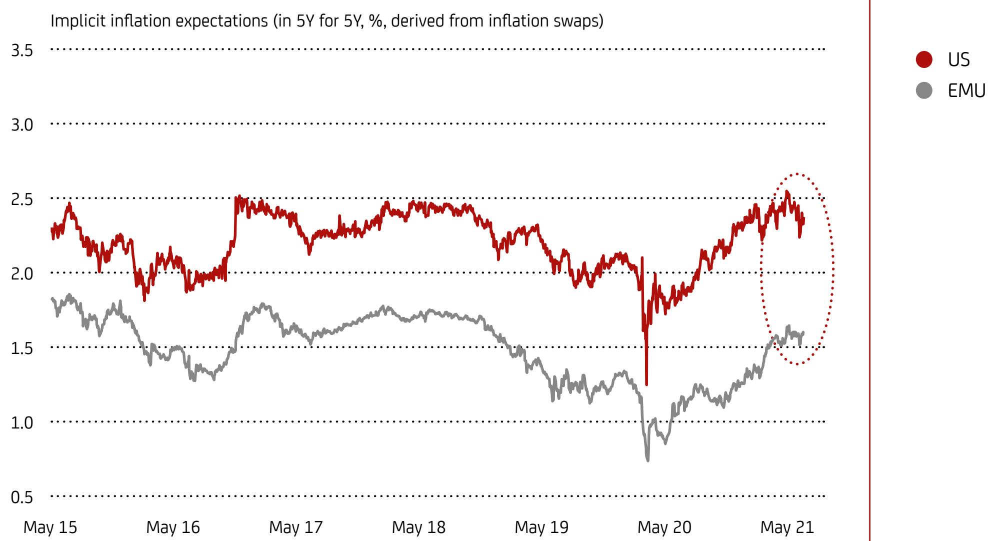
However, central banks need to finalise their exit strategy now, as the need for hyperexpansionary monetary policy will gradually disappear from next year onwards. As is so often the case, the Fed should lead the pack and start tapering its securities purchases at the turn of the year. The ECB is also likely to scale back its pandemic purchase programme – albeit only in the course of next year.

Germany's industrial and auto production, which have been quite weak up until recently (-0.3% and -7.2% m-o-m, respectively), are still suffering from shortages of semiconductors and other intermediate goods.

Our UniCredit Research colleagues expect EMU-wide consumer price inflation to peak at 2¾% at the turn of the year, but to fall back below the new ECB target of 2% in 2022. In the US, on the other hand, the zenith seems to have been reached already (albeit at a high 5%). Towards the end of 2022, inflation there should approach its 2% target again.

The ECB tapering should initially be less pronounced than that of the Fed. After all, it will still take time until all countries have closed the Covid gaps. The expected decline in inflation below the ECB's target of 2% also argues for a cautious tapering overall.

7. INVESTORS' INFLATION EXPECTATIONS WELL ANCHORED

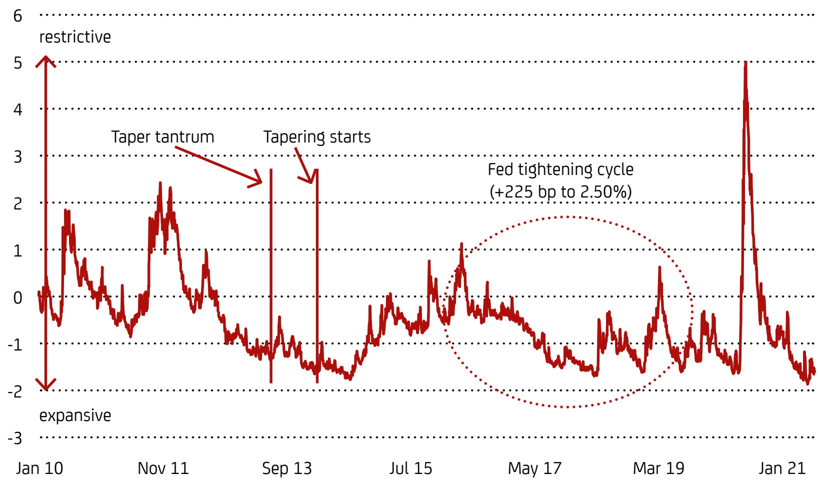


Source: Refinitiv Datastream, UniCredit Wealth Management

Tapering should not have a lasting impact on the financial environment, i.e. yields, curves and spreads, because it is largely priced in. This also applies to the first phase of the interest rate hike cycle, which should not start before mid-2023. In any case, the last Fed cycle did not really cause the US Financial Conditions indicator to rise (see chart 8). It will therefore take years before (US) monetary policy becomes sustainably restrictive.

The taper tantrum as of spring 2013 was a kind of collective panic (tantrum) following the Fed's announcement of its intention to scale back its securities purchases. Government bond yields shot up. At the same time, the yield curve steepened. However, bond markets were able to recover even before the tapering programme started.

8. STILL A LONG WAY TO A REALLY RESTRICTIVE US MONETARY POLICY



Source: Refinitiv Datastream, UniCredit Wealth Management

The same applies to fiscal policy. The gigantic fiscal packages have prevented an even worse Covid recession and spurred a rapid, albeit very volatile recovery. If the stimuli are scaled back, this naturally means a drag on growth (fiscal drag). If the reduction is hasty and aggressive (tax increases and/or spending cuts), the recovery can even be terminated. An example of this is the debt-driven austerity policy of 2010/11 in the euro area. But it should not be repeated this time. Why not?

1. The majority of fiscal programmes are spread out over time, with some spending even over ten years. This is especially true for the US, but also for the EU programmes (Recovery Fund, multi-year financial plan) and partly for national aid packages.

2. Fiscal retrenchment will thus likely be measured, and an outright shift towards a truly restrictive policy is not to be expected. Covid has underlined the need for a rapid, coordinated monetary and fiscal policy response. Europe, especially Germany, has been heavily criticised for its dogmatic austerity orientation even before. In the meantime, a change of heart has set in. The introduction of a common fiscal policy and the overdue orientation towards public investment gives hope. The Stability and Growth Pact should be handled more flexibly.

In 2010/11, shortly after the global economy grew out of the financial market crisis, Europe tightened the fiscal reins noticeably. At the end of 2011, the euro area fell back into recession (sovereign debt crisis). The dogmatic austerity course also contributed to the unusually weak recovery phase in 2012-18.

3. The need for budget consolidation should be decided not as much of by the debt level than by the interest burden. And the latter will remain extremely low in the coming years. Public investments can currently be financed (almost) at zero cost. Debt and interest service ratios may even decline through the stimulation of growth.

4. In macroeconomic terms, a measured fiscal (and also monetary) tapering is likely to be offset by stronger underlying growth. In addition, there is a chance that with the recent allocation of public funds to digitalisation, future technologies, infrastructure and climate change, potential growth will be higher further down the road.

5. One should not overestimate the fiscal multipliers. Just as the massive transfer payments in 2020/21 were not entirely growth-effective because parts of them were saved, the dampening effect of fiscal tapering in the dis-saving process could also be smaller.

Therefore, there are reasons enough to state that the overall economic condition should be strong enough in the coming years to cope with a measured reduction in fiscal and monetary stimuli without noticeable setbacks. As a result, the recovery will continue even as growth rates normalise. This is good news after almost two years of ongoing crisis and huge swings in economic growth.

Structural fiscal policy is therefore considered counter-cyclical. Historically, the fiscal thrust has therefore been negatively correlated with underlying growth.

If the fiscal drag is lower than textbook multipliers suggest, the underlying growth is correspondingly higher. Only overall economic growth can be measured.

In Focus & Asset Allocation

2021 Mid-year review and outlook

In this combined “In Focus & Asset Allocation” section we will provide an in-depth review and preview of the major asset classes together with a concise summary of our current stance in all asset classes.

Stock markets: Strong

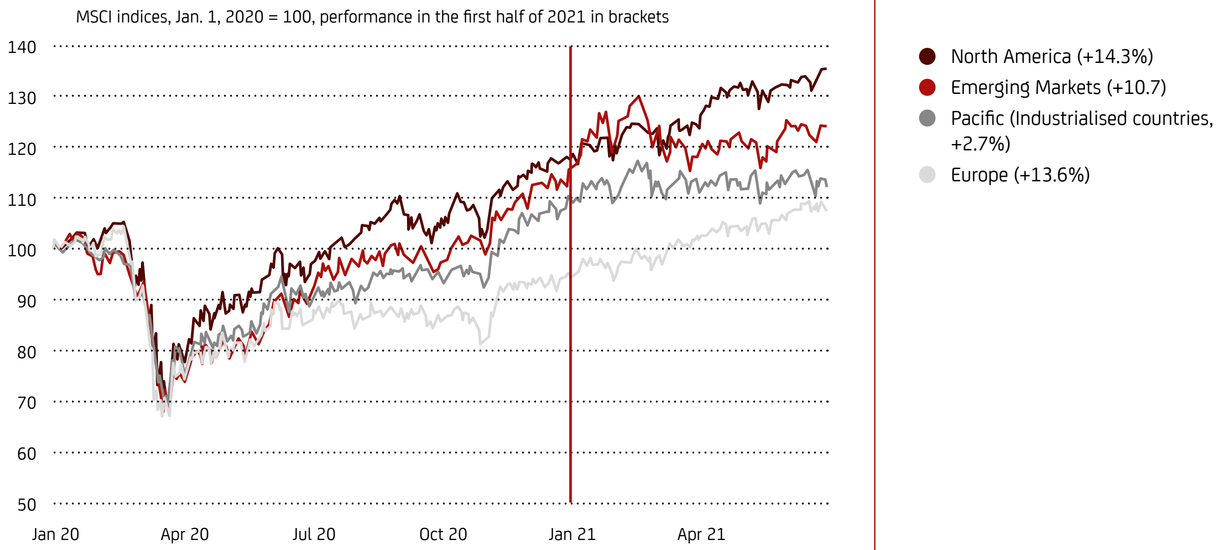
The review: Very good first half of 2021

In the second half of 2020, European stock markets were able to make more modest gains compared to the rest of the world. However, following this, the first half of 2021 was characterised by a brilliant rally in Europe (see chart 9). For a while, the old continent was even ahead of the US. At the end of the second quarter, however, the markets on the other side of the Atlantic were able to pick up noticeably and narrowly outperform European indices. As of June 30, North American equities posted a cumulative half-year gain of 14.3%, closely followed by Europe with 13.6% (MSCI indices). Emerging Markets were significantly behind, their performance held back in particular by the weaker performance of Chinese stocks (H1: only 1.2%). In a regional comparison, the Pacific segment was the weakest performer with 2.7%.

The MSCI index for the Pacific region relates only to the industrialised countries there.

In the first half of 2021, the recovery rally was therefore fuelled in particular by the stock markets of the Western industrialised nations, while the Emerging Markets together with Asia Pacific took a breather after the brilliant year of 2020. On the one hand, this is due to the fact that China is already much further advanced in terms of post-Covid normalisation (“first-in, first out”) and the structural problems that were already affecting the markets before the pandemic are therefore having a greater impact. These include, for example, the high indebtedness of companies and provinces, but also the increasing confrontation with the West. On the other hand, the Covid infection situation worsened in India, among other countries, leading to a hard lockdown and dragging down the economy as well as markets. Rising commodity prices, on the other hand, are affecting Emerging Markets to varying degrees. On the one hand, commodity producers are benefiting from the boom, while on the other hand, countries such as China faced rising prices for basic products, which could not always be passed on to customers.

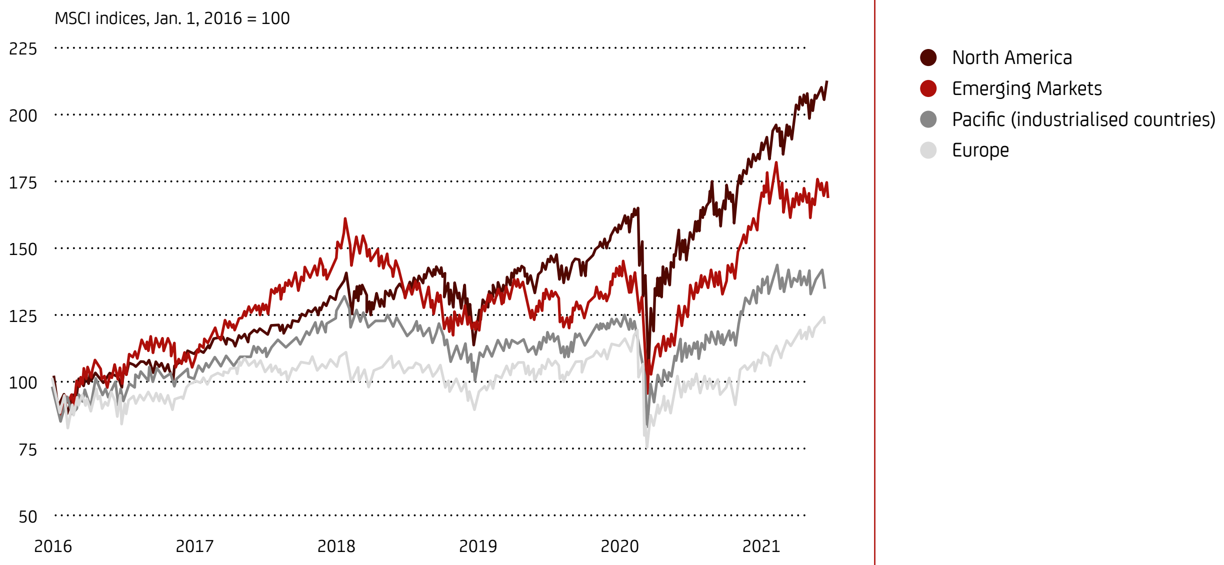
9. STOCK MARKETS IN TIMES OF COVID



Please note: Past values and forecasts are not a reliable indicator of future development. The indices cannot be purchased and therefore do not include costs. When investing in securities, costs are incurred which reduce the performance.
Source: Refinitiv Datastream, UniCredit Wealth Management. Status: 30.6.2021

While European equities finished more or less on par with North America in the first half of 2021, and thus performed better than Emerging Markets and the Pacific region, the old continent still trails other regions over a longer-term perspective – and in some cases, significantly (see chart 10). For example, based on MSCI price indices, European equities trended little more than sideways between 2016 and 2020. It was not until the fall of 2020 that the rally began, which lasted until mid-year and drove stock indices to new highs. By contrast, corresponding North American stocks doubled in the same period. The Emerging Markets index lags somewhat behind its North American counterpart. However, the gap between Europe and the Pacific region (industrialised countries) shrank in the first half of 2021.

10. STOCK MARKETS OVER A LONGER-TERM COMPARISON



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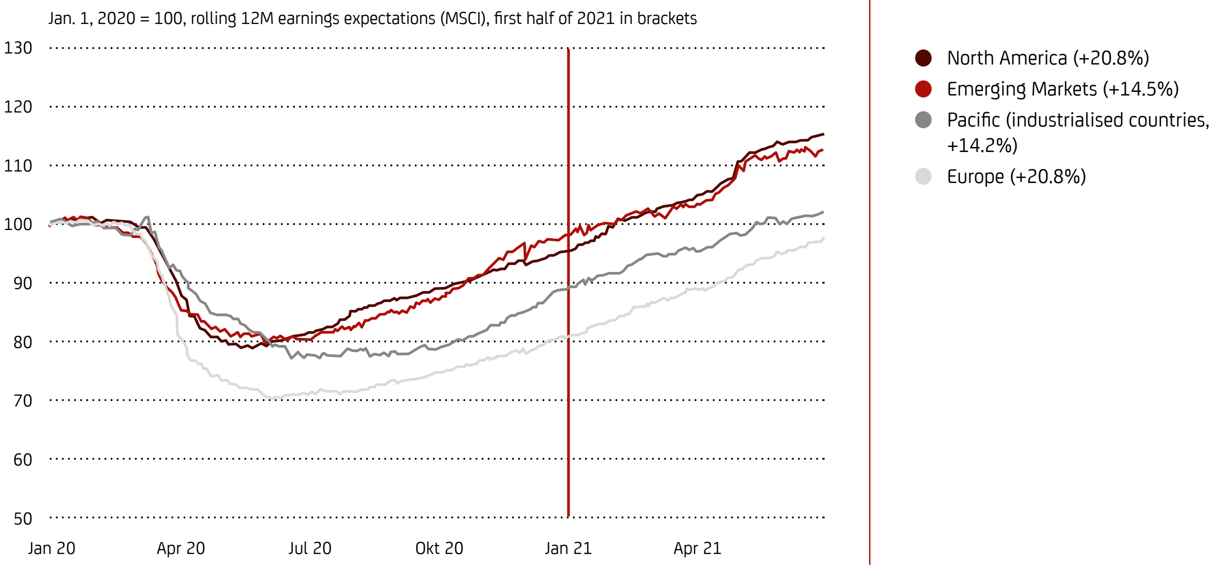
Source: Refinitiv Datastream, UniCredit Wealth Management. Status: 30.6.2021

The outlook: Broad economic recovery as support

Stock markets roughly follow the development of earnings expectations. This can be illustrated very clearly by the relative development during the Covid crisis. In Europe, earnings expectations in the first half of 2020 slumped much more sharply than in North America or the Emerging Markets, for example (see chart 11). In the Pacific region, on the other hand, the negative corrections at the height of the crisis were similarly pronounced to those in North America, but the recovery thereafter was much more subdued for a long time. In the current year, earnings expectations in Europe and North America, at 20.8% in each case, increased much more strongly than, for example, in the Emerging Markets (1st half: 14.6%) or the Pacific region (14.2%).

In capital market analysis, rolling 12-month earnings estimates are often used for this purpose. They are based on the average estimates of many stock analysts (consensus estimates).

11. EARNINGS EXPECTATIONS SHAPE STOCK MARKET PERFORMANCE



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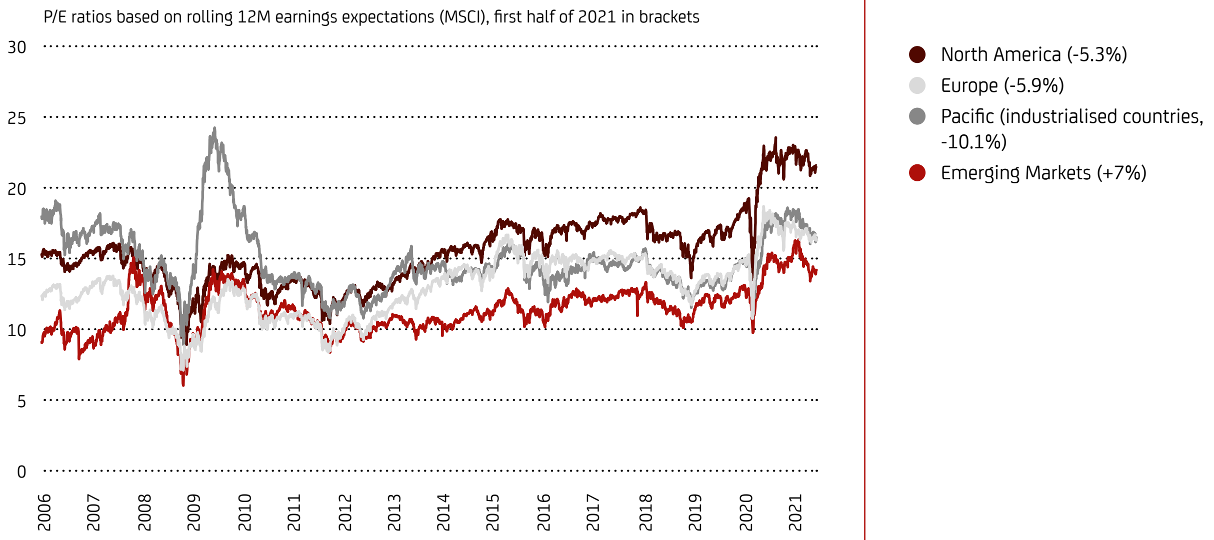
Source: Refinitiv Datastream, UniCredit Wealth Management. Status: 30.6.2021

Another correlation is interesting here. In 2020, share performance in all regions exceeded the recovery in earnings expectations. It follows that valuations, i.e. the price/earnings ratio (P/E), were higher at the end of last year than at the beginning of 2020. This trend reversed in the first half of 2021. Stock indices rose less than earnings expectations. As a result, valuations declined (see chart 12).

A simple calculation example illustrates the relationship. The price-earnings ratio is calculated by dividing the share price by the (expected) earnings of a share. The price/earnings ratio thus indicates the multiple of the (expected) annual profit that an investor pays for a share. If, for example, the share price increases by 15% but the expected profit by 20%, the P/E ratio decreases by a factor of (1+0.15)/(1+0.20) = 0.958. Conversely, a constant P/E ratio means that the share price moves in line with the (expected) profit.

At the turn of the year, the P/E ratio of the MSCI Europe was 17.1, compared with 14.7 a year earlier. The corresponding figures for the North American index were 22.6 and 18.3, respectively.

12. THE PRICE/EARNINGS RATIO (P/E RATIO) HAS RECENTLY FALLEN AGAIN



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Source: Refinitiv Datastream, UniCredit Wealth Management. Status: 30.6.2021

But this means that in the early phase of the post-Covid recovery, markets rose more than earnings expectations, whereas currently this trend is reversing. In other words, markets have already priced in part of the recovery. Such a development is not unusual, especially given the V-shape of the recovery.

Our positioning

Against the backdrop of the global economic recovery – supported by monetary and fiscal stimulus in conjunction with the increasing success of vaccinations – the stock markets remain well supported overall in the current year. However, most of the post-Covid rally is likely already behind us. In addition, worries about virus variants that could delay the economic recovery are likely to keep weighing on market sentiment. A volatile sideways movement in the coming summer months is therefore a perfectly conceivable development path for equities. Overall, however, the opportunities clearly outweigh the risk potential – in part thanks to the low interest rate environment. On the one hand, this allows companies to finance themselves very favourably, while on the other hand, low and even negative yields make equities more or less without any alternatives. We are therefore maintaining an above-average position in equities, i.e. we are betting on robust equity market development. In this environment, cyclical stocks such as the chemicals and industrial sectors are likely to increasingly come into focus of investors.

Regionally, we prefer Europe to the US. Europe is epidemiologically well positioned, has industries that are likely to be in demand during the recovery phase of the global economy, and has more favourable valuations on average. Emerging Markets also remain interesting.

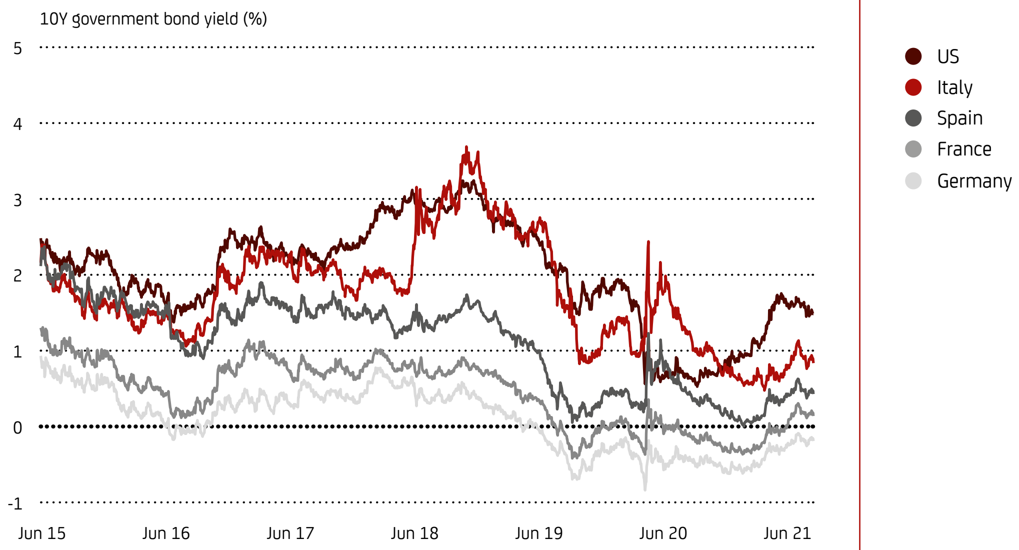
Bond markets: Weak

The review: Yield volatility keeps investors on their toes

Yields on longer-dated government bonds rose significantly, especially in the first quarter. US Treasuries were particularly affected. The corresponding 10-year yield climbed to 1.75% in the meantime – a sharp increase compared with a yield level of below 1% at the end of last year. In the second quarter, longer-dated yields in the USD area then fell again significantly. In the euro area, by contrast, they rose less sharply on average. Moreover, the development over the two quarters was relatively more uniform.

In addition to rising inflation expectations, a key driver in the bond markets was the assessment of future central bank policy. In the US, the forecast published by the Fed's central bank governors, who now expect the first interest rate hikes as early as 2023, caused quite a stir. This has left its mark on the shorter and medium maturity segments of the USD curve. The corresponding yields have risen significantly and have not retreated even in the phase of declining long-term interest rates.

13. YIELDS ON SELECTED 10-YEAR GOVERNMENT BONDS

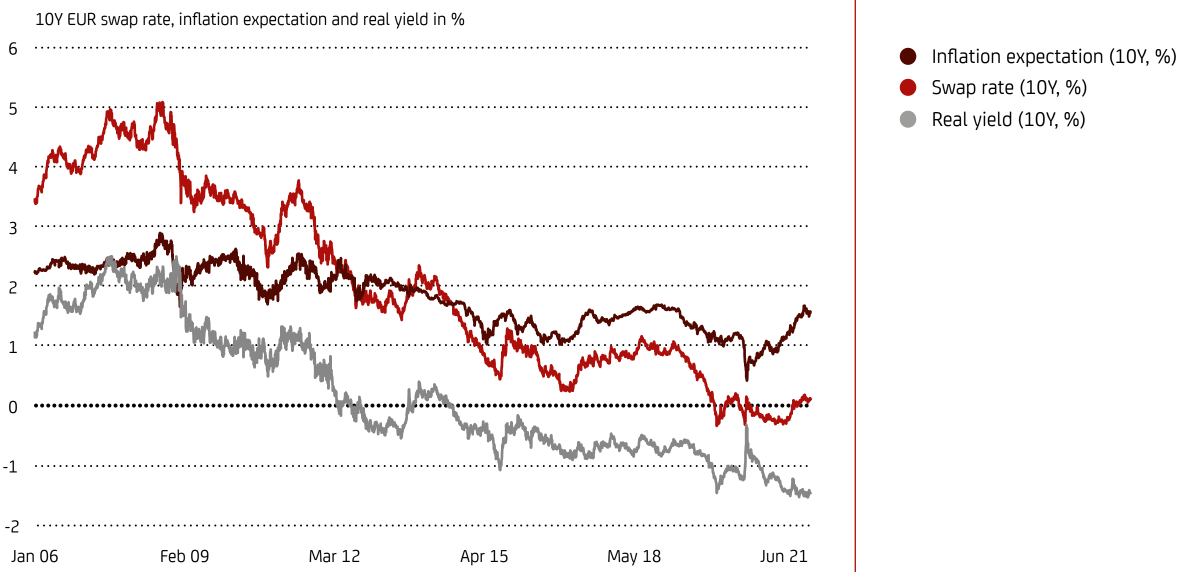


Please note: Past values and forecasts are not a reliable indicator of future performance. The synthetic bonds cannot be purchased and therefore do not include any costs. When investing in securities, costs are incurred which reduce the performance. In order to reflect the development of government bonds in a fixed maturity range, so-called synthetic bonds are calculated. In each case, the most "suitable" real (real) government bond at the relevant time is used as a reference for the yield opportunity of the synthetic bond. The following table shows the development of the expected yield to final maturity under the following conditions: Interest payments are serviced and redeemed in accordance with the terms and conditions, and the bond is held to maturity. In this respect, it is a yield opportunity.
Source: Refinitiv Datastream, UniCredit Wealth Management. Status: 30.6.2021

Bond market developments can be illustrated very nicely using the real yield, i.e. the inflation-adjusted long-term interest rate. For this purpose, we have used the 10-year EUR swap rate in chart 14 and compared it with the implied inflation expectation (for the period of the next 10 years). The latter can be derived from the so-called inflation swaps. In this way, we ensure that both the interest rate and the inflation measure refer to the same period, thus avoiding any time inconsistencies. The difference between the two measures is calculated as the 10-year real return, i.e. the inflation-adjusted return that would be earned by an investor investing at the current 10-year swap rate – assuming that inflation develops over the next 10 years in exactly the same way as expected in the inflation swaps.

This real yield is deep in negative territory for both the euro area and the US (not shown here) (see chart 14). This means that investors would have to settle for a significantly negative inflation-adjusted return if they invested in safe fixed income securities at current conditions, held them to maturity and inflation settled at an average of 1.6%. However, this means that the inflation swaps are pricing in a rather moderate interest rate path, in which inflation should settle at well below 2% in one to two years' time after the current phase of elevated inflation.

14. REAL YIELD IN THE EURO AREA



Please note: Past values and forecasts are not a reliable indicator of future performance. The synthetic bonds cannot be purchased and therefore do not include any costs. When investing in securities, costs are incurred which reduce the performance. For synthetic bonds, see the footnote of the previous chart. Source: Refinitiv Datastream, UniCredit Wealth Management. Status: 30.6.2021

The outlook: Debate on scaling back bond purchases to dominate fall

The ECB will continue its extremely expansionary monetary policy in the coming months, keeping yields at a low level – and for many "safe havens", even in negative territory. As early as the fall, however, both the Fed and the ECB will have to debate and decide on the future of their bond buying programmes. The ECB's Pandemic Emergency Purchase Programme (PEPP) is currently scheduled for March 2022. However, it is not only the absolute purchase volume that will be decisive for the ECB. In addition to the PEPP, the current purchase programme (the Asset Purchase Programme or APP), which has been in place since 2015, will continue to run. While the ECB is currently buying bonds for around EUR80 billion per month under the PEPP, the figure for the APP is around EUR20 billion.

In addition to the higher purchase volume under the PEPP – which could also be passed on to the APP, at least in part – the two programmes also differ in terms of their flexibility. While the ECB is more or less free to decide how many government bonds it wants to buy from the respective member states in the PEPP, the proportions are fixed in the APP. This flexibility has prevented interest rate conditions in individual member countries from drifting apart in times of the pandemic. In the early months of Covid, for example, the interest rate differential between Italy and Spain on the one hand and Germany on the other rose sharply, as the two peripheral countries were hit much harder by the pandemic, and the economic consequences for them were therefore also much more dramatic.

Our positioning

Interest rates and yields (both nominal and real) that remain clearly negative are no reason to move away from our underweight position in top-rated European government bonds. In this environment, securities from the peripheral countries Italy and Spain are more interesting than, for example, Bunds. However, these securities are unlikely to make a significant positive contribution to performance at present. We also see no reason to position ourselves more aggressively in US Treasuries, as there is a risk of price losses if yields continue to rise.

European corporate bonds with good credit ratings offer yield advantages over government bonds (but also entail higher risks). In addition, demand from the ECB remains strong, as the central bank will continue to purchase corporate bonds under the APP. Exposures to European corporate bonds with good credit ratings ("investment grade") remain interesting. We expect at least a stable development in risk premiums ("spreads") and would prefer shorter maturities (one to five years). We also see yield potential in high quality US corporate bonds. We remain generally cautious in the high yield segment.

In the search for yield, buying opportunities are also opening up for Emerging Markets bonds. However, higher long-term US yields and a temporarily stronger USD have made us more defensive and selective here.

Currencies and commodities: EUR-USD and gold with slight upside potential

The review: US dollar weakening significantly

While the US dollar was in high demand among investors as a global "safe haven" in the early phase of the crisis and was able to make significant gains, the currency markets then switched to the other direction. The greenback lost considerable ground, with the result that the EUR-USD gained until 2021 and at times reached the 1.22 mark. Since then, the exchange rate has fluctuated in a bank range between 1.18 and 1.22 – without a new trend being established. At the end of the first half of the year, the EUR-USD was trading at the lower end of this trading range, but it certainly has the potential to reach the upper limit again by the end of the year. Against the backdrop of a presumably broadly similar economic cycle in the US and Europe (the US lead in the spring is likely to reverse with the summer) and similarly pronounced negative real yields in both currency areas, there is little to suggest a pronounced currency trend over the shorter time horizon.

After last year's highs, the gold price developed in a volatile sideways movement in the first half of 2021. The USD real yield was the driving force here. With rising (i.e. less negative) real yields, the gold price fell at times to levels below USD1,700 per troy ounce, but then managed to firm up again and closed the second quarter at USD1,770. At times, the gold price even climbed back into the USD1,900 range.

Outlook and Positioning: Increasing Risk Appetite Supports EUR-USD, Gold Remains Supported by Low Real Yields

The risk appetite of globally active investors will remain a determining factor for currency markets in the second half of 2021. In the meantime, rising regional or local Covid cases (new virus variants) could make stricter lockdown measures necessary and thus temporarily become important drivers for exchange rates. In general, however, the increasing global economic recovery should tend to reduce the need for safe havens such as the USD. This will help the euro, as will structural advantages (better fiscal and current account balances). Against this backdrop, a slight underweight of the greenback seems appropriate. We would advise currency hedging US fixed income exposures – even if it costs performance.

In our view, the gold price remains well supported. With the expected economic recovery, goods price inflation should also pick up, but ultimately only moderately. However, as monetary policy remains expansionary, the gap between nominal interest rates and the inflation rate is likely to widen, and real yields could consequently slip further into negative territory. Meanwhile, declining opportunity costs of holding gold are supporting the price of the precious metal. Moreover, gold can continue to develop its hedging character against market setbacks in the future. Even if real yields do not slide further into negative territory, the gold price is very well supported by the current level. We therefore recommend a gold position as a portfolio component.

Asset Allocation

ASSET		INVESTMENT UNIVERSE	▲*	INVESTMENT VIEW: NEGATIVE	INVESTMENT VIEW: NEUTRAL	INVESTMENT VIEW: POSITIVE
MAIN ASSET CLASSES		Global Equities		○	○	●
MAIN ASSET CLASSES		Global Bonds	▼	●	○	○
MAIN ASSET CLASSES		Money Markets	▲	○	●	○
MAIN ASSET CLASSES		Alternatives		○	●	○
MAIN ASSET CLASSES IN DETAIL	EQUITIES	US		○	●	○
MAIN ASSET CLASSES IN DETAIL	EQUITIES	Europe		○	○	●
MAIN ASSET CLASSES IN DETAIL	EQUITIES	Pacific (DM[1])		○	●	○
MAIN ASSET CLASSES IN DETAIL	EQUITIES	EM[2]		○	○	●
MAIN ASSET CLASSES IN DETAIL	BONDS	EMU Governments		●	○	○
MAIN ASSET CLASSES IN DETAIL	BONDS	Non-EMU Government Bonds		○	●	○
MAIN ASSET CLASSES IN DETAIL	BONDS	EUR IG Corporate Bonds		○	○	●
MAIN ASSET CLASSES IN DETAIL	BONDS	HY Corporate Bonds[3]		●	○	○
MAIN ASSET CLASSES IN DETAIL	BONDS	EM Bonds		○	○	●
MAIN ASSET CLASSES IN DETAIL	COMMODITIES	Oil		○	●	○
MAIN ASSET CLASSES IN DETAIL	COMMODITIES	Gold		○	○	●

* Change versus 23 March 2021
[1]DM = Developed Markets (Australia, Japan, Hong Kong, New Zealand, Singapore)
[2]EM = Emerging Markets
[3]European HY CB

Equities

Overweight Global equities
The combination of massive fiscal and monetary action and a strengthening global recovery supports equities, despite still lingering uncertainty due to the pandemic (inlcuding virus mutations).

Overweight European equities
Monetary and fiscal policies are highly expansive. Macro momentum is building–up, as also suggested by PMIs and the IFO. Higher weightings of value and cyclical sectors versus the US equity market coupled with a more favourable valuation and attractive dividend yields, which are well above government and corporate bond yields.

Neutral US equities
A booming US economy due to Biden's very expansionary fiscal policy and the rapid and successful vaccination campaign, 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 rates are higher. Countries and sectors selectivity among Emerging Markets is strongly recommended. Low vaccination rates are a source of concern.

Neutral Pacific equities
Japanese equities are supported by the global recovery and the high weighting of value/cyclical sectors, but the pandemic situation remains a source of concern due to the low vaccination rate.

Bonds

Underweight (from neutral) Global bonds
Vulnerable to increasing inflation and the expectation of rising government bond yields.

Overweight (reduced) on 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.

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 (stronger) on EMU government bonds
We accentuate the underweight core Euro governments bonds, given their high benchmark duration (7.9). We prefer peripheral government bonds, such as Italian and Spanish 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 a temporary increase of inflation.

Neutral on non-EMU government bonds
Despite still accommodative monetray policies, we expect the yields of US Treasuries to increase by year end.

Overweight Emerging Market bonds
The search for yield supports our positive stance, but we are now more defensive and selective given the expectations of rising yields of US Treasuries and the temporary stronger USD.

Neutral (from underweight) Money Markets
To be used mostly as liquidity parking and hedging for uncertainty.

Neutral Alternatives
They offer portfolios de-correlation opportunities.

Commodities: Positive Gold
The price of gold is sustained by central banks' accommodative monetary policies and low interest rates.

Currencies: EUR/USD
The dollar has recently strengthened due to the more hawkish FOMC Dot Plot and its role as a safe heaven. In the longer term, the dollar is expected to remain weak due to the so-called twin deficits, trade and fiscal, of the US.

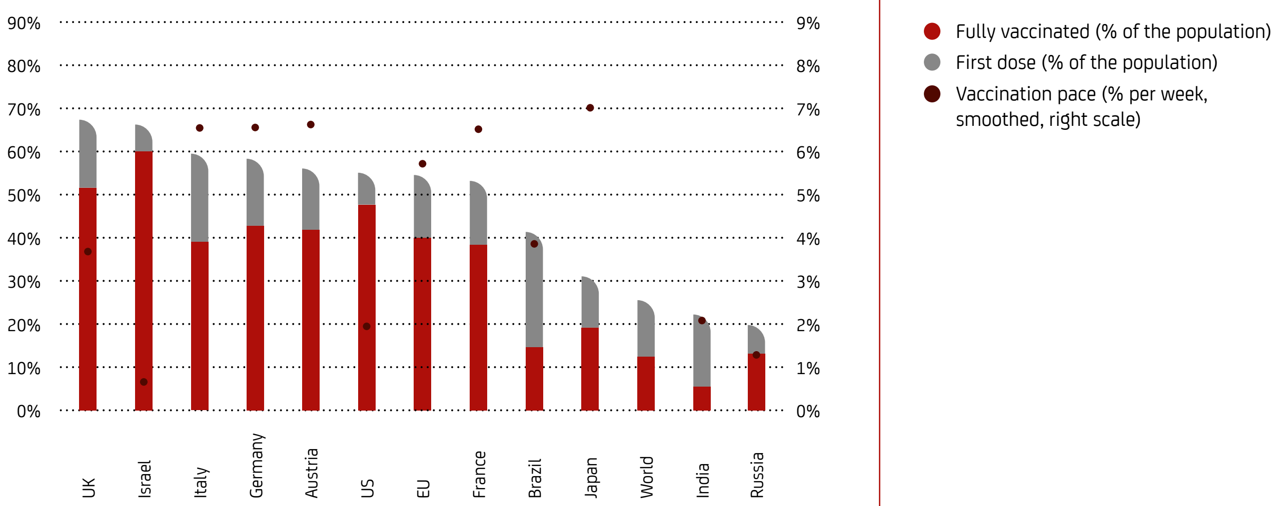
Main Risk Scenarios

We currently see two main risks to our baseline scanario:

1. **A deflationary risk linked to a worsening of the pandemic due to the spreading of new variants.**

From chart 15 relating to vaccination rates on a global scale, it is clear that the countries most at risk from the spreading of the Delta variant are the Emerging Markets and Japan (where the government has declared a state of emergency in Tokyo and the Olympics will ban spectators), while in Europe the tourist seasons of countries such as Spain and Portugal are now at risk (France has warned citizens from spending their vacations there), as is the reopening of schools.

15. COVID-VACCINATIONS BY COUNTRY



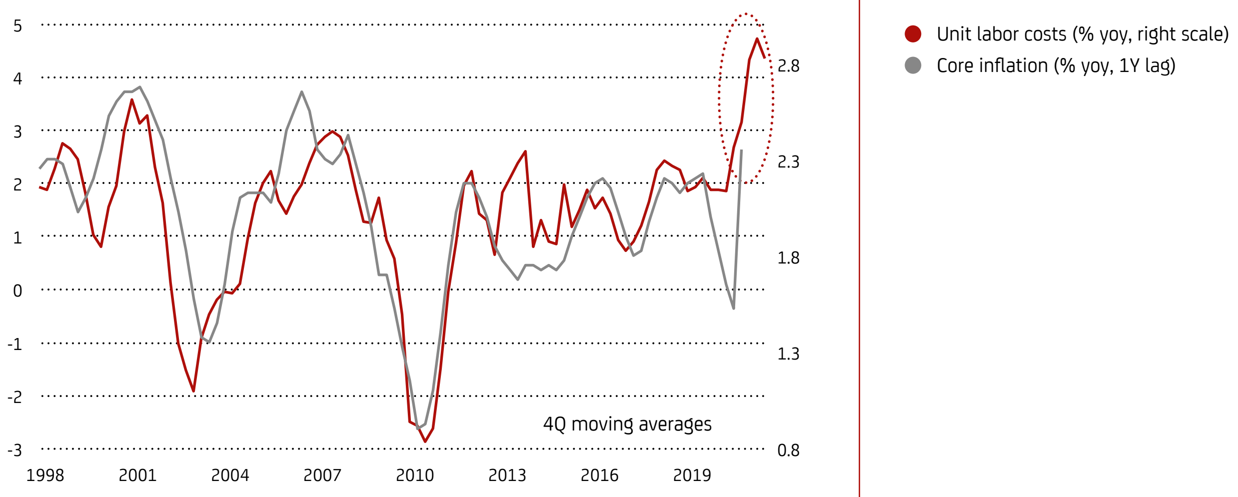
Source: www.ourwoldindata.org, UniCredit Wealth Management

2. **An inflationary risk due to a long lasting inflation over-shooting.**

While we expect an inflation overshooting in the coming months due to the reopening of the economies (especially of services) and the continuation of supply shortages, we judge its underlying dynamics (wages) to remain mostly under control, leading to a long-term inflation path close (Fed) or below (ECB) the main central banks' targets.

In more detail, the Fed believes that increases in inflation are transitory and that wage pressures, which drive long-term structural inflation, once unemployment benefits expire in September, will normalise and remain under control. Recall that currently many US companies are struggling to find available labour, considering that their wage offers are often equal to or less than government unemployment benefits.

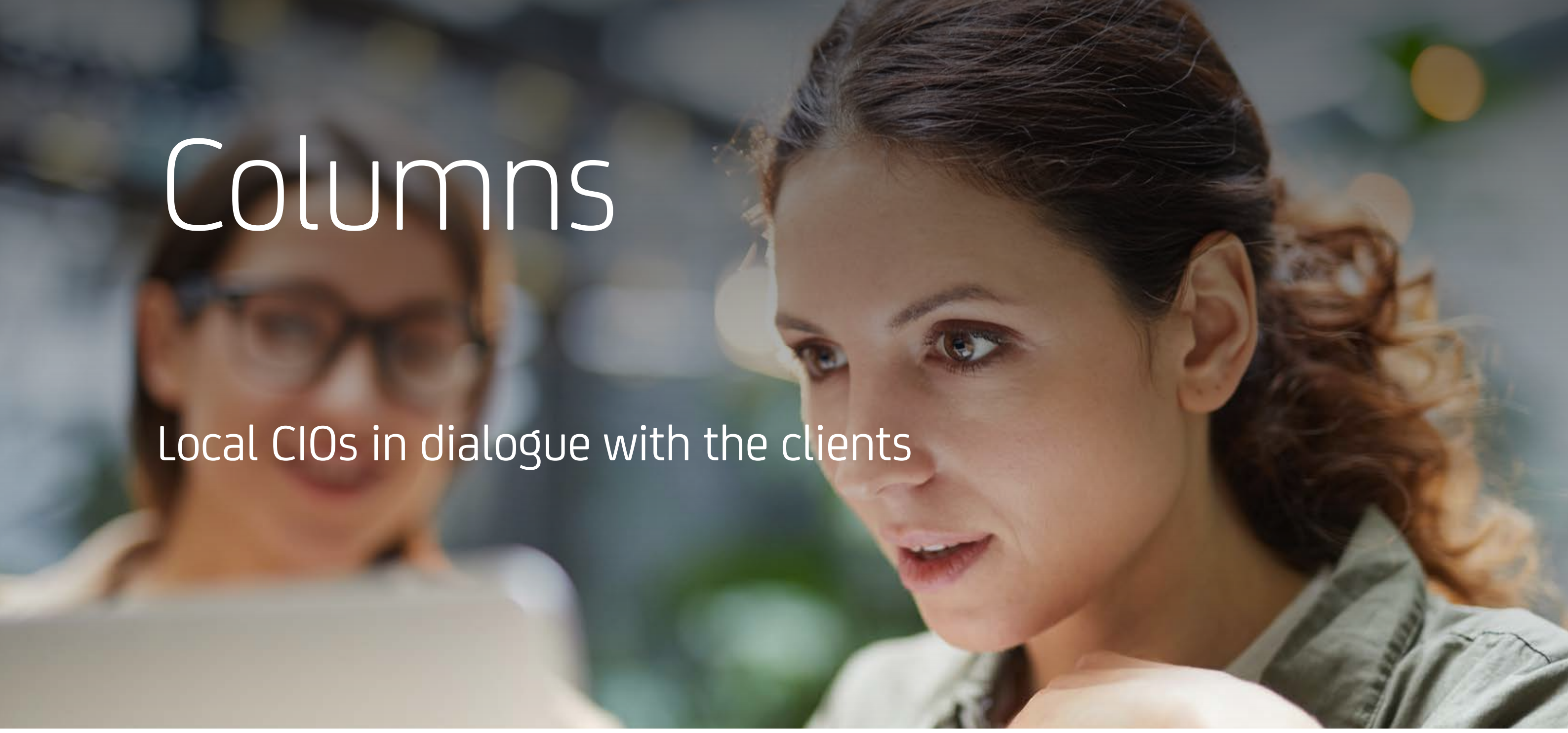
16. WAGE PRESSURES DRIVE LONG-TERM STRUCTURAL INFLATION



Source: Refinitiv Datastream, UniCredit Wealth Management

However, the overall 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.

For these reasons, a longer lasting 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.



Columns

Local CIOs in dialogue with the clients

Answers from Italy

What's the role of central banks in the "sustainable economy" transition?

The behaviours of consumers and producers play a fundamental role in the transition towards a more sustainable economy – one that is more respectful of the environment, of communities, and of the needs of future generations. Indeed, politicians, which have powerful tools such as tax relief or penalties, have the ability to encourage these behaviours.

And not surprisingly, central banks are also able to influence these behaviours. The role that monetary authorities play within our economies has constantly grown in recent years, due to the quantitative easing policies that followed various crises. For instance, in 2011, the ratio between the central bank balance sheet and GDP was at 15% for the Fed and 20% for the ECB: today, these figures stand at 40% and 70%, respectively.

On this specific topic I would like to highlight a recent press release from the ECB, dated July 8. There are various points that, when combined, define a roadmap for the 2021-2024 period.

The ECB will incorporate climate change consideration into its monetary policy framework. Climate change has an impact on the main economic indicators: production, employment, productivity. All of these are strictly connected with inflation, and since the ECB's actions are guided by a price stability target, these actions must consider environmental risks. The ECB's research departments will develop their own macroeconomic models, in order to assess how climate change interferes with monetary policy transmission.

Our experts:

Alessandro Caviglia

CIO
Cordusio Sim (Italy)

Moreover, the huge changes in the future energy production processes already affect the potential performance and risk of the assets held by the ECB (e.g. corporate bonds issued by utilities, mining and oil companies). So, as every professional fixed income portfolio manager does, the central bank needs to integrate ESG factors into its eligibility criteria. And the same concepts apply to collateral management, when the central bank provides liquidity to markets or institutions: the more "virtuous" the asset provided as a credit guarantee, the lower the discount applied by the ECB. The central bank, within its activity of financial system supervision, will also provide guidelines to financial institutions to have a common and comparable set of indicators for risk assessment, reporting and disclosure in the field of environmental sustainability.

We expect many other central banks to soon move in the same direction. With this wide set of initiatives in place in the coming years, we also think that there will be a positive spill-over effect on the asset management industry. Since central banks are probably the most relevant player in the market today, bond issuance activities will be strongly guided by these eligibility criteria. As of today, looking through an ESG lens, we believe the equity world is the best place in terms of available opportunity set: investors have a broad equity investment universe with both generic ESG and SRI solutions, as well as products that target specific industry and themes with a very high sustainability profile and impact.

Central banks' actions will undoubtedly enrich the sustainable fixed income investment universe too – especially in those segments with an intrinsic lower average ESG profile. For example, in the Emerging Market Debt and Global High Yield sectors, the current country and industry composition implies a relevant exposure to companies and governments with a medium-high sustainability risk. And as portfolio theory teaches us, the wider the opportunity set, the better the results for clients, investors… and the future of the planet!

Answers from Austria

Inflation scare does not trigger a negative outlook

Interest rates, which were already trending upwards last year, picked up speed in the first quarter of 2021, only to slow down again in the second quarter. Since the beginning of this year, overall, interest rates have risen by roughly 50 basis points (10-year US government bonds) and by around 30 basis points (10-year German government bonds). As a result, investors in nominal bonds have faced losses.

Oliver Prinz

Co-CIO Bank Austria and Schoellerbank (Austria)

The trend looks set to remain for the medium term, with the recent surge in inflation providing support. Nevertheless, the Federal Reserve in the US is not yet worried about the levels attained – and we also believe that further increases in rates at the long end are realistic. Behind these rate movements are higher inflationary expectations, especially in the short to medium term. Regardless of emerging concerns, the interest rate movements we are currently seeing are not yet a reason to worry. Rather, they are contributing to the normalization of the situation.

Hence, and this is important: Now is not the time to exit the stock market. Although we heard quite a few warnings last year, there are still several compelling reasons to pursue a quality strategy in equity investments. For instance, sector rotation currently suggests a preference for quality stocks. Our approach of picking companies with strong competitive advantages and pricing power proves beneficial, particularly in an environment of rising inflation. Stock market valuations are also attractive compared to other investment alternatives, and the sometimes very bullish sentiment has recently become increasingly cautious – which is a good sign, in our view. Although speculative bubbles seem to be emerging in smaller segments such as crypto-currencies or in the case of the often cited "meme stocks" combined with concerted actions in social media, we believe these are only sideshows with no or only a limited impact on the overall financial markets. On the other hand, the angst word "tapering" is frequently heard, and there are several warnings of the deteriorating liquidity of central banks, or even of rising interest rates – but this is not what a dangerous euphoria looks like.

Meme stocks are shares that attract the attention of investors organized on social networks. The viral activity of these retail traders can lead to strong changes in price in a very short time span

The Asian region lagged behind expectations this year. Nonetheless, in our opinion this region still has huge potential. For example, Asian countries returned to growth faster than Europe or the US. Another factor in this region is the lower volume of government debt and financial aid from central banks that need to be repaid – unlike in the Western world.

However, the journey in stock markets will certainly become rockier and tactical decisions will have to be taken with great care. A pure buy-and-hold strategy is losing appeal, and active asset allocation will remain the preferred course.

Answers from Germany

The ECB has recently adjusted both its monetary policy strategy and its forward guidance. What does this mean for investors?

Philip Gisdakis

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

As Professor Dr. Isabel Schnabel, member of the ECB's Executive Board, has recently noted in a speech, the European economy has changed fundamentally since the ECB was founded. The changes reflect three main macroeconomic trends: digitalisation, globalisation and demographic change. Amplified by the two most severe crises since World War II – the financial crisis and the Corona pandemic – the challenge for monetary policy has changed from fighting too high inflation to preventing too low inflation or even deflation. The ECB's monetary policy strategy in place to date has not adequately reflected this challenge. Added to this was the problem that many central banks had reached the lower end of the possible spectrum with their traditional tools, such as setting the monetary policy interest rate.

As Professor Schnabel explains, structural factors such as an aging society and declining productivity growth have led to an increase in savings and a decrease in demand for investment. This has caused the so-called real equilibrium interest rate (an abstract and not directly measurable economic variable) to fall further and further, and for Europe, into negative territory. This development of the declining real equilibrium interest rate did not only occur in Europe but is a global phenomenon. At the same time, inflation has continued to fall. This development poses major challenges for the central banks of the industrialised countries. They have had to develop new methods to meet these challenges. In particular, the public focus has been on the new definition of price stability, which we will discuss in more detail below. In addition, the ECB has also commented on its sustainability orientation. You can find more details on this in Alessandro Caviglia's Q&A article.

First of all, the ECB has stated that it will integrate the development of real estate prices with regard to owner-occupied housing into the inflation measurement and is thus responding to corresponding criticism, among others, from countries with strong increases in real estate prices. According to estimates by UniCredit economists, this could increase the annual inflation rate by 0.1-0.2 percentage points.

In addition, the ECB has clarified its inflation target, as the old formulation "below but close to 2%" offered the risk of being interpreted as an upper limit rather than a target, i.e. in the sense of an asymmetric target. The new formulation of a symmetric 2% target, in which both overshooting and undershooting over a medium-term time horizon are not desired, offers much more clarity here.

To make the operationalisation of this inflation target in ECB monetary policy decisions even more tangible, ECB President Christine Lagarde went into detail about the central bank's new "forward guidance" in her recent press conference. According to this, monetary policy interest rates will not rise until the ECB sees inflation reaching 2% well ahead of the end of its projection horizon (the current projection horizon lasts until 2023 and will be extended by another year towards the end of the year), and remains there for the rest of the projection horizon, and it believes that realised inflation from the time of the interest rate hike will also reach the 2%. This may also imply a transitory period in which inflation is moderately above target.

This complicated formulation is intended to take account, for example, of the case where the ECB's projected inflation to reach the 2% mark is only temporary. In this way, it wants to avoid raising interest rates prematurely. It is important to note that the ECB does not manage realised (i.e. measured) inflation, but rather the inflation expectations over the medium term. In the press conference, Christine Lagarde explained that the phrase "well before the end of its projection horizon" means that the 2% target will be reached around the middle of the respective projection period and will then remain there for the rest of the projection period. However, the ECB's latest statements do not provide any information on the intensity of the monetary stimulus that the ECB believes is necessary to bring inflation to target. Further insights will presumably be provided at the next meeting in September, which may deal with the future of the asset purchase programmes.

Ms. Lagarde also reiterated that the new "forward guidance" is not about keeping interest rates low for longer, but about reaching the 2% inflation target as quickly as possible.

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