UniCredit Wealth Management

Monthly Outlook

September 2021

After the summer lull

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CIOs Letter

After the summer lull

The summer break of the second Covid year was relatively uneventful, if one disregards the surprising and dramatic developments in Afghanistan. The latter has implications on a geostrategic level – not least for the Western world – but no immediate consequences for the global economy and international capital markets. Our hope remains that the war-torn country will find a peaceful path to the future and that key human rights will be respected – including, of course, the rights of girls and women as well as those of minorities. For the country itself and its people, economic development will be crucial. Afghanistan is one of the poorest countries in the world and its economy is heavily dependent on aid payments. It is uncertain whether and to what extent these will flow in the future. An inclusive society order is a key factor here, both in terms of economic aid and from the perspective of the domestic economy. The exclusion of large parts of the population from social life would be a disaster, not only from a human rights perspective, but also from an economic point of view.

Two developments were much more market-relevant during the summer break: the sharp rise in Covid infection rates in Asia, the US and some European countries, and the fact that economic data mostly fell short of expectations – in particular, the recently quite weak US labour market report. As a result, the majority of observers no longer believe that the Federal Reserve's (Fed) tapering is imminent. Rather, the Fed will likely want to wait and see the implications of the Delta wave on labour markets. As the October report will be published only at the beginning of November, tapering could likely start in December. In fact, this timeline was already considered as the most probable scenario by many market observers before the summer break.

However, rising infection rates, together with supply chain problems and China's weak growth, not only had an impact on the Fed's tapering expectations, but also dampened growth forecasts. Consensus estimates for US economic growth for the current and the next two quarters fell by a half percentage point each (annualised). Meanwhile, forecasts for the remainder of 2022 were raised only slightly.

Rising infection rates are therefore increasingly causing headaches. This is particularly true in countries and states with comparatively low vaccination rates. In Europe, Germany is one of the countries with rather inadequate vaccination protection. Countries that were hit with the full force of the pandemic and have

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seen a lot of suffering, but also stricter lockdown measures, have so far shown a higher vaccination readiness and will likely be less burdened this autumn. These include Italy, Spain and Portugal.

However, the already existing vaccination protection of the population, especially among vulnerable groups, will ensure that the Delta wave will have less dramatic consequences than the wave of infections last autumn. The higher vaccination rates in Europe compared to the US, combined with the cheaper valuation of European equity markets and the presumably longer-lasting monetary policy support from the European Central Bank (ECB), are likely provide European equities with an advantage over their US counterparts. This underlines our long-standing relative preference for European stocks.

All in all, the picture is somewhat less euphoric than at the beginning of the summer. But back then, the high expectations seemed somewhat exaggerated to us. Nevertheless, the overall positive global equity environment remains intact for the time being. At the same time, the sector mix should become less cyclical. Companies with solid business models and robust balance sheets will continue to perform well. Temporary setbacks, which are to be expected, can probably be used for selective buying. A positive development in vaccination rates – especially in countries with large unvaccinated populations – may provide additional support for markets.

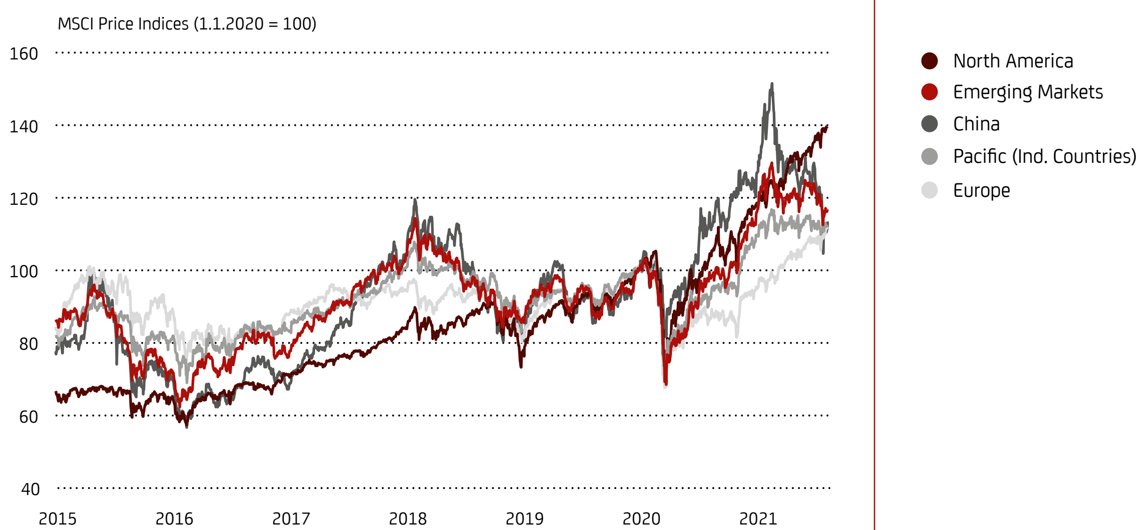
In Focus

China’s stock market: from Covid winner to global loser

Last year, Chinese equities were the Covid winners par excellence. The MSCI China Index gained a strong 27% and was well ahead of its North American counterpart (18%). This year, on the other hand, the Chinese stock market is clearly lagging behind, although Chinese equities had made a brilliant start to the year. By mid-February they had risen by almost 20%, before collapsing and falling back to pre-Covid levels (see chart 1). What is this rollercoaster ride all about?

> So far this year, the Chinese stock market has lost 11% and is thus far behind North America and Europe, which have both gained 18%.

1. GLOBAL STOCK INDICES IN COMPARISON



Source: Bloomberg, UniCredit Wealth Management.
Please note: Past performance and forecasts are not reliable indicators of future performance. Indices may not be purchased and therefore do not include costs. When investing in securities, costs are incurred which reduce the performance. Status: 3.9.2021.

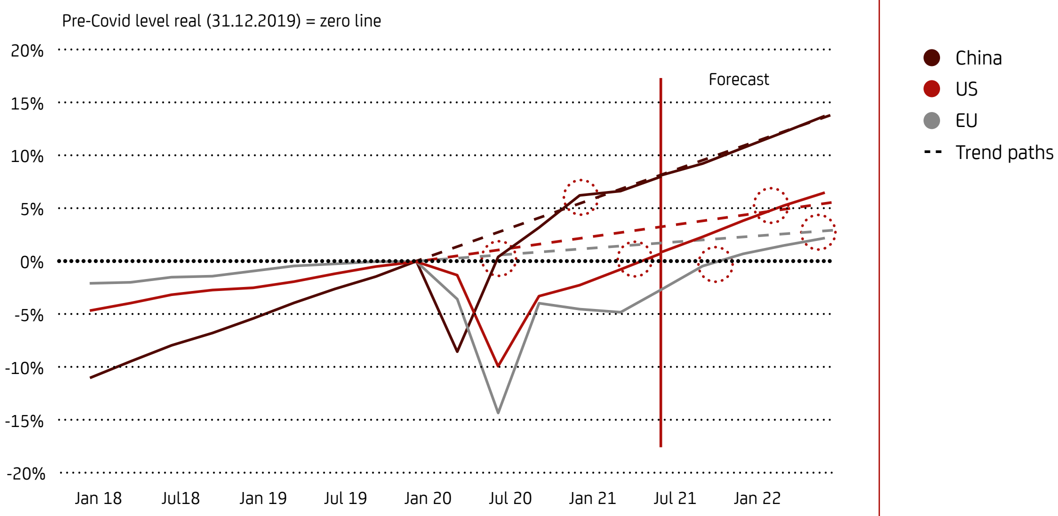
For a long time, China and the Chinese stock markets were seen as the winners of the pandemic. With rapid and drastic lockdown measures, the government managed to quickly bring the epidemic under control. While public life in Europe and the US came to a standstill repeatedly last year, pictures of celebrating summer holidaymakers could already be seen again in China last summer. Although the Chinese economy also felt the effects of the economic slump in the Western world, as well as global supply chain problems, domestic consumption recovered quickly – and noticeably.

China's economic success can be illustrated by chart 2. It shows the development of real Gross Domestic Product (GDP) for China, the US and the euro area. For visual support, we have extrapolated the respective pre-Covid trend paths and added forecast values (based on Bloomberg consensus estimates).

China plunged into the Covid recession as early as the first quarter of 2020, some months earlier than in Europe and the US. But by the second quarter, the Chinese economy had already recovered to pre-crisis levels. And shortly afterwards, economic output had returned to its pre-Covid trend path. Just how impressive this development is can be seen in particular in a comparison with the EMU. Here, pre-crisis GDP is not expected to be reached until the current quarter. The euro area will likely not be able to catch up with its (flatter) trend path until mid-2022. China's economy, on the other hand, is likely to continue growing at the pre-crisis rate beyond short-term fluctuations.

The US managed to do both a bit earlier (at the beginning of the year and end of 2021, respectively) than Europe. But even they are lagging behind China.

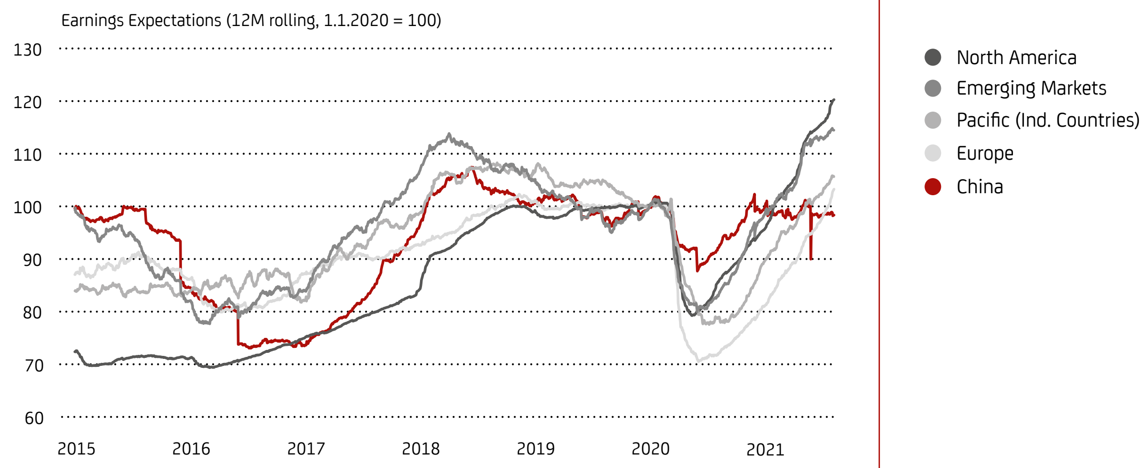
2. GLOBAL GDP DEVELOPMENTS IN COMPARISON



Source: Bloomberg, UniCredit Wealth Management

However, this impressive development does not translate to the Chinese equity market, either in terms of price or earnings performance. Chart 3 shows the expected earnings performance (based on rolling 12M consensus estimates) of Chinese equities with the corresponding performance of the other major regional indices (North America, Europe, Pacific and Emerging Markets). The relatively muted plunge and quick recovery was soon followed by sideways movement this year. In contrast to this, earnings expectations in other regions continued to rise noticeably.

3. GLOBAL EARNINGS EXPECTATIONS IN COMPARISON



Source: Bloomberg, UniCredit Wealth Management.
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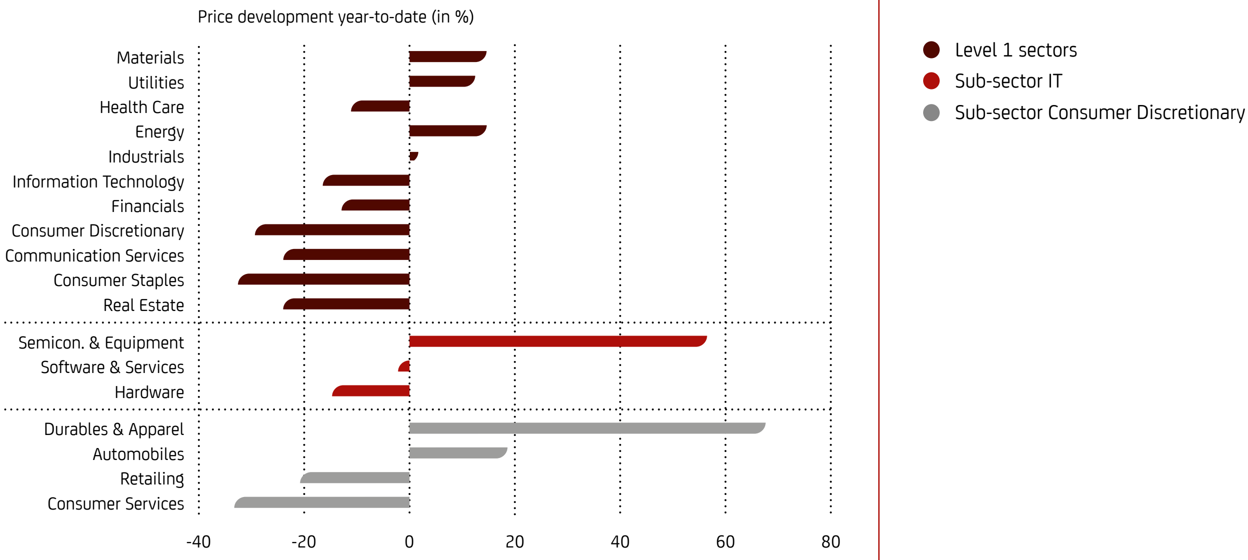
However, a detailed analysis of the Chinese stock market's performance quickly shows that the price performance was ultimately driven by only a few sectors. Chart 4 shows the performance of the main branches of the Chinese MSCI index. It is striking that there are sectors that have experienced very strong performance this year and those that have been very weak. The middle of the performance table is thinly populated.

A closer look at the sub-sectors accentuates the picture. We have illustrated this in the lower part of the chart by showing the composition of the information technology and consumer discretionary sectors. The semiconductor & equipment sub-sector was one of the star performers. Its software and hardware counterpart, on the other hand, lost ground. The differences were even more pronounced between durables & apparel and autos, which performed strongly, and retail and consumer services, which suffered heavy losses.

This is primarily due to the global demand pull and the supply bottlenecks for semiconductors and related equipment.

4. SECTOR DEVELOPMENTS OF THE MSCI CHINA INDEX



Source: Bloomberg, UniCredit Wealth Management.
Please note: Past performance and forecasts are not reliable indicators of future performance. Indices may not be purchased and therefore do not include costs. When investing in securities, costs are incurred which reduce the performance. Status: 3.9.2021

The main reason for the significant differences in performance was the Chinese government's regulatory initiatives. They focused on specific industries such as financial services, real estate and the private education sector. The latter is part of the consumer services sector, which suffered a 40% slump. This also explained the negative performance in hardware and software.

Sector developments are thus a consequence of the political agenda. Growing income disparities coupled with high costs for housing, health care and tutoring are burdening broad sections of the population. In addition, the rapidly growing technology sector has so far been little regulated, resulting in the emergence of anti-competitive monopolies and oligopolies. The aim of the regulatory measures is to reduce the growing inequality and to ease the burden on families – as well as to alleviate the demographic problems (low birth rate). However, other political factors also play a role. For example, the Chinese government is not only trying to exert greater control over educational and media content, but also to tap more data from consumers and the financial sector. In addition, the influence of foreign investors on important industries and companies is to be pushed back. Moreover, the number of infections (Delta) is rising and the domestic economy has recently weakened substantially (see the Macro & Markets section).

> In the eyes of Chinese parents, tutoring is essential to make their children competitive for the challenges of the future.

All these developments do not mean that one has to withdraw from Chinese investments. However, investors should be selective and monitor developments closely. A robust economic development in China over the medium to longer term, which is based on inclusive growth and should enable economic participation for broader sections of the population, should be advantageous, also for European companies as well. The Chinese markets remain interesting and European companies that are competitively positioned here will likely benefit from this.

Macro & Markets

A tempered summer

The Delta wave, supply bottlenecks, China's growth pause and the tapering outlook – these are the topics that are currently affecting economies and financial markets the most, and have repeatedly spoiled the mood of investors, companies and consumers. But even hard economic data such as production and retail sales numbers have disappointed of late. Therefore, it is quite possible that economic growth over the summer months will fall short of high expectations. However, the global catch-up process will not stall or even break down. In fact, the global economy is not only expected to grow more strongly this quarter than in the spring, but at almost 6%, it is also likely to grow almost twice as fast as its potential. Even more, the second half of the year will likely be the strongest since the beginning of the Covid crisis – at least for Developed Market economies – as the current strains should prove to be relatively short-lived.

> This implies that the current growth setbacks (compared to expectations) can largely be made up for this autumn and winter.

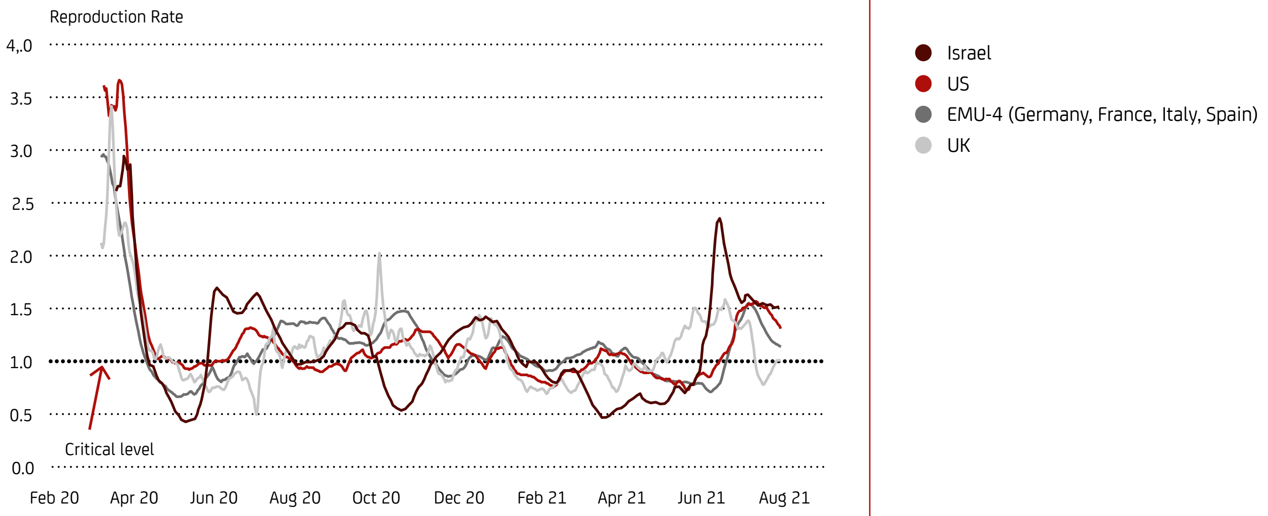
Delta on the way, but no new lockdowns

The highly infectious Delta variant caused a sharp rise in the number of Covid infections this summer. This applies primarily to countries with low vaccination rates, especially in Asia. However, even former vaccination champions such as Israel, the US and the UK are now faced with high incidence rates of 500 and more per million people. Still lacking herd immunity, growing carelessness ("freedom day") and, to some extent, ideological ignorance, are likely to play a main role here.

Continental Europe, on the other hand, is holding up much better in terms of infection rates. And on top of that, there are initial indications that the Delta wave is also approaching its peak elsewhere in the world and should then subside step by step. The reproduction rate, i.e. the number of people infected by an infected person, is already declining again in high-incidence countries as well and is approaching the critical level of 1 (see chart 5).

> However, the development is quite different at national levels. Infection rates in Spain and France rose rapidly and strongly in early summer, but are now clearly declining again. In Italy, a plateau has already formed at a relatively low level. However, this development is only just beginning to emerge in Germany.

5. DELTA WAVE COULD REACH ITS PEAK SOON

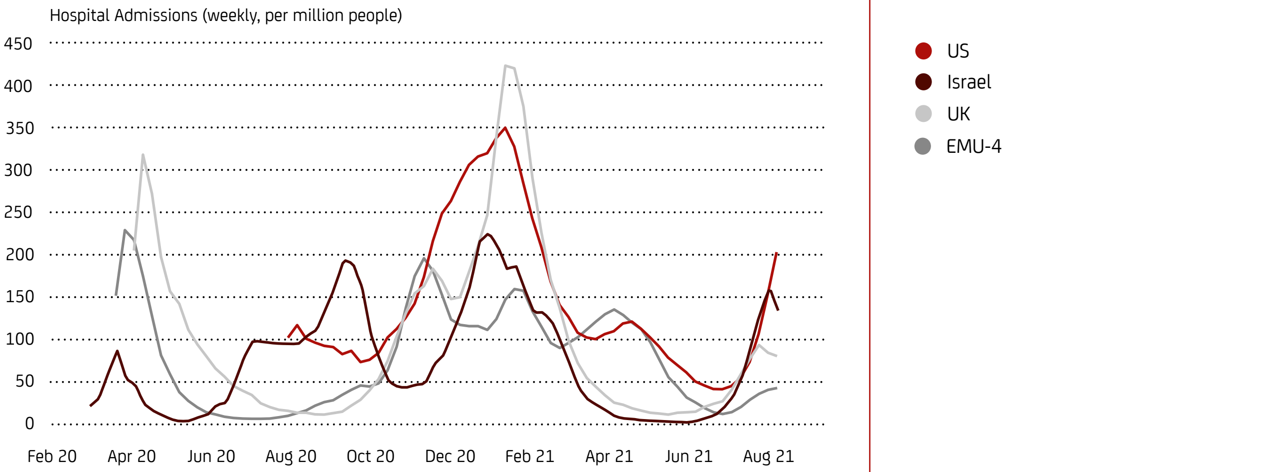


Source: www. ourworldindata.org, UniCredit Wealth Management

> However, we are concerned about the development in the US. Not only has the number of hospital admissions risen rapidly in the US, but the number of intensive care patients has as well. The latter is only slightly below the previous high at the beginning of the year.

In addition, thanks to the progress made in vaccination and improved treatment methods, health systems are significantly less fragile than at the beginning of the pandemic. Although the number of hospital admissions, intensive care patients and deaths have also increased during the Delta wave, they remains well below previous highs, especially in Europe (see chart 6).

6. NO IMMINENT THREAT TO HEALTHCARE SYSTEMS

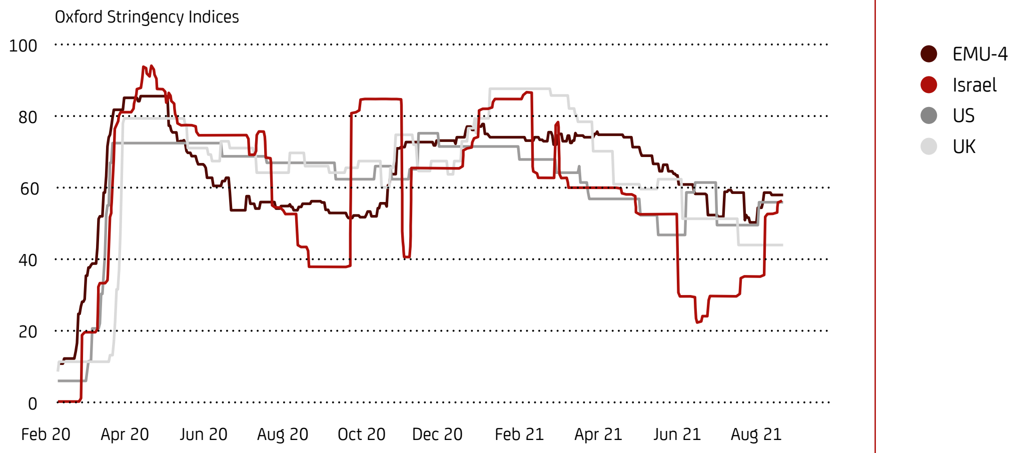


Source: Refinitiv Datastream, IMF, UniCredit Wealth Management

This makes renewed lockdowns in the service sector, which were so common in the second and third waves, unnecessary – not to mention the comprehensive company shutdowns at the beginning of the pandemic. What's more, thanks to the progress made in vaccinations, the restrictions were even eased compared to the spring. The renowned Oxford stringency indices have been trending downwards (see chart 7) – even if the decline has (temporarily) stalled more recently.

> In Asia in particular, but also in Israel and France, restrictions have been tight-ened again, at least temporarily.

7. VACCINATION PROGRESS MAKES FURTHER RELAXATION POSSIBLE



Source: www. ourworldindata.org, UniCredit Wealth Management

And with further opening steps on the horizon – even if social distancing and hygiene requirements are likely to be with us well into next year – the all-important mobility indices will most probably continue to trend upwards. In the retail and recreation sub-segment, the pre-Corona levels have even been reached again across the EMU. However, there is still some upside potential in public transport and workplace visitors.

Currently, further opening steps are being prepared, especially in the sports and cultural industries. The emerging change from incidence to hospitalisation indicators as a guideline for restrictions could also bring some relief.

This is good news for our economies, as stringency and mobility indices have strongly correlated with GDP growth in past quarters. The comprehensive opening of the service sector (in combination with catch-up effects in consumption and investment as well as economic policy stimuli) was the key assumption for our expectation of a growth spurt in the second half of this year.

Supply bottlenecks are likely to be temporary

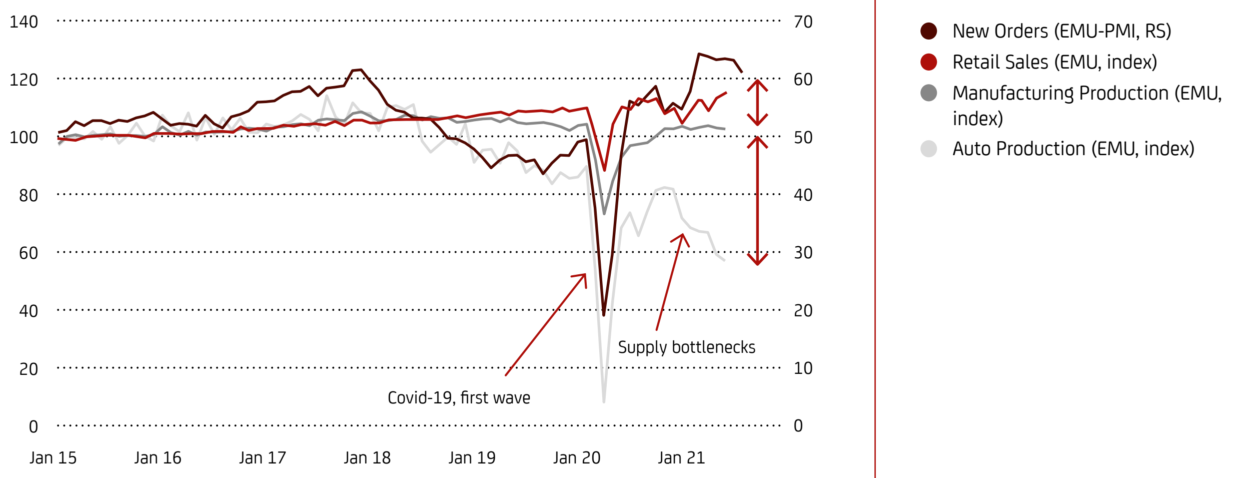
Therefore, it is no longer the pandemic that is severely affecting (global) supply chains and slowing down manufacturing and services production. Instead, an increasing number of companies are complaining about non-Covid-induced supply bottlenecks, delivery delays and shortages of materials and components. This not only limits their production possibilities, but also contributes significantly to the strong rise in inflation.

According to the Ifo Institute, two thirds of German industrial companies are currently complaining about supply chain problems. There is a shortage of chips and electronic components, plastic granulates, steel and industrial metals respectively, but also construction materials. In addition, transportation capacities (ships and planes) are lacking as well. It is, therefore, hardly surprising that not only carmakers, but also the electrical industry, mechanical engineering, the plastics industry, construction and trade are currently facing supply chain problems.

At the beginning of the year, the figure was not even 20%.

A study by the renowned Kiel Institute for the World Economy (ifw) concludes that industrial production in Germany is currently around 10% below the level that new orders would have led one to expect. According to the report, this is costing Germany about one GDP point at the moment. However, the divergence of new orders, demand and (car) production is not limited to Germany, but applies to the entire EMU (see chart 8).

8. PRODUCTION SUFFERS FROM SUPPLY CHAIN PROBLEMS

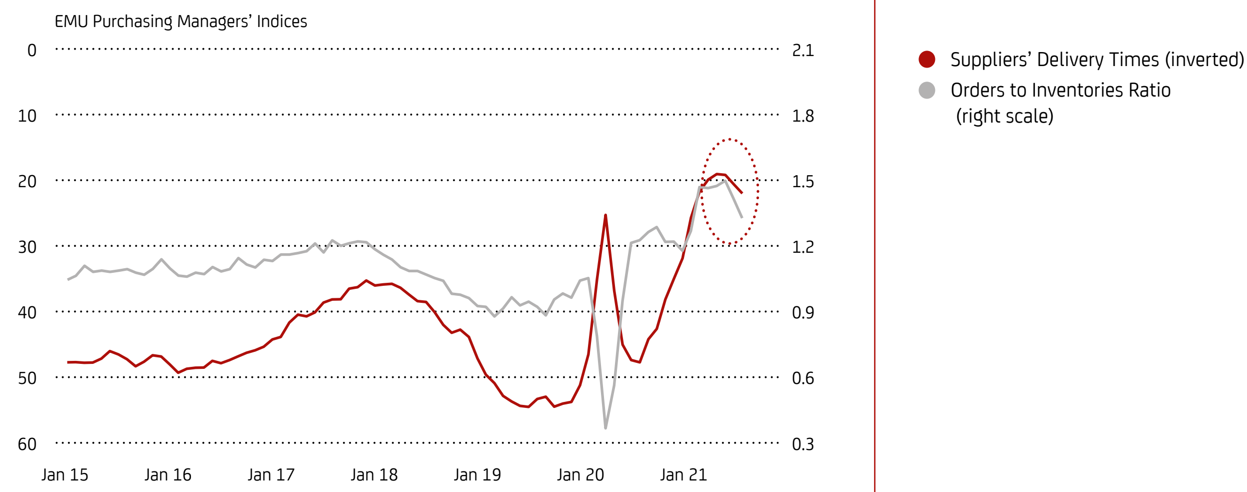


Source: Refinitiv Datastream, Markit, UniCredit Wealth Management

Global supply chain problems will likely be with us for some time. But signs are pointing to an improvement beyond the short term. In the past, according to the authors of the ifw study, deviations in the long-term relationship between new orders and production have been reduced quite quickly within a month (about 20% to 40%). It should, therefore, take another 3 to 6 months until these deviations are largely corrected by short-term adjustments in industrial production – in other words, the catch-up effect. The authors expect the first corrections to occur during the current quarter. This is in line with our expectations. The purchasing managers' indices also provide a first indication of this. Suppliers' delivery times have declined recently, as has the ratio of new orders to inventories (see chart 9).

For details and calculations see "Bedeutung von Lieferengpässen für die lau-fende Produktion in Deutschland", ifw-Box 2021.09 (link)

9. HOPING FOR RELIEF ON SUPPLY CHAIN PROBLEMS



Source: Markit, UniCredit Wealth Management

In addition, companies are increasingly diversifying their supply chains. More warehousing, more suppliers, more supplier countries and relocations back are the catchwords. This should bring relief further down the road – especially since the one-time burdens such as the blockade of the Suez Canal, the extreme weather events in the US or the fire-related downtime in chip production in Japan are a thing of the past.

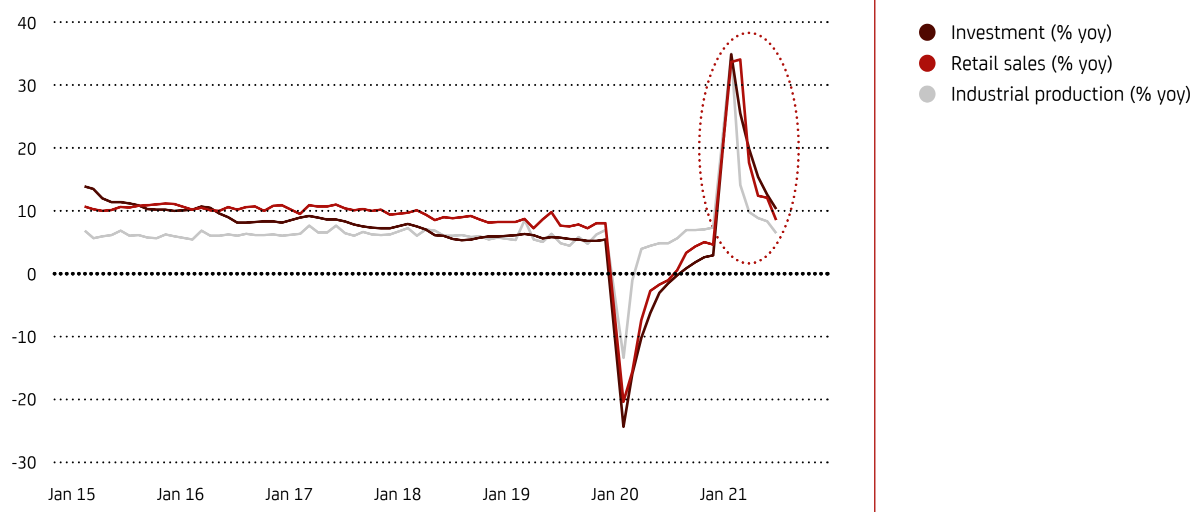
All this suggests that, in addition to production of services (additional opening), industrial output should also pick up significantly in the second half of this year. The soft patch of the past few months should therefore gradually come to an end.

China's bout of weakness should be quickly corrected by economic stimuli

It was to be expected that after the textbook V-shaped recovery, China's GDP growth could undershoot temporarily. However, no one had foreseen that China's economic growth would collapse in the current quarter and likely almost stalled. However, sharply declining sentiment, leading and also hard economic figures speak a clear language (see chart 10). Month-on-month, they even mostly declined in July – and August should hardly have been better.

The GDP plus of 4.9% (annualised) at the beginning of the year therefore came as no surprise to us. At 6.1%, growth in the spring quarter was already above China's growth potential of 5.75%.

10. CHINA'S CURRENT GROWTH SLUMP



Source: Refinitiv Datastream, UniCredit Wealth Management

Part of the weakness is likely to be due to the extremely harsh restrictions on mobility in the wake of rising Covid (Delta) numbers. The bulk of the setback, however, seems to be due to (economic) policy. The rapid, V-shaped recovery in conjunction with the recovery of the world economy since mid-last year has induced policymakers in Beijing to tighten monetary and fiscal reins noticeably – especially as the first (speculative) tensions became apparent not least in real estate markets. The consequences: growth of nationwide lending (total social financing) declined noticeably, as did the issuance of public bonds to finance spending programmes.

It is therefore hardly surprising that housing, but especially public infrastructure investments, have weakened considerably. The latter even declined in July (-10% y-o-y).

This was joined by major regulatory interventions, especially in the real estate sector (which threatened to run hot) and in large (private) IT and social media companies (see our "In Focus" article on this). In addition, China, like the rest of the world, has not been spared from global supply chain problems.

However, the slump in China's growth is likely to be transitory. This is because the policy support is already on the road. Ultimately, solid economic growth is the sole legitimation for the communist rulers. And already in July, the reserve requirement rates were lowered. Another two or three rate cuts are likely to follow. At the same time, fiscal policy is switching back to expansion. There is plenty of scope for financing and spending. During the first half of the year, government revenues grew far above plan. In contrast, bond issuance by central and regional governments was well below target. This suggests rapidly rising emission volumes, which should primarily be channelled into public infrastructure investment.

At its July meeting, the Politburo stressed that it was the task of fiscal policy to support economic activity at the end of this year and the beginning of next year.

We thus expect China's economy to grow above potential once again in the fourth quarter at around 7.5%. This will also likely apply, at a slower pace, to the start of 2022. Therefore, China's current growth pause should not have a lasting impact on the global economy.

Tapering: central banks remain relaxed

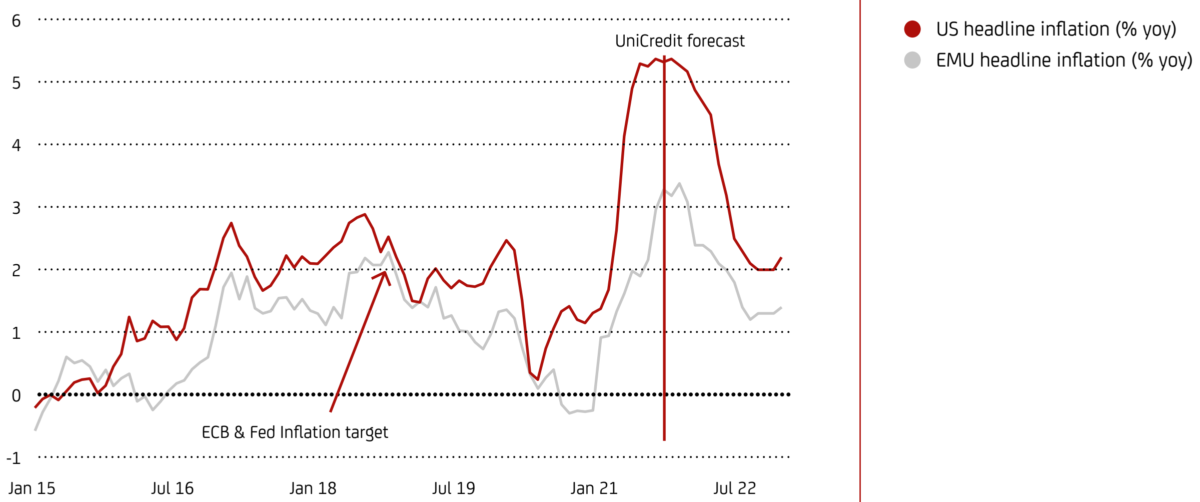
In August, consumer prices in the euro area were 3% above the previous year and thus as high as at the end of 2011. In the US, one even has to go back to mid-2008 to find similarly high inflation rates as recently (5.3%).

That leaves the issue of inflation and central banks. The flip side of the strong global economic catch-up process and the supply chain problems is rapidly rising prices. Inflation rates around the world have now reached new cyclical highs, continuously exceeding expectations. Therefore, it is of no surprise that speculation has been running high that central banks might tighten monetary policy sooner than previously expected. At the top of the radar screen is the US Federal Reserve (Fed), which sets the pace internationally.

In the past three months, an average of 750,000 new jobs were created in the US, although the August figure disappointed heavily. Nevertheless, employment as well as the unemployment rate (5.2%) are approaching their pre-Covid levels step by step. The same is true for the euro area.

But the Fed remains relaxed. The current price pressures, according to Fed Chairman Powell at the recent meeting in Jackson Hole, are only temporary and inflation will go back to levels consistent with (the Fed's) goal of inflation averaging 2% over time. We share his view. Although the peak of inflation on both sides of the Atlantic is yet to come, inflation should fall noticeably next year (see chart 11) – once the demand backlog has been cleared, the higher raw material and transport costs have dropped out of the annual rates and the supply bottlenecks have been widely eliminated. The decisive factor here is that there is no wage pressure before that. However, this is not evident despite tightening labour markets.

11. PRICE PRESSURE TEMPORARY IN NATURE



Source: Refinitiv Datastream, UniCredit Wealth Management

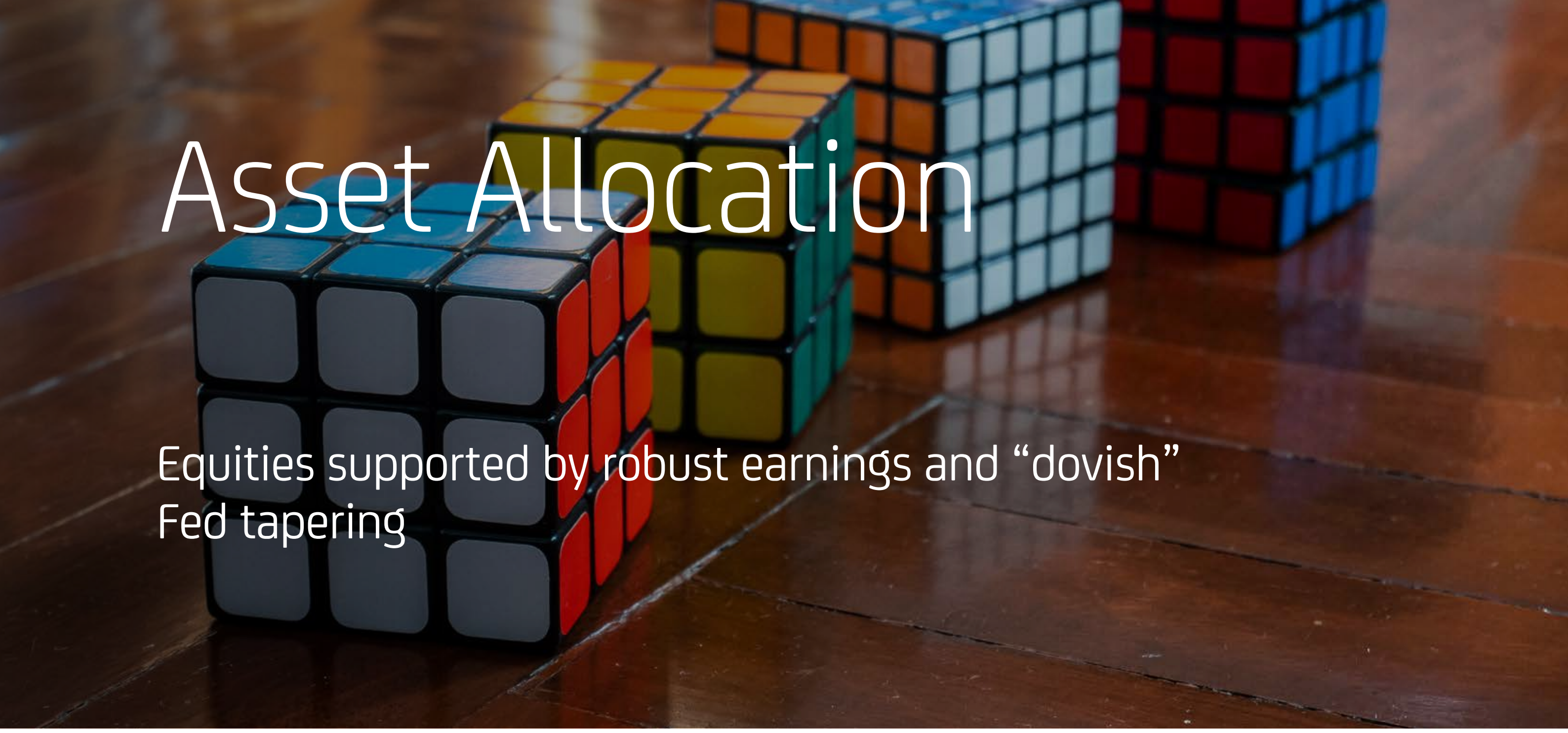
This means that the previously outlined tapering timetable remains in place. The Fed is likely to announce the reduction of its securities purchases before the end of this year – most likely at the Open Market Committee meeting in mid-December, or possibly as early as the beginning of November if labour market figures come up surprisingly strong. But tapering should not have a lasting impact on the financial environment on both sides of the Atlantic i.e. yields, curves and spreads, because it is largely priced in. This is shown by the experience of 2013 (taper tantrum). It also applies to Fed rate hikes, which should not start before 2023 anyway. Powell explicitly pointed out at Jackson Hole that the starting signal for tapering does not prejudge the timetable for rate hikes.

Our monetary policy expectations for the euro area have not changed either. The European Central Bank is likely to follow the Fed's tapering strategy – albeit with a time lag and probably less aggressively. After all, unlike in the US, EMU-wide inflation should fall below the central bank target in the second half of 2022. Furthermore, the cycle of interest rate hikes is likely to start later in the euro area than in the US.

In contrast, the (incipient) monetary policy normalisation in the US could be more of a problem for the Emerging Markets. They are economically not robust enough (purchasing managers' index below the critical threshold of 50) to easily absorb a (moderate) rise in US yields. This could mean price losses not only for their foreign currency bonds, but also for equities. It is therefore necessary to monitor Emerging Market exposures even more closely.

Global recovery continues, normalisation next year

To sum up, developments over the summer do not give us cause to change our global view substantially. It is quite possible that the current quarter will fall somewhat short of the high expectations in view of the supply chain problems, the growth pause in China and the downturn in sentiment. However, this can largely be made up for in the coming months. In addition, the macroeconomic indicator spectrum is still extremely dominated by the goods economy. There are only a few genuine indicators for the service sector. Yet it is precisely the further opening steps in the service sector that should provide the impetus – together with catch-up effects in private consumption (dis-saving) and investment activity (tight capacities, empty inventories), as well as the still strongly expansive monetary and fiscal policy. We continue to expect a growth spurt in the current half-year, especially for the euro area, but also for the global economy. 2022 will then be the year of normalisation – in terms of monetary policy, because leading central banks will start to taper, and in macroeconomic terms, because growth will approach its potential rates from above. Therefore, it should not surprise anyone that the economic indicators will also crumble from their interim highs in 2022.



Asset Allocation

Equities supported by robust earnings and “dovish” Fed tapering

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

Despite summer fears about the spreading of the Delta variant and Fed tapering, equities have been supported by a very positive Q2 earnings season. Also, the Fed sounded dovish at the margin. Let’s get into the details.

Q2 2021 results from US and European companies showed significant earnings growth due to the accelerating economy and favourable comparative basis, with the percentage of companies beating analysts’ expectations remaining at high levels. In the US, 85% of companies beat earnings expectations with 90% growth and a positive surprise of 17%. The sectors that showed the greatest increase in profits were those that had been most penalised by the pandemic last year, namely energy, materials, industrials, consumer discretionary and financials. There was also a significant recovery in revenue growth, which stood at 27%, with a positive surprise of 5% and with all sectors showing double-digit growth, while the percentage of companies that beat revenue expectations (83%) reached the highest levels since 2009.

12. Q2 EARNINGS SEASON IN THE US

	No. of reported/ Total	% reported	% cos Beating EPS estimates	% cos Missing EPS estimates	EPS surprise	% yoy EPS growth	% Beating Sales estimates	% cos Missing Sales estimates	Sales surprise	% yoy Sales growth
S&P500	**439 / 497**	**88%**	**85%**	**13%**	**17%**	**90%**	**83%**	**11%**	**5%**	**27%**
Energy	22 / 22	100%	77%	18%	15%	-	73%	23%	12%	115%
Materials	27 / 28	96%	67%	26%	4%	105%	74%	19%	3%	36%
Industrials	70 / 73	96%	83%	14%	12%	420%	83%	6%	2%	28%
Discretionary	42 / 62	68%	83%	17%	21%	524%	83%	14%	2%	48%
Staples	22 / 30	73%	86%	9%	10%	22%	82%	14%	6%	17%
Healthcare	59 / 64	92%	92%	8%	9%	26%	95%	2%	4%	19%
Financials	65 / 65	100%	91%	8%	28%	137%	78%	14%	5%	11%
IT	54 / 74	73%	94%	6%	16%	53%	91%	4%	5%	24%
Com. Services	21 / 22	95%	90%	10%	25%	69%	90%	5%	5%	24%
Utilities	28 / 28	100%	75%	25%	5%	7%	61%	29%	5%	11%
Real Estate	29 / 29	100%	79%	17%	9%	36%	86%	10%	4%	18%
Ex-Financials & Real Estate	**345 / 403**	**86%**	**85%**	**14%**	**14%**	**83%**	**83%**	**10%**	**5%**	**31%**
Ex-Energy	**417 / 475**	**88%**	**86%**	**13%**	**17%**	**74%**	**83%**	**10%**	**4%**	**22%**

Source: JP Morgan, UniCredit Wealth Management

In Europe, 64% of companies in the Stoxx600 index beat earnings expectations with 71% growth and a positive surprise of 16%, and with 10 out of 11 sectors showing double-digit growth. The most significant growth came from cyclical and commodity-related sectors. At the revenue level, 69% of companies beat expectations with 28% growth and a positive surprise of 3%, and with 10 out of 11 sectors reporting revenue growth.

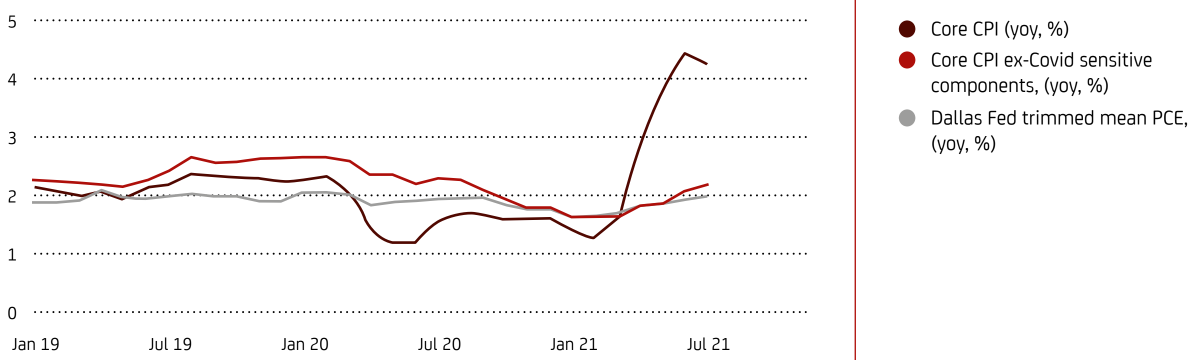
13. Q2 EARNINGS SEASON IN EUROPE

	No. of reported/ Total	% reported	% cos Beating EPS estimates	% cos Missing EPS estimates	EPS surprise	% yoy EPS growth	% Beating Sales estimates	% cos Missing Sales estimates	Sales surprise	% yoy Sales growth
Stoxx600	**387 / 437**	**89%**	**64%**	**36%**	**16%**	**71%**	**69%**	**18%**	**3%**	**28%**
Energy	15 / 18	83%	73%	27%	19%	310%	60%	40%	-6%	66%
Materials	34 / 38	89%	76%	24%	12%	56%	84%	3%	4%	36%
Industrials	73 / 83	88%	59%	41%	7%	-	67%	20%	2%	25%
Discretionary	42 / 46	91%	79%	21%	36%	81%	69%	20%	5%	66%
Staples	22 / 34	65%	50%	50%	1%	38%	63%	11%	0%	8%
Healthcare	36 / 42	86%	62%	38%	12%	15%	77%	11%	4%	12%
Financials	63 / 64	98%	80%	20%	27%	67%	78%	8%	5%	4%
IT	29 / 30	97%	60%	40%	-1%	69%	57%	29%	2%	21%
Com. Services	29 / 32	91%	30%	70%	17%	32%	71%	21%	3%	4%
Utilities	24 / 25	96%	59%	41%	22%	36%	57%	33%	14%	32%
Real Estate	20 / 25	80%	45%	55%	-235%	6%	46%	31%	9%	-5%
Ex-Financials & Real Estate	**304 / 348**	**87%**	**61%**	**39%**	**15%**	**75%**	**68%**	**20%**	**2%**	**34%**
Ex-Energy	**372 / 419**	**89%**	**64%**	**36%**	**16%**	**58%**	**69%**	**17%**	**4%**	**24%**

Source: JP Morgan, UniCredit Wealth Management

At the online meeting of central bankers in Jackson Hole (August 26-28), Fed Chair Jerome Powell outlined what we could define as a “dovish taper”: the Fed is ready to reduce its asset purchases, currently amounting to USD120 billion per month. However, Powell has made it clear that a) higher inflation will prove transitory as it has mostly been concentrated in Covid-sensitive components (See Chart 14, notably the used cars market), b) the Fed will act gradually and pragmatically, and c) that this will not lead to an increase in interest rates.

14. THE SURGE IN CORE INFLATION IS COVID-DRIVEN

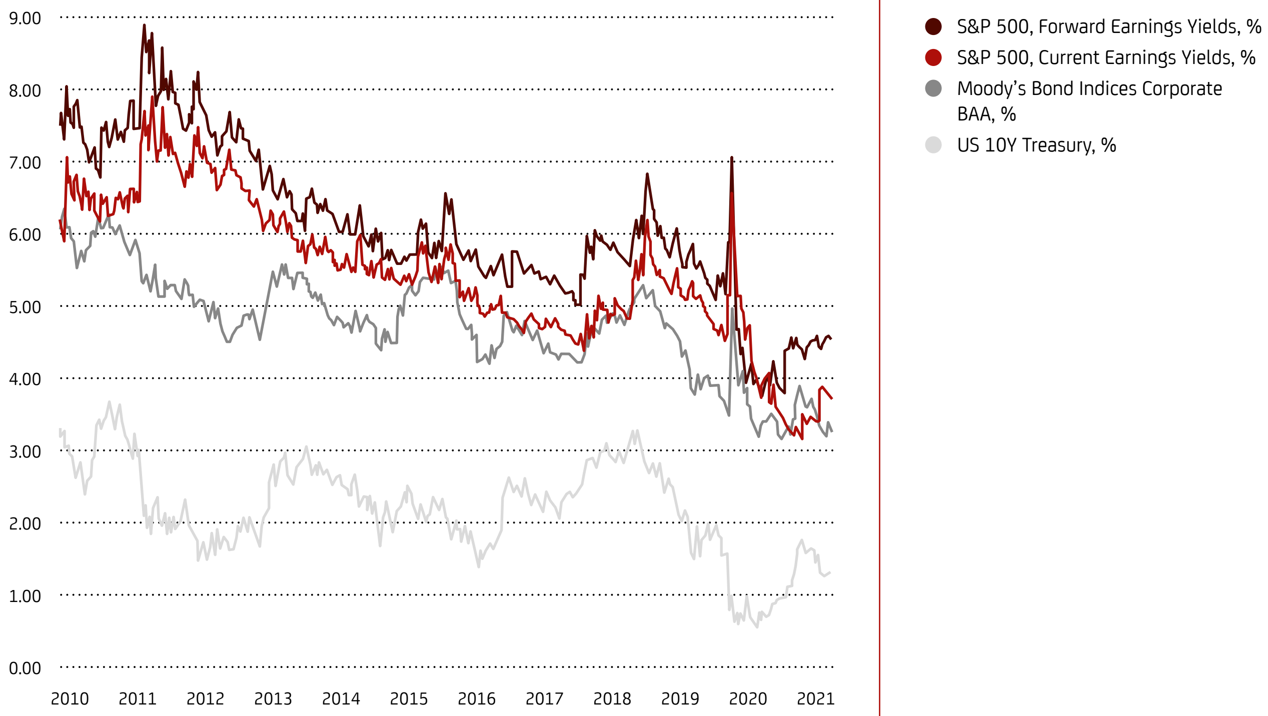


Source: Pantheon Macroeconomics, UniCredit Wealth Management

Financial markets have reacted positively to Powell’s statements and yields on US Treasury bonds remain at low levels (the 10-year US Treasury yield is currently running at 1.3%), which, in turn, favours the risk asset classes and, on the bonds side, the search for yield or carry trades. In other words, real bond yields (TIPS yields) remain low, and the equity risk premium remains high.

On a historical basis, the equity risk premium, or the difference between the earning equity yield and the corporate and government bonds yields, continues to justify our strategic positive stance on equities versus credits and govies.

15. EQUITIES RISK PREMIUM REMAINS COMPELLING



Source: UniCredit Wealth Management, Refinitiv Datastream

UniCredit GWM Asset Allocation stances

Overweight Global equities

The combination of massive fiscal and monetary policy action and the global recovery is supportive for equities, despite uncertainty due to the pandemic.

Overweight European equities

Monetary and fiscal policies are highly expansive. 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 the Biden's very expansionary fiscal policy, but less attractive valuations 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 EMs is strongly recommended.

Neutral Pacific equities

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

Underweight Global bonds

Vulnerable to increasing inflation and the expectation of rising government bond yields.

Overweight Euro investment grade corporate bonds

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

Underweight high yield corporate bonds

Among the risk asset classes we currently prefer equities, as the lack of market liquidity remains an issue for high yields bonds.

Underweight EMU government bonds

We are 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 non-EMU government bonds

Despite still accommodative monetary policies, we expect US Treasury yields to increase by year-end.

Overweight Emerging Market bonds

The search for yield supports our positive stance, but we are more defensive and selective given the expectations of rising US Treasury yields and the temporarily stronger USD.

Neutral Money Markets

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

Neutral Alternatives

They offer portfolios de-correlation opportunities.

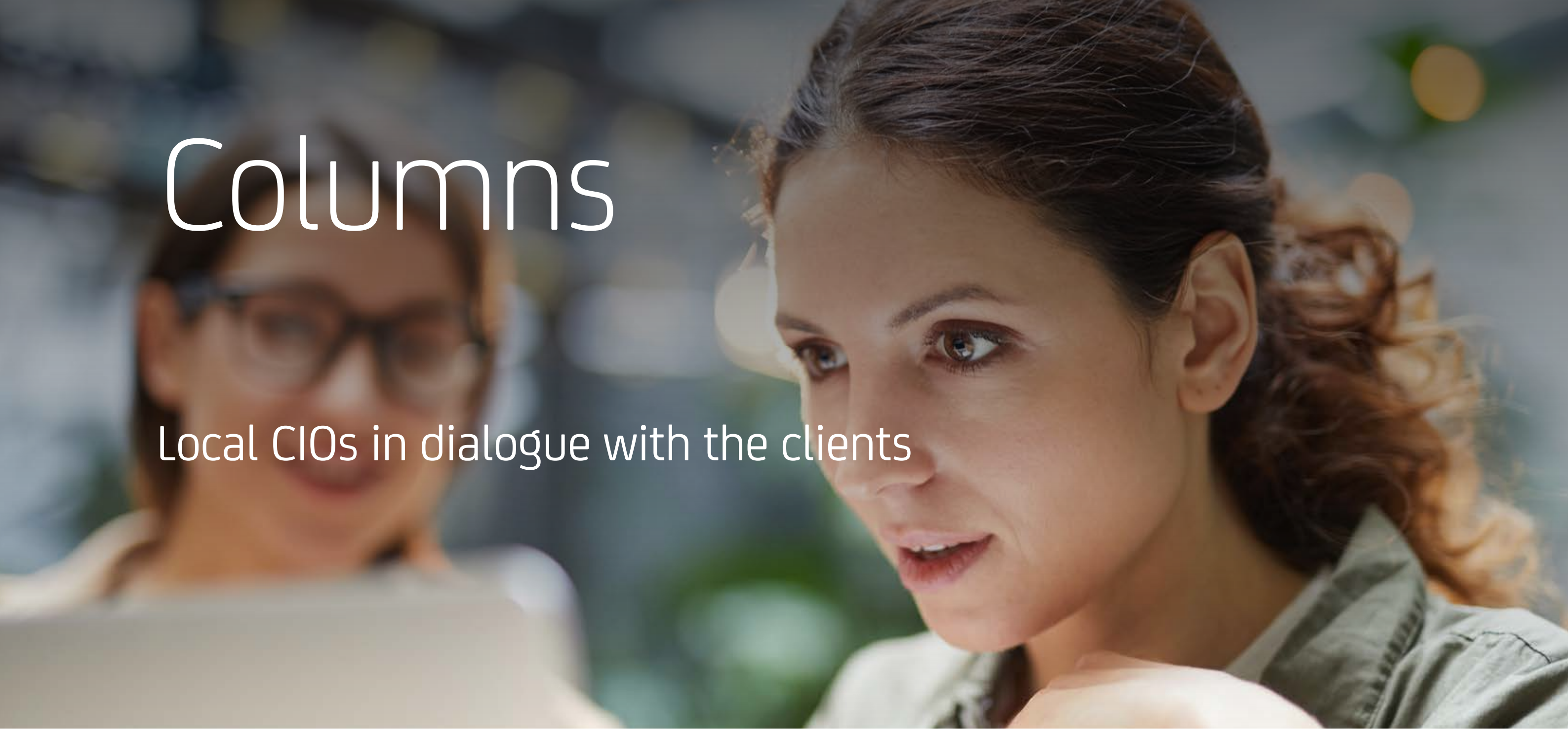
Commodities

We are positive gold, as we believe the price is sustained by accommodative central banks' monetary policies and low interest rates.

Currencies

EUR/USD

The EUR/USD looks to be nearing an equilibrium point in the short-term, after the dovish tapering announcement by the Fed. 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

Inflation numbers are rising rapidly. Are we sure these increases will be temporary?

Let's start with a medical parallel. Inflation, in a certain way, is like the human body's temperature. Too high is not good, because it is a symptom of bad functioning in certain areas or sectors that could even determine a total shutdown for the economic body. Neither is too low good, because this is the symptom that the economic body is cooling down and is losing momentum or even vitality. Japan's deflation (which is negative inflation), for example, is a clear consequence of an economy with very bad demographic developments and great difficulty in increasing output productivity, due to a very high level already reached. Another feature we observe is that the higher the level of the inflation, the higher the volatility. So, high inflation is more difficult to tame. On the other hand, negative inflation is very sticky and persistent and makes it extremely hard to revive the economic body.

Then, to determine what the "fair" level is corresponding to the 36-37 Celsius degree range of the human body temperature is another story. This fair level is likely different based on the "age" of the economy and its development stage. Usually, we observe a higher fair level of inflation in emerging economies. Then, when the economy evolves and stabilizes, that fair level comes down. In addition, technology and globalisation are powerful forces that impact the long-term inflation trajectory. They act as powerful vitamins or integrators that make production factors circulation very fast and efficient – and in the last decades, western economy greatly benefitted from those forces.

Our experts:

Alessandro Caviglia

CIO
Cordusio Sim (Italy)

Now, coming to the point. The last preliminary Eurozone headline inflation year-on-year reading, released on August 31, was 3.0% from 2.2%, the highest in 10 years. Core inflation, a subset excluding more volatile components such as energy and food, advanced to 1.6% from 0.6%. Both data were higher than consensus had anticipated, and this caused some jitters in government bond markets. Central bankers are reassuring us that these moves are temporary. But should we be worried about these numbers? Are we on the verge of a turning point in the secular inflation downtrend?

Let's dig a little under the surface of these numbers for more information. The headline number was heavily impacted by a sustained increase in energy inflation at 15.4% on a yearly base. Additionally, a further rebound in the food, alcohol and tobacco component of inflation, rising by to 2.0%, are part of the explanation for the relevant headline move. These numbers for trends are consistent with the story of global supply-side disruptions and higher transportation costs, though in the case of energy, we think the trend is not sustainable. In fact, energy prices will contribute lower and lower (when the oil price per barrel moves from USD35 to USD70, it contributes with a 100% increase; when it hovers around USD70, after one year it will contribute with a 0% increase).

In the core inflation number, non-energy goods inflation substantially increased to 2.7%, as certain goods (mainly clothing) in France and Italy rebounded after a temporary correction in July, due to a shift in the timing of summer sales. In addition, last year's VAT cut in Germany is creating upside base effects that will continue to persist until the end of the year. In summary, yes, we can trust our central bankers, and most of the effect we see will prove to be temporary.

That said, we still have two main observations. First, temporary will not mean three months but probably some quarters. The pandemic has created a huge shift in consumer behaviours, which in the end have determined the bottlenecks we are experiencing. Most of those shifts will not be temporary (we have previously discussed the transition from contact economy to the remote economy), so they will require adjustments in the global production chain, which will require more effort and time than expected. Second, geopolitical events are telling us that we have entered an historical period where globalisation forces at the best are not so strong anymore, and we could even experience some phases of deglobalisation, mainly because of the US-China confrontation. As we explained before, if people and capital, fixed or financial, meet hurdles to their free circulation in the world, this will result in a higher fair level of inflation.

To conclude, we see no risks that inflation will go out of control. Inflation will calm down and stabilise, but with a slower pace than expected and, probably, at a higher level than what we have experienced in past decades.

Answers from Austria

US labour market: Signs of weakness?

Oliver Prinz

Co-CIO Bank Austria and Schoellerbank (Austria)

The US labour market has been booming in the past few months and signs of this trend were prevailing across several economic indicators. Given the Fed's increased focus on the labour market instead of inflation numbers, the significance of this trend increases even further. Hence, an ever-larger number of economists and market participants expect a move from the Fed to taper and increase interest rates. However, regardless of these developments, labour market numbers in August have shown a serious downturn.

Taking a closer look at the employment numbers in the US, the stark downturn in new non-farm payrolls becomes apparent. The reported number of 235,000 new jobs has missed the estimates (733,000) by almost half a million jobs, indicating the largest slowdown in employment since last winter. The labour force participation rate remains below consensus at 61.7%, nevertheless the average hourly earnings increased substantially, while unemployment and underemployment remain favourable. The reported information suggests a discrepancy in labour market data that I want to explore.

Further analysis of the data reveals that the lack of jobs growth can be attributed to several factors. First, there is a major gap between the service and manufacturing sectors, whereas the latter does not seem to host major problems with solid growth rates. On the other hand, the service sector posts larger issues, showing a decline in retail trade employment – there are still about 285,000 fewer jobs in retail trade compared to February 2020. Lastly, by far the largest impact on jobs growth continues to originate in leisure and hospitality where there has been negative growth in August for the first time in a few months. Furthermore, employment is still down by a staggering 10% or 1.7 million jobs since February 2020.

At the same time, wages rose in August by the most (1.3% month-on-month) in leisure and hospitality, suggesting a supply side problem rather than a demand side issue in the labour market. COVID cases are discussed as one of the drivers of this trend since employees tend to stay away from these jobs out of fear. Although this is a factor, what seems to be more significant are both unemployment benefits as well as a reorientation of employees that previously worked in these fields. Both of these factors suggest a supply side issue, which can hamper economic growth on the one side for the respective industries, as well as drive inflation further. Nevertheless, it does not suggest a general issue in the US labour market. The continuously growing number of job openings, as seen in the Job Openings and Labour Turnover Survey (JOLTS) report from July (+861,000 job openings), also supports this thesis. Hence, due to the growing inflationary trends supported by a supply side shortage in the labour market, the Fed will likely remain on track.

In the long-term, we remain positive on the equity market, however, we do expect volatility in the short run. The labour market weakness as seen in August's data can be attributed to a supply side issue, and one that is driving inflation higher due to increased wages. This will push the Fed further towards tapering and could even undermine their narrative of a temporary inflation story.

Answers from Germany

How will the German election impact the economy and capital markets?

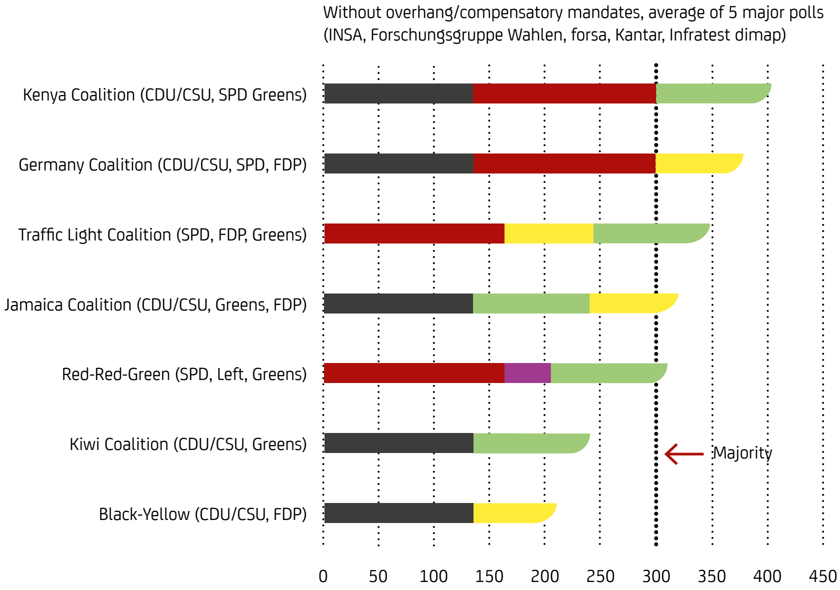
The election to the German Bundestag (parliament) will take place on September 26. After the coalition agreements have been concluded, the new parliament will then elect the Chancellor based on the formal recommendation of the President. Current polls suggest that the coming federal government will be supported by a cross-camp coalition – i.e. one or two parties from the centre-right (CDU/CSU, FDP) and one or two parties from the centre-left (SPD, GRÜNE-Greens). It has become a common practice to name possible alliances after party colours and/or corresponding colour analogies, for example country flags.

Currently, only three-party coalitions would be able to govern. Two-party alliances that have been common since 1961 would thus become a relic of the past. Currently, a Kenya coalition of CDU/CSU (black), SPD (red) and Greens would get most seats (see Chart 16). This is followed by the Germany alliance of CDU/CSU, SPD and FDP (yellow), the so-called traffic light (SPD, FDP and Greens) and the Jamaica coalition of CDU/CSU, Greens and FDP. After recent SPD gains, even a red-red-green alliance of SPD, Die Linke and Greens would be capable of gaining a majority. The Kiwi coalition (CDU/CSU, Greens), which was still possible this spring, would currently not have a majority.

Philip Gisdakis

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

16 POSSIBLE GOVERNING COALITIONS IN GERMANY



Source: www.bundestagswahl-2021.de/koalitionen, UniCredit Wealth Management

It also remains open who will be the strongest force in the new Bundestag. For quite some time it looked as if the CDU/CSU would once again be in the lead – coalitions with their participation would thus be led by Armin Laschet, the candidate of the CDU/CSU, as Federal Chancellor. Over recent weeks, however, the CDU/CSU has lost support. At the same time, the SPD under its candidate, the current Finance Minister Olaf Scholz, has been able to catch up noticeably and even take the lead in polls. The gaps between the two parties, however, are too close to call. The Greens under their candidate Annalena Baerbock have also lost some ground after their interim high last May. She is no longer seen as having much chance of succeeding Angela Merkel in the chancellorship.

Since five alliances now appear to be capable of governing, a long government formation phase seems unavoidable. However, lasting implications for capital markets are not to be expected during this phase. The German public is used to lengthy coalition negotiations at both state and federal level. Eight years ago it took almost three months, and after the 2017 election almost six months, for the new federal cabinet to be sworn in.

The impulses that a future federal government will ultimately set depend on the corresponding "colour combination". However, the election programmes of the governing parties imply that a future federal government will take a climate-oriented, Europe-focused and – except for a red-red-green alliance – also pro-business course. While in the election campaign the focus is usually on programmatic differences in order to present a party with a clear profile to the voters, the political actors in Germany usually switch to a cooperative path after an election. For a coalition, the unifying elements of the party programmes are then emphasised. This process of coalition-building is well established in Germany and some of the coalitions mentioned above exist or have already existed at the state level.

The cornerstones of German economic, financial and foreign policy should therefore remain in place – if one disregards a red-red-green alliance for the time being. The short-term implications for the financial markets should thus be limited. A unifying element between all the parties mentioned could be a focus on increased investment in the areas of climate protection (decarbonisation of the economy & renewable energies), digitalisation (broadband expansion, 5G network, digitalisation of public administration), education (the pandemic has exposed the weaknesses of the German education system) and health & care issues. Comprehensive initiatives in these areas could be growth-enhancing and thus provide positive impetus for the German and European economies – and thus also for financial markets.

In the case of a red-red-green alliance market reaction is likely to depend strongly on which "radical" economic, defence and foreign policy elements of its election programme The Left would have to give up in a coalition agreement. Nevertheless, already with the beginning of serious red-red-green negotiations, one should expect noticeable uncertainty for the economy and the markets to emerge.

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