



Prepare for landing



Monthly Outlook

July 2022

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Summary

Prepare for landing



MARKET UPDATE

Although over the last two months, economic data in the US and the euro area have continued to deteriorate, we do not have the global recession scenario as our baseline scenario. The probability of a material downturn has increased remarkably in recent weeks. However, positive signals came most recently from the US labour market, which continues to be in solid shape, although employment momentum is slowing here as well. Another positive factor should come from the US consumer, who despite a deterioration in consumer sentiment and a lower savings rate, still has a massive pandemic savings surplus of around USD2.5 trillion to fall back on.

Global supply chain bottlenecks have eased somewhat over the past six months, but not to the extent that could have been hoped for at the end of last year due to China's Covid-related lockdowns.

Our main concern in this respect is the Eurozone, which associates the risk of a recession driven by restrictive monetary policy, as it is in the US, with the obvious implications of energy policy and dependence on Russia, particularly in Germany and Italy. The supply situation has eased due to increased gas storage levels in Germany and the recent agreement reached between Italy and Algeria. These developments should dampen the risk of a gas supply shortfall in the winter of 2022/23 and, as a result, also the risk of an adverse economic scenario.



INFLATION AND MONETARY POLICY

Due to the persistently high inflation rates, the Fed has significantly pulled forward its targeted interest rate hikes. Above all, the danger that the Fed, due to its strict focus on fighting inflation, will continue to burden the US economy with an excessively tight monetary policy could further increase the probability of recession in the coming year. While Fed Chairman Powell had explicitly stated at his press conference in June that the Fed did not intend to deliberately induce a recession, a "soft landing" would be difficult to achieve.

After more than a decade of loose monetary policy, the European Central Bank (ECB) has now also initiated the announced entry into monetary policy normalisation via a first 50 bp rate hike. The ECB is flanking the interest rate turnaround with the so-called Transmission Protection Instrument (TPI), which is intended to ensure that the debt spread levels of the individual euro countries do not move too far apart.



FINANCIAL MARKETS

In the first half of 2022, the traditional global asset allocation portfolio failed to protect investors due to the positive correlation between bonds and equities, which were both penalised by fears of stagflation.

On the equity side, we stick to our neutral stance with a global geographic tilt

Sustainable equity buying opportunities may well rise over the medium- to long-term horizon, especially considering the growth companies, while on a short-term basis, we stick to our call for quality.

As for credits, we believe that, like equities, they are not yet fully pricing the hard landing scenario and we judge their spreads vulnerable to further widening.

On the contrary, we already see first entry points on US and European government bonds, where we have reduced the underweight versus the benchmark and gradually increased their duration.

At least, after the worst first half year in decades, the traditional global balanced portfolio could resume functioning. And government bonds may prove to be a precious macro hedge in case of a pronounced global slowdown, provided we see inflation peak and fall over the next months on a sustained basis.

CIO's Letter

Prepare for landing

A nerve-wracking first half of 2022 has come to an end. It was marked by the war in Ukraine, which was accompanied by concerns about the security situation in Europe, the guarantee of energy supplies, and a further surge in inflation – to which central banks want to react to or have already reacted with significant interest rate hikes and other measures. According to expectations on the capital markets, the US Federal Reserve (Fed) will raise interest rates to 3.5% by the end of the year (mind you, coming from a zero-interest rate environment last year). And after more than a decade of loose monetary policy, the European Central Bank (ECB) has now also initiated the announced entry into monetary policy normalisation via an interest rate turnaround. The extent of the first rate hike, by 50 basis points (bp), came as a surprise because the ECB had recently held out the prospect of a 25 bps rate hike. In one stroke, the ECB abolished the negative interest rates on deposits introduced in 2014 under then ECB President Mario Draghi. At the same time, the decision is a clear signal that the ECB is now resolutely trying to curb high inflation.

ECB President Christine Lagarde deliberately left open whether the next interest rate step in September will be 25 bps or 50 bps: the ECB Governing Council will only decide immediately before the meeting on 8 September, depending on the data and forecasts at the time. The ECB is flanking the interest rate turnaround with a new anti-fragmentation tool, the so-called Transmission Protection Instrument (TPI), which is intended to ensure that the debt spread levels of the individual euro countries do not move too far apart. The purchase volumes of the programme are not limited ex-ante, and a prerequisite for its use is that essential fiscal criteria are met. Both the rate hike and the TPI were approved unanimously, indicating a carefully negotiated compromise between the hawks and the doves in the Governing Council.

Meanwhile, global supply chain bottlenecks have eased somewhat over the past six months, but not to the extent that could have been hoped for at the end of last year due to China's Covid-related lockdowns. And constraints from supply chain bottlenecks remain at historically high levels, which were particularly felt by the manufacturing sector in Europe.

The developments of the first half of the year have left clear traces on the capital markets. In a historical context, the stock markets are not necessarily remarkable. Although they have had to contend with losses of around 20% in Europe and the US, these are still rather moderate compared to other crises in the last 20-30 years. This crisis is notable mainly because of the massive price losses in bonds, which go hand in hand with rising interest rates. Measured against standard bond indices, government bonds in the eurozone have never seen such price declines since the launch of the euro. And in the US, there has been no period of such sharp price falls in the last 50 years – as far back as the data of common indices on US government bonds go. The situation is exacerbated by the simultaneity of bond and equity price declines in Europe and the US. There was hardly any escape for investors, because the retreat into the traditionally safe haven of government bonds was also associated with massive price losses. European investors were able to partially compensate for price losses in non-European investments through exchange rate gains. Investments in gold, which are usually quoted in the US dollar, also benefited from this, as the gold price was also moderately in the red at the end of the second quarter.

Particularly noteworthy are also the details of the price developments for equities. Although these have seen significant reductions in Europe and the US, as mentioned earlier, the underlying profit expectations have continued to rise. Many analysts assume that the majority of companies will be able to pass on rising input prices to their customers. The higher profit expectations reflect

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the fact that investment in the real economy offers a degree of inflation protection. It is only in recent weeks that the momentum of expected profit increases has flattened somewhat. This development (falling share prices with simultaneous noticeable increases in profit expectations) has led to significantly falling price-earnings ratios. The latter, especially for Europe, are no longer far from lows reached during the financial crisis and the sovereign debt crisis. From a valuation perspective, equities are therefore at least no longer expensive.

It remains to be seen whether weakening economic dynamics with lower growth expectations and even recession risks in the US and Europe will lead to declining profit expectations. However, when it comes to recession risks, it should be noted that the main drivers of these risks remain at least partially controllable by the relevant actors in the US and Europe. In the US, the recession worries are a result of the Fed's expected cycle of interest rate hikes – i.e., from the concern that the latter could stifle economic growth with its measures to fight inflation. However, if there is a noticeable cooling of economic momentum, inflationary pressures can also be expected to cool. This in turn should give the Fed more leeway in its monetary policy and could suggest that a possible recession in the US (which is still not our baseline scenario) should not be overly dramatic.

And in Europe, too, the recession risks that could result from a possible gas supply shortfall, especially for the German economy, are no longer as dramatic as they were at the beginning of the war in Ukraine. Recently, the focus of public discourse shifted back to this topic (due to the planned shutdown of the Nord Stream 1 pipeline for maintenance reasons and the concern that the latter could not be reconnected to the grid by Russia for political reasons); however, the supply situation has eased due to increased gas storage levels in Germany. At the same time, the gas storage facilities were filled to a lower degree in April than on average over the past five years. But since significantly more gas was stored than usual in the following months, this backlog was made up and the current filling level corresponds to the corresponding average value. Even more, the current storage level (about 65%) is only slightly lower than the maximum storage level in 2021 (about 72%).

This development should dampen the risk of a gas supply shortfall in the winter of 2022/23 and, as a result, also the risk of an adverse economic scenario. However, it does not mean that the risks have been banished. The so-called Joint Forecast 2022 of five leading German economic research institutes puts the risk of a gas supply gap in Germany at 20% in a simulation calculation, a significant reduction of the risk compared to the corresponding situation in April. So there is no reason to panic. However, there is also no reason to be careless, because if Europe wants to come through this crisis unscathed and keep the reins of trade in its own hands, further steps are necessary to be able to guarantee the energy supply – also through reduced gas consumption by industry and private consumption. This could still result in political pressure in the winter months.

If the recession risks in Europe and the US do not materialise (which is still our base case), and both the gas crisis and the central banks' fight against inflation do not show any signs of excessively slowing down the economy, risky investments such as equities could once again come into investors' focus. In particular, equities look cheap in a historical context due to the price reductions of the past few months, coupled with further increases in profit expectations.

In Focus

What the current US bear market means for investors

Concerns about persistently high inflation, the war in Ukraine, uncertainty about the future path of the pandemic, and, last but not least, the Fed's efforts to curb inflation with an epoch-making turnaround on interest rates: this is the mix that caused the S&P 500 index to enter a **bear market**¹ in early summer.

THERE HAVE ALWAYS BEEN BEAR MARKETS IN THE HISTORY OF THE STOCK MARKET

Sharp falls in shares of 20% or more are relatively rare, yet they have occurred time and again in the history of the stock market. Although recessions do not necessarily follow bear markets, the latter can be an indicator of an impending recession. The duration and extent of bear markets can vary greatly, as can their causes – for example, exogenous events such as the Coronavirus outbreak or major (monetary) policy decisions. Basically, a bear market is characterised by a high degree of uncertainty and the expectation of (even) further falling prices. The price decline can either affect the entire market or only individual sectors or asset classes.

If the current year 2022 is also taken into account, there have been nine declines of 20% to 40% for the S&P 500 index since World War II – and three more of over 40% (see table 1). On average, it took a good year for prices to recover from these massive setbacks.

¹In defining a bear market, a 20% decline from the asset's 52-week high is often considered the determining factor. The US Securities and Exchange Commission defines a bear market as a situation in which a broad market index falls by 20% or more over a period of at least two months.

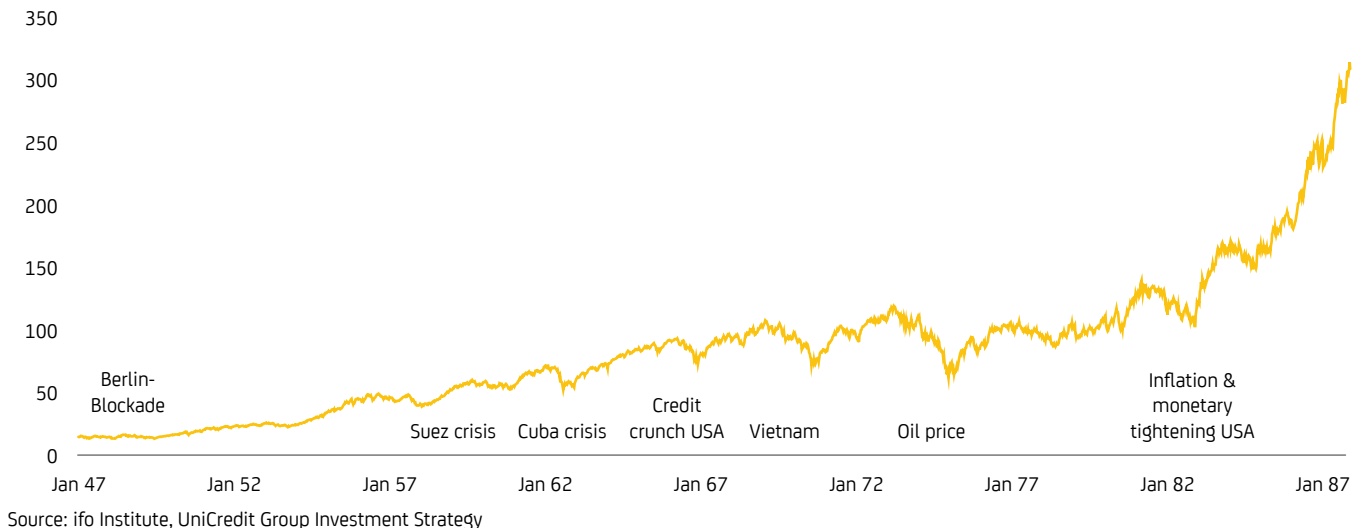
1. TWELVE BEAR MARKETS SINCE WORLD WAR II (S&P 500)

High	Low	Decrease (rounded)	Duration (in weeks, rounded)	New high	Recovery (in weeks, rounded)
15 June 1948	13 June 1949	-21%	52	22 September 1954	275
15 July 1957	22 October 1957	-21%	14	24 September 1958	48
12 December 1961	26 June 1962	-28%	28	3 September 1963	62
9 February 1966	7 October 1966	-22%	34	4 May 1967	30
29 November 1968	26 May 1970	-36%	78	6 March 1972	93
11 January 1973	3 October 1974	-48%	90	17 July 1980	302
28 November 1980	12 August 1982	-27%	89	3 November 1982	12
25 August 1987	4 December 1987	-34%	14	26 July 1989	86
24 March 2000	9 October 2002	-49%	133	30 May 2007	242
9 October 2007	9 March 2009	-57%	74	28 March 2013	211
19 February 2020	23 March 2020	-34%	5	18 August 2020	21
3 January 2022	16 June 2022	-24%	52	?	?

In the late 1960s, a weakening US economy, high inflation combined with assassinations and riots, and tensions related to the Vietnam War caused a bear market to develop (see chart 2); it was accompanied by a mild recession. In 1973, the Arab oil embargo drove up petrol prices and triggered not only double-digit inflation and a recession, but also a bear market in the stock market. For almost a decade, the US struggled with persistent inflation and slow economic growth. To combat **stagflation**², the US Federal Reserve (Fed) tightened interest rates in the early 1980s, which, combined with a deep recession, led to a relatively shallow stock market bear market that lasted about 21 months.

²Combination of stagnation and inflation, i.e. a cyclical situation characterised by the fact that the economy is not growing and inflation and underemployment prevail at the same time.

2. US BEAR MARKETS (S&P 500) BETWEEN 1947 AND 1987

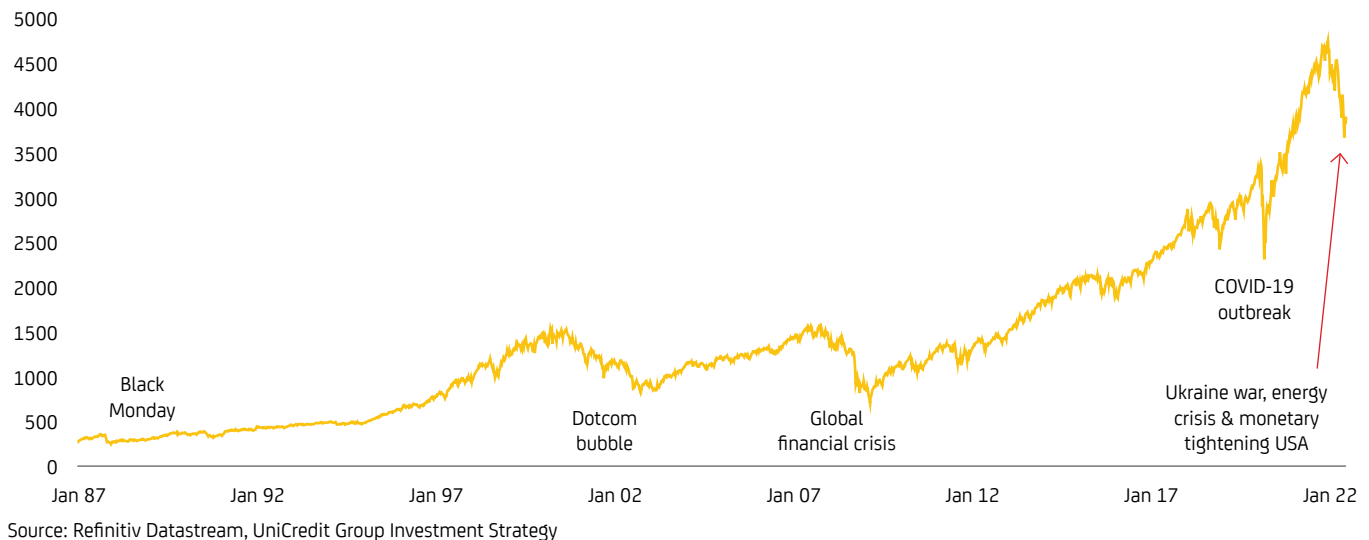


The longest bear market to date occurred at the end of 2000, when the dot-com bubble burst and many tech companies went bankrupt; it lasted longer than two years. In the last bear market, triggered by the outbreak of the pandemic, the S&P 500 index slid by around 34% between 19 February and 23 March 2020. However, stocks recovered within a few months and eventually more than doubled by 3 January 2022.

The first half of 2022 is likely to go down in history as the period in which the major central banks set the public up for a steep rate hike cycle (in the US it would even be the steepest interest rate cycle in decades), while inflation reached its highest level in 40 years, due to rising energy and food prices, in particular. While at the beginning of the year investors expected the Fed to raise interest rates by a maximum of 50 basis points (bps) this year, this value has since risen to almost 350 bps. It currently stands at around 300 bps. At the beginning of the year, the European Central Bank (ECB) was not expected to raise interest rates at all. In mid-June market expectations reached a recent high of around 200 bps.

So, with rising interest rates and a shrinking Fed balance sheet, markets must manage the transition from a decade of very low interest rates and excess liquidity and relatively low volatility to a much tighter liquidity environment, while rising commodity prices and widening credit spreads put additional pressure on corporate profits and disposable income. In this environment, the S&P 500 index had its worst first half since 1970 (see chart 3).

3. US BEAR MARKETS (S&P 500) BETWEEN 1987 AND TODAY



CURRENT BEAR MARKET SHOWS PATTERN OF A CYCLICAL BEAR MARKET

Looking at the long-term history (using US data), bear markets can be divided into **three categories**³ according to an analysis by Goldman Sachs, which depend on different triggers and have different characteristics:

1. Structural bear market – triggered by structural imbalances and financial bubbles; very often followed by a “price” shock such as deflation
2. Cyclical bear market – typically a consequence of rising interest rates, looming recessions and falling profits; they are a function of the economic cycle
3. Event-driven bear market – triggered by a one-off “shock” that does not lead to a domestic recession (e.g. war, oil price shock, EM crisis or technical market dislocation).

Even if event-driven influencing factors (especially the Russian invasion of Ukraine) and patterns of a structural bear market (such as the speculative rise in cryptocurrencies) can be observed in the current bear market, it has clear characteristics of a cyclical bear market with the high inflation and the initiated US interest rate turnaround. At the same time, the still very healthy balance sheets of households and companies (high excess savings) and the robust labour market also speak for a cyclical character. Indeed, the concern that the Fed might be forced to curb economic growth by tightening its monetary policy to such an extent that a recession is inevitable as a result has contributed significantly to the current bear market. Unsettled by the Fed’s aggressive steps to make borrowing more expensive for businesses and households, markets seem to be pricing in the risk of recession.

³Goldman Sachs Global Macroscope (21 June 2022): A Bear Market Transition to the Post-Modern Cycle.

BEAR MARKETS IN THE PAST OFTEN A FAVOURABLE TIME FOR MEDIUM TO LONG-TERM ASSET ACCUMULATION

While investors often tend to use periods of high volatility and sharp price corrections as an opportunity to sell rather than invest in their portfolios at low prices, a well-balanced diversified portfolio with high quality can help cushion losses. Bear markets have, moreover, often been a good time for investors to build up assets over the medium to long term in the past, and the successive deterioration in sentiment in recent months, combined with rising interest rates, has already made equity valuations much more attractive. We believe we are well prepared and positioned to realise long-term return opportunities when it becomes apparent that we are leaving the current challenging market phase behind.

The crucial question investors ask themselves is whether we are only at the beginning of a bear market or have already passed the bottom. Sometimes the bear market lasts for months after the market has already fallen by 20% (like during 2000/2001), sometimes it is over after a few weeks (like in 2020). But what does it take for the stock markets to experience a sustainable recovery? An **analysis by Goldman Sachs**⁴ suggests that in previous corrections, which like the recent bear market were essentially triggered by monetary tightening, the US stock market usually bottomed out when the Fed sent signals of monetary easing – even before the economy picked up again.

⁴Goldman Sachs Global Markets Daily (23 May 2022): What Makes a Trough the Trough?

When the correction is essentially due to monetary tightening, the transition to a less **hawkish**⁵ monetary policy has usually provided fairly immediate relief.

When the time will come for such a regime change in US monetary policy can hardly be estimated at present. There are still no sustainable signs of a trend reversal in inflation. However, bringing the latter under control and stabilising prices is currently the Fed's top priority. Its commitment to restoring price stability is "unconditional", Fed policymakers recently stressed in their semi-annual monetary policy report to the US Congress – their most emphatic commitment yet to tackling the most acute inflation problem in some 40 years.

⁵The term "hawkish" refers to an economic situation in which higher interest rates are expected. This is based on the assumption that an increase in inflation will have a negative impact on the economy.

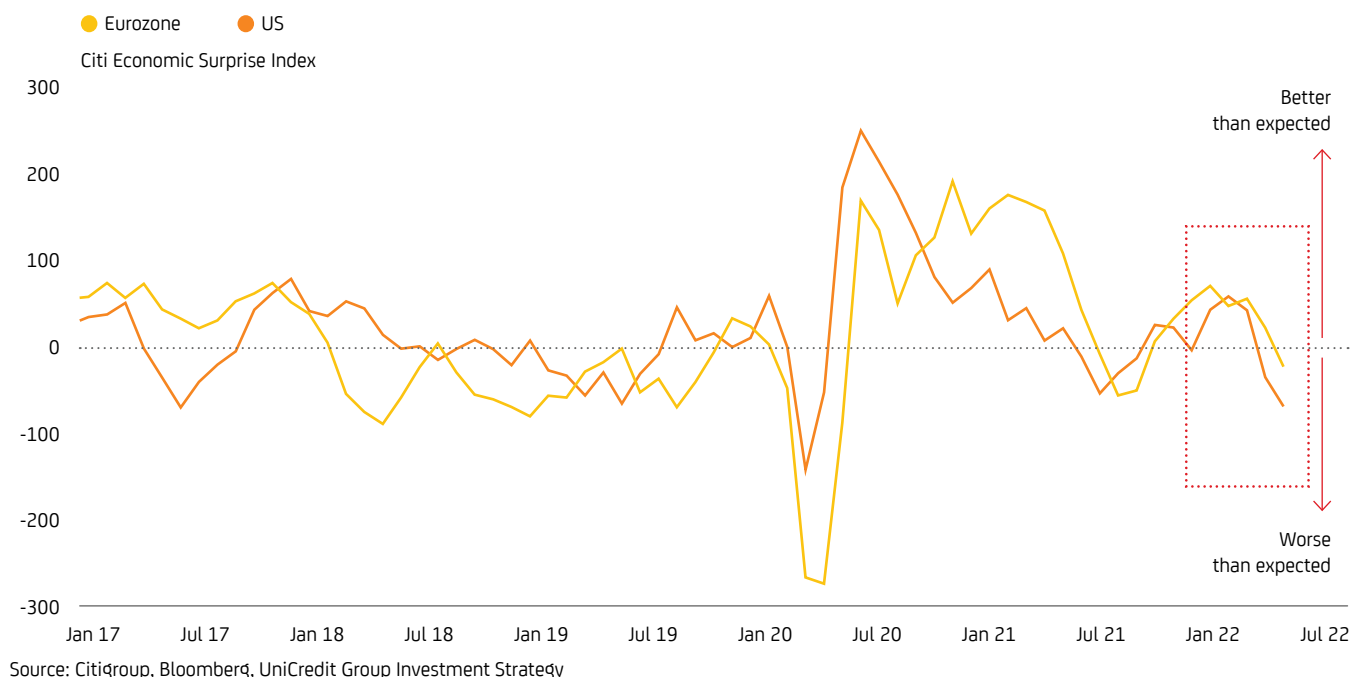
Macro & Markets

US economy: recession risk increases for 2023 – will the soft landing succeed?

Over the last two months, economic data in the US and the euro area have continued to deteriorate. The **Citigroup Economic Surprise Index**⁶ last showed in June that the corresponding indicators in both regions have developed worse than analysts expected (see chart 4). There are increasing signs of a slowdown in economic activity, especially in the US: employment growth continues to weaken over time (despite the most recent good June figures), wage growth is declining, and supply chain bottlenecks continue to ease. Still high commodity prices as well as persistently high inflation expectations of private households are increasingly weighing on the economy.

⁶The Citigroup Economic Surprise Index is a Citigroup indicator that shows the extent to which the actual economic development (measured via published indicators) corresponds to the general forecasts (for these indicators). If the indicator is positive, the actual development was better than the forecasts. If, on the other hand, it is negative, the forecasts were not met.

4. ECONOMIC DATA HAVE DISAPPOINTED RECENTLY

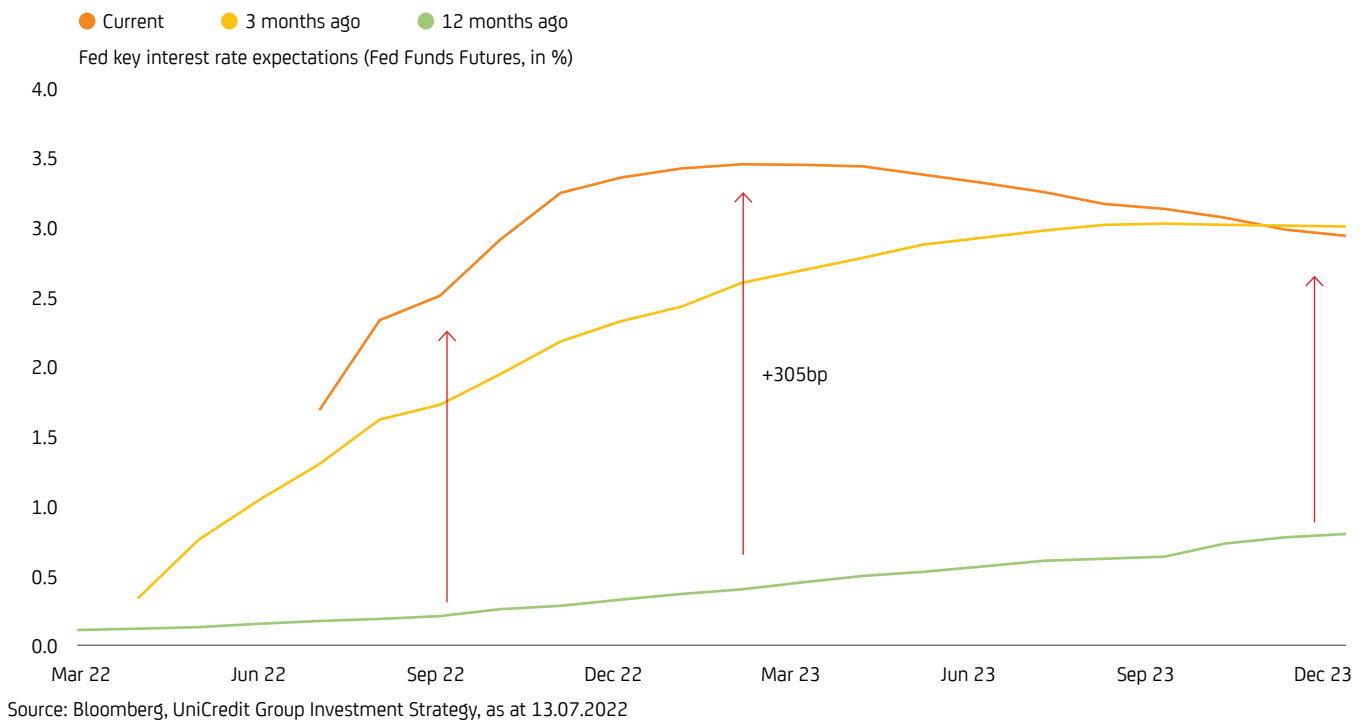


TIGHTER MONETARY POLICY AND FINANCIAL CONDITIONS WEIGH ON US GROWTH

Due to the persistently high inflation rates, the Fed has significantly pulled forward its targeted interest rate hikes. As a result, market-based expectations for future rate hikes have also increased significantly (see chart 5). Thus, key interest rate expectations, as measured by the **Fed Fund Futures rates**⁷, have risen by more than 300 bps at their peak within the last 12 months, even though expectations of higher key interest rates have recently been lowered again. However, compared to three months ago, the financial markets are now pricing in the first interest rate cuts next year. The latter are mainly driven by the recession fears that have arisen for 2023, which have pushed investors' inflation concerns into the background.

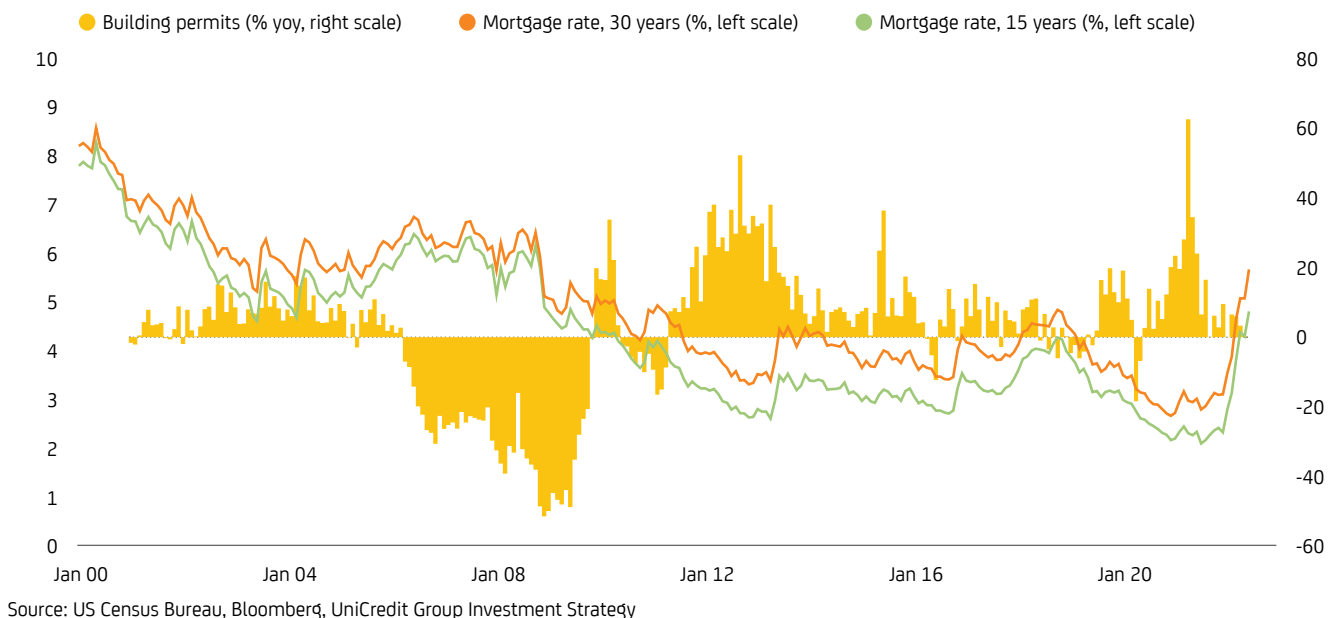
⁷Fed funds futures are financial contracts that reflect market participants' expectations about where the daily official Fed Funds rate will be at the time the contract expires. The Fed Funds Rate is the interest rate that US commercial banks charge each other for one-day loans (Interbank Overnight Lending Rate). This interest rate is thus determined by the market and not explicitly by the Fed. Through liquidity adjustments, however, the Fed tries to steer the Fed Funds Rate towards its monetary policy target rate.

5. INTEREST RATE EXPECTATIONS HAVE CORRECTED SIGNIFICANTLY UPWARDS



The tightening of US monetary policy so far, and the outlook for possible further interest rate hikes, are already having an effect in some sectors, especially in the US housing market. Accordingly, for example, US mortgage rates for 15- and 30-year fixed-rate mortgages have risen significantly in the first half of this year (see chart 6). While 15-year rates are currently just below 5%, 30-year rates are already above this mark at 5.7%. During the same period, building permits declined noticeably, and it is probably only a matter of time before they too decrease more significantly.

6. RISING MORTGAGE RATES HAVE HAD A NEGATIVE IMPACT ON THE US REAL ESTATE MARKET



In addition to the slowdown in the US housing market and the weakening economic momentum in the US economy, financial conditions have also continued to deteriorate (see chart 7). The **National Financial Conditions Index (NFCI)**⁸, published by the Chicago Regional Federal Reserve, moved out of the range of loose financial conditions and into the tightening range in June. We expect tighter financial conditions, which are the transmission channel of tighter monetary policy, to also weigh on US growth in the coming months.

⁸The NFCI measures financial conditions in the US: positive values are associated with tighter than average financial conditions, while negative values represent looser than average financial conditions. The index takes into account conditions in the money markets, the bond and equity markets, and the traditional and “shadow” banking systems.

7. TIGHTENING FINANCIAL CONDITIONS WILL WEIGH ON US GROWTH



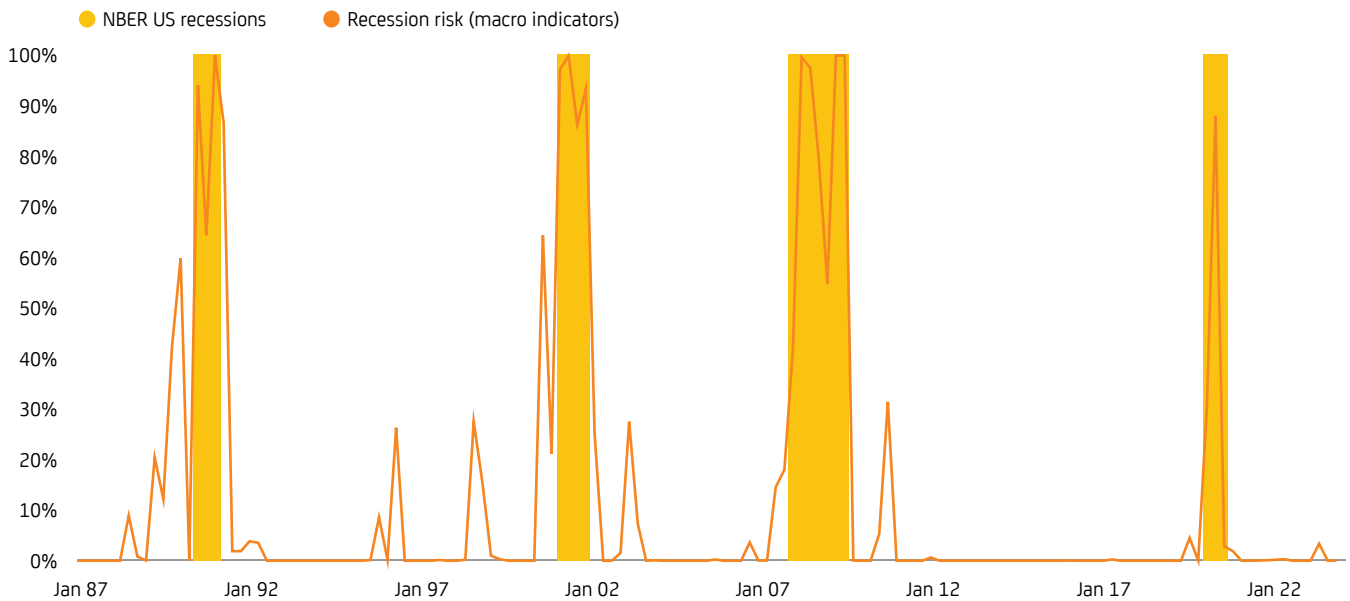
RISK INCREASES, BUT NO RECESSION TO BE EXPECTED IN THE NEAR FUTURE

In addition to the weakening tendencies, however, supporting factors can also be observed. Positive signals came most recently from the US labour market, which continues to be in solid shape, although employment momentum is slowing here as well. According to the report, 372,000 new jobs were created in June, about 100,000 more than expected, although the two months before were revised downwards by about 70,000 jobs. Overall, however, this is still a fairly solid gain, underpinning the strength of the US labour market and, in our view, significantly increasing the likelihood of a 75 bps hike by the Fed at its upcoming July meeting. Another positive factor should come from the US consumer, who despite a deterioration in consumer sentiment and a lower savings rate of around 5%, still has a massive pandemic savings surplus (since March 2020) of around USD2.5 trillion to fall back on. This should support consumption and thus growth in the second half of this year.

Looking only at macroeconomic indicators and assuming a further cyclical weakening of the economy over the next few quarters, these indicators do not show an increased risk of recession at present or in the next twelve months (see chart 8). Many macro indicators have already weakened over the past months and are expected to continue to do so over the course of the year. In addition to survey data, such as the ISM for industry and consumer confidence, “hard” data such as employment and building permits have also lost momentum. Still, the slowdown is not sufficiently large for our **recession indicator**⁹ to show more significant swings of a higher probability of recession.

⁹Our recession indicator attempts to predict the likelihood of a recession in the US with the help of four macro indicators. The indicators include the ISM for industry, consumer confidence from the Conference Board, as well as employment and building permits. The forecast over the next twelve months is based on forward projections of each macro indicator over that period. Higher percentage values then indicate an increased risk of recession.

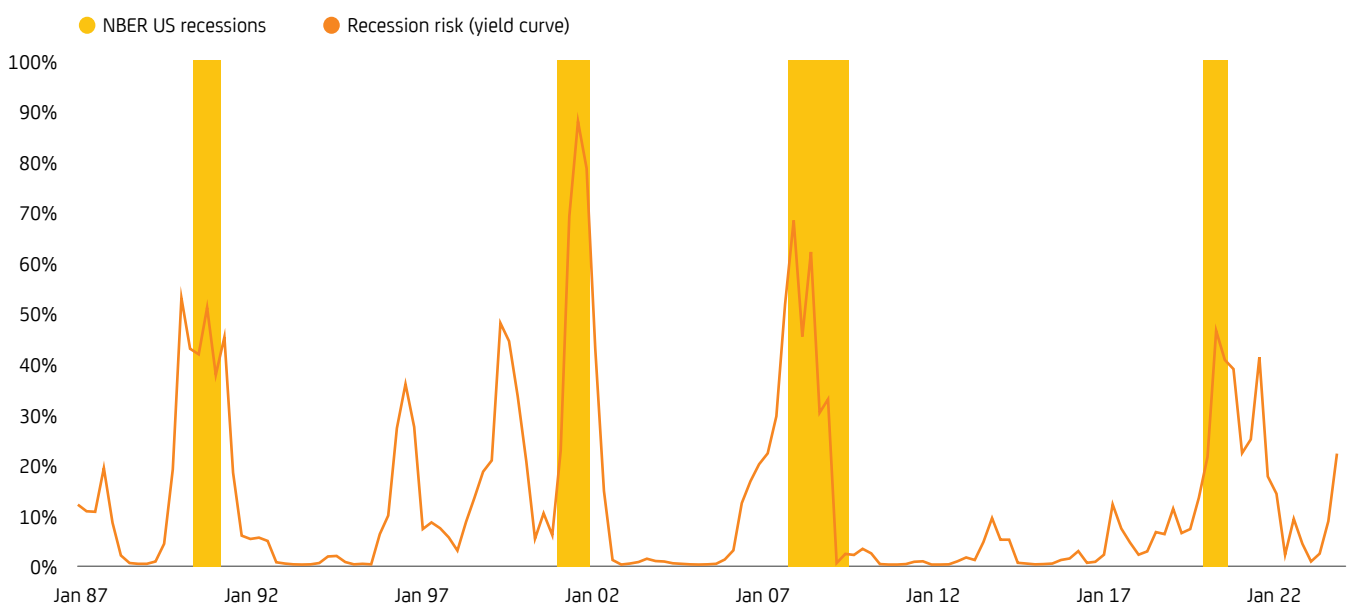
8. TIGHTENING FINANCIAL CONDITIONS WILL WEIGH ON US GROWTH



However, the probability of a recession can also be estimated using financial market variables. Using the interest rate structure of US government bonds as an indicator, for example, one of our alternative **recession models**¹⁰ shows an increased risk of a US recession of around 20% in 2023 (see chart 9). The model assumes that a flattening or inversion of the interest rate structure (i.e. short-term government bond yields exceed long-term yields) is a valid signal of an impending recession. The background to this is the assumption of market participants who, as a result of an economic slowdown, demand long-dated government bonds more strongly, as they assess short-term economic risks higher than long-term ones – with the consequence that yields at the long end of the curve fall. Nevertheless, it remains to be mentioned that the recession signals derived from the interest rate structure have shown higher volatility in risk premia and thus several false signals over the past years. This is probably largely due to the ultra-loose monetary policy of central banks since the financial crisis. Nevertheless, the recession probabilities derived from interest rate structure models can usefully complement the economic picture in the US. Independent of our own research, market analysts currently put the US recession probability at just over 30%.

¹⁰We use a recession model in which only the interest rate structure is used. This uses the yield differential between the 2-year and 10-year and the differential between the 3-month and 10-year US government bond yields. The forecast over the next 12 months is made using forward projections of the individual interest rates over this period.

9. ALTERNATIVE INDICATORS SEE INCREASED RECESSION RISK IN 2023



FACTORS THAT INCREASE OR REDUCE THE RISK OF RECESSION

We currently see two factors that could increase the risk of a recession in 2023. The first factor relates to the Fed's move to tighten monetary policy more sharply by raising policy rates further into the restrictive range (i.e. further above the **neutral rate**¹¹ of 2.5%). Some of this is likely already reflected in the yield curve, though not all. This tightening could lead to an additional acceleration of the weakening of economic activity, which can already be observed due to the very "hawkish" orientation of the Fed. This would then also increase the risk of an increasingly severe weakening of the US economy to the point of a contraction next year.

The second factor concerns the Fed's basic stance of focusing primarily on fighting inflation. While Fed Chairman Powell had explicitly stated at his press conference in June that the Fed did not intend to deliberately induce a recession, a "soft landing" would be difficult to achieve. However, with its focus on fighting inflation at all costs, the Fed has set the bar very high for a slowdown in the pace of monetary tightening. Conversely, this means that a "hard" landing has become more likely. The Fed may eventually be forced to respond forcefully to high headline inflation, especially if energy prices continue to rise.

In contrast, a key factor that should dampen both factors and thus the probability of recession over the coming quarters is the likely further weakening of economic momentum, which in turn should lead to a weakening of inflation momentum. We believe that the Fed will pause its tightening cycle or possibly end it altogether as soon as inflation rates have peaked and inflation shows significantly lower year-on-year growth rates (if only because of the elimination of the high base effects next year). This is also supported by the fact that the current high inflation expectations do not seem to be nearly as firmly anchored as they were in the 1980s, when the two oil price shocks set in motion a wage-price spiral over a longer period of time. With declining household inflation expectations, a further weakening of labour market dynamics and a concomitant decline in wage growth, a "soft" landing may still succeed.

CONCLUSION

Tighter monetary policy and tightening financial conditions will further strengthen the already weakening economic momentum of the US economy. We do not see the risk of a recession in the US this year, but the risk has increased for 2023. Above all, the danger that the Fed, due to its strict focus on fighting inflation, will continue to burden the US economy with an excessively tight monetary policy could further increase the probability of recession in the coming year. In the end, therefore, it will be up to the US central bank itself to decide whether the intended soft landing turns into a bumpy, or even hard, landing.

¹¹The neutral interest rate describes the equilibrium interest rate of an economy at which economic activity is neither slowed down nor accelerated. Interest rates above (below) the neutral interest rate are therefore in the restrictive (expansionary) range.

Asset Allocation – How we manage our portfolio mandate

Defensive but ready to catch up the next investment opportunities

Asset		Investment Universe	Investment View		
			Negative	Neutral	Positive
Main Asset Classes		Global Equities	○	●	○
		Global Bonds	●	○	○
		Money Markets	○	○	●
		Alternatives	○	●	○
Main Asset Classes in Detail	Equities	US	○	●	○
		Europe	○	●	○
		Pacific (DM ¹)	○	●	○
		Emerging Markets	○	●	○
	Bonds	EMU Government Bonds	●	○	○
		Non-EMU Government Bonds	○	●	○
		EUR IG Corporate Bonds	○	○	●
		HY Corporate Bonds	○	●	○
	Commodities	Emerging Market Bonds	○	○	●
		Oil	○	●	○
		Gold	○	○	●

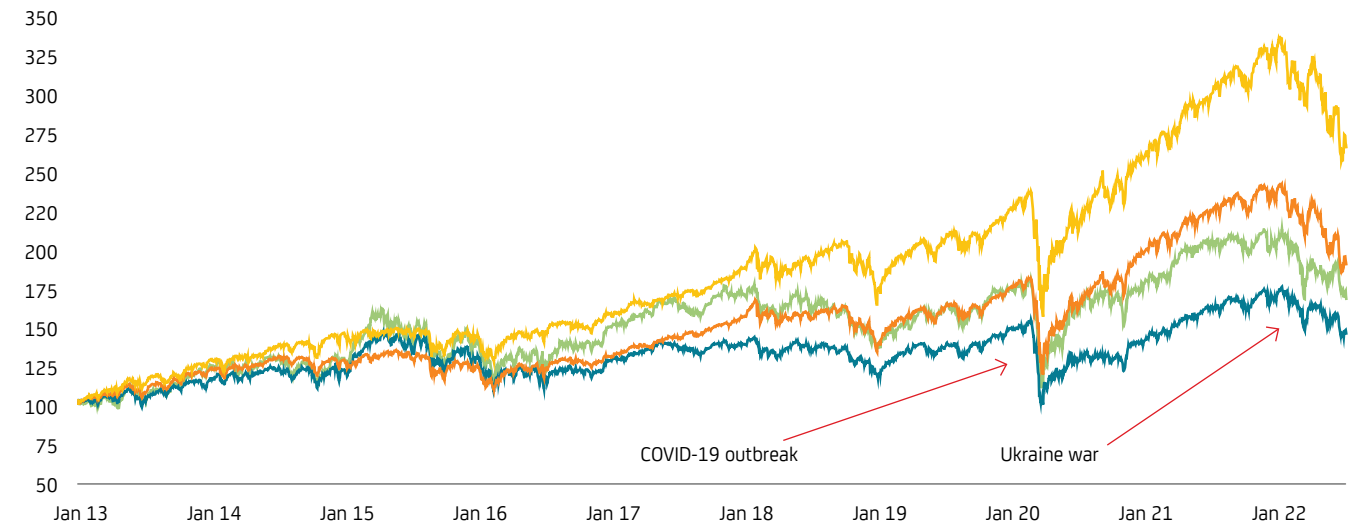
¹DM= Developed Markets (Australia, Japan, Hong Kong, New Zealand, Singapore)

In the first half of 2022, the traditional global asset allocation portfolio failed to protect investors due to the positive correlation between bonds and equities, which were both penalised by fears of stagflation, i.e. the combination of high inflation and low growth.

10. WEAKEST FIRST HALF-YEAR PERFORMANCE IN DECADES

● S&P 500 (in USD) ● MSCI World (in USD) ● DAX 40 (in EUR) ● Stoxx Europe 600 (in EUR)

Stock markets worldwide (1.1.2013 = 100)



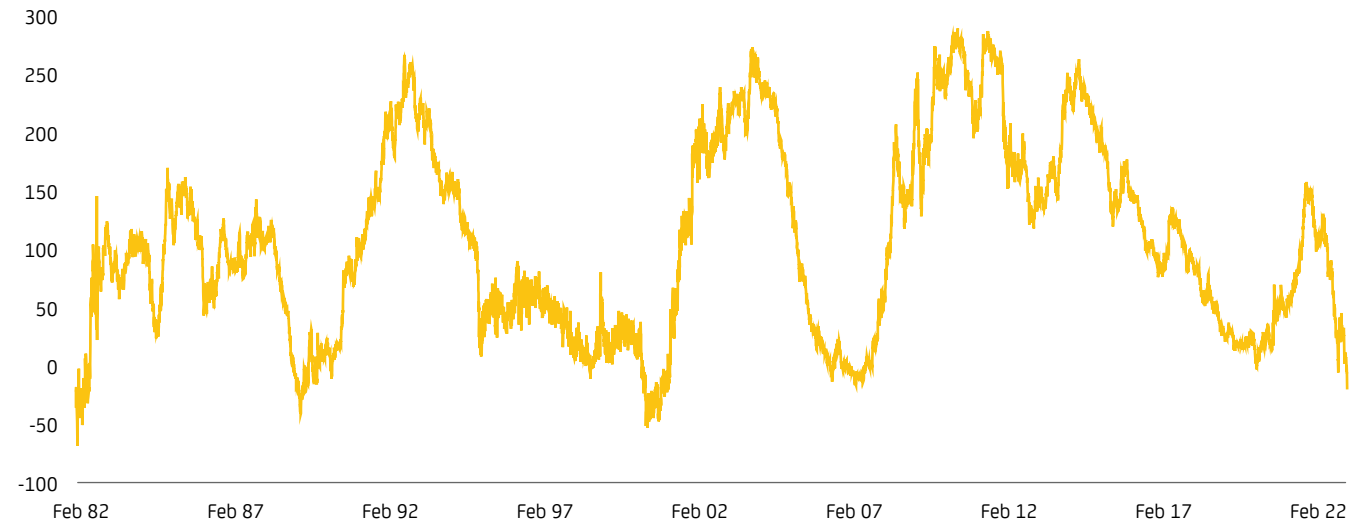
Source: Refinitiv Datastream, UniCredit Group Investment Strategy

As for growth, while we do not have the global recession scenario as the baseline scenario, the probability of a material downturn has increased remarkably in recent weeks.

On 12 July, the 2-10 year government bond yield gap, one of the most watched indicator of recession risk, dropped to nearly 10, a level last seen in 2007.

11. THE US 2 YR-10 YR GOVERNMENT BOND YIELD CURVE INVERTED AT LEVEL LAST SEEN IN 2007

● Yield spread between 2Y and 10Y US treasuries



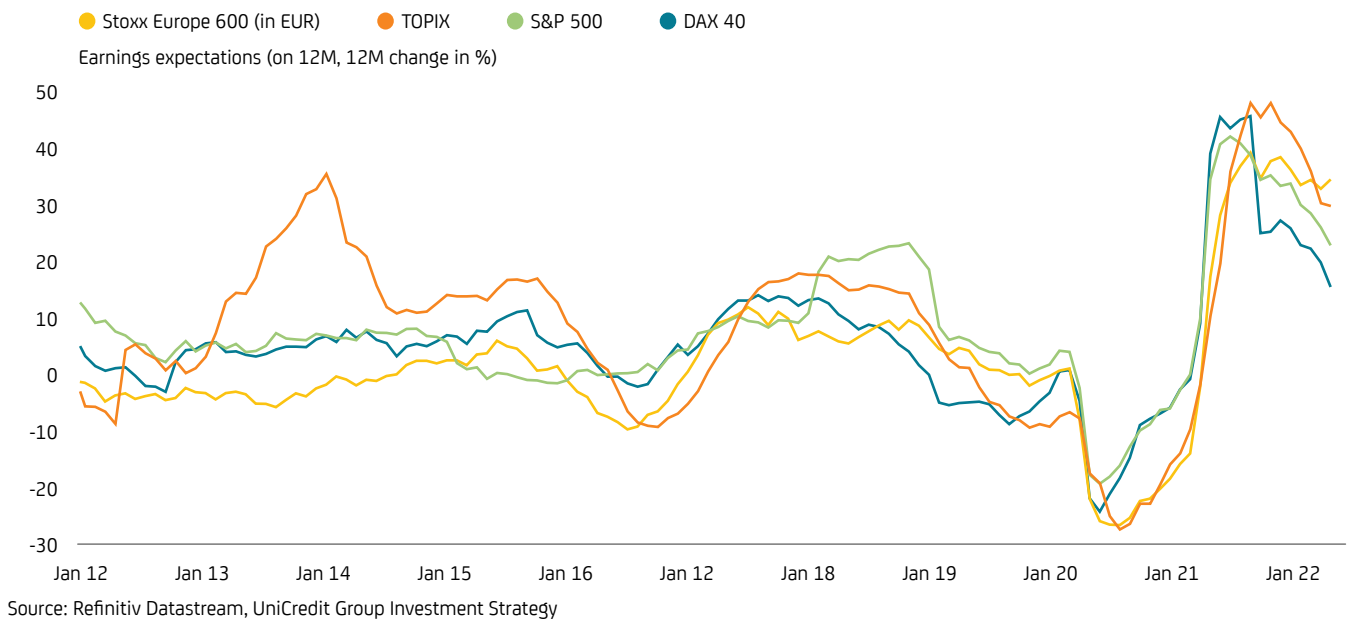
Source: Bloomberg, UniCredit Group Investment Strategy

Our main concern in this respect is the Eurozone, due to the obvious implications of energy policy and dependence on Russia. In Germany the government is even considering the bail-out of the troubled utilities, to face the issue of Russia's squeezing of gas supplies.

In other words, the Eurozone associates the risk of a recession driven by restrictive monetary policy, as it is in the US, with the risk of recession due to gas rationing, particularly in Germany and Italy.

Earnings growth forecasts still appear too high to us, which is why we assume further revisions, as financial analysts tend to revise them with a certain time lag and wait for top management guidance.

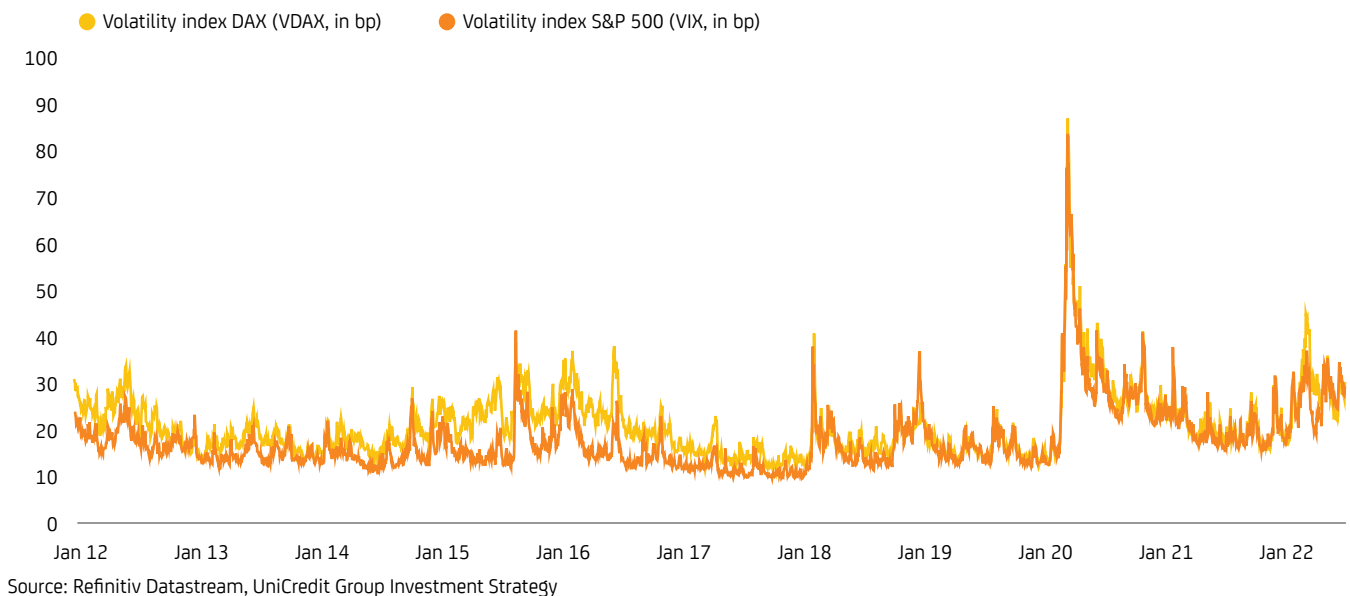
12. PROFITS EXPECTATIONS POSSIBLY TOO OPTIMISTIC



Under this perspective, the ongoing Q2 earnings season will be an important test, particularly with regard to the earnings guidance of the top management. It will be key to understand if companies have still enough pricing power to defend their margins.

We expect equity markets to remain vulnerable and volatile over the summer. So far, we have seen 'bear market rallies' and not yet the phase preceding sustainable stock market recoveries, the so-called 'capitulation' phase – which is characterised by equity volatility of more than 40% and strong equity redemptions. Year-to-date we have in fact not yet seen any noteworthy equity redemptions, except, to a small extent, for long-only funds.

13. HIGHER EQUITY VOLATILITY, BUT STILL BELOW THE CAPITULATION PHASE



14. YEAR-TO-DATE FLOWS INTO EQUITIES REMAIN POSITIVE

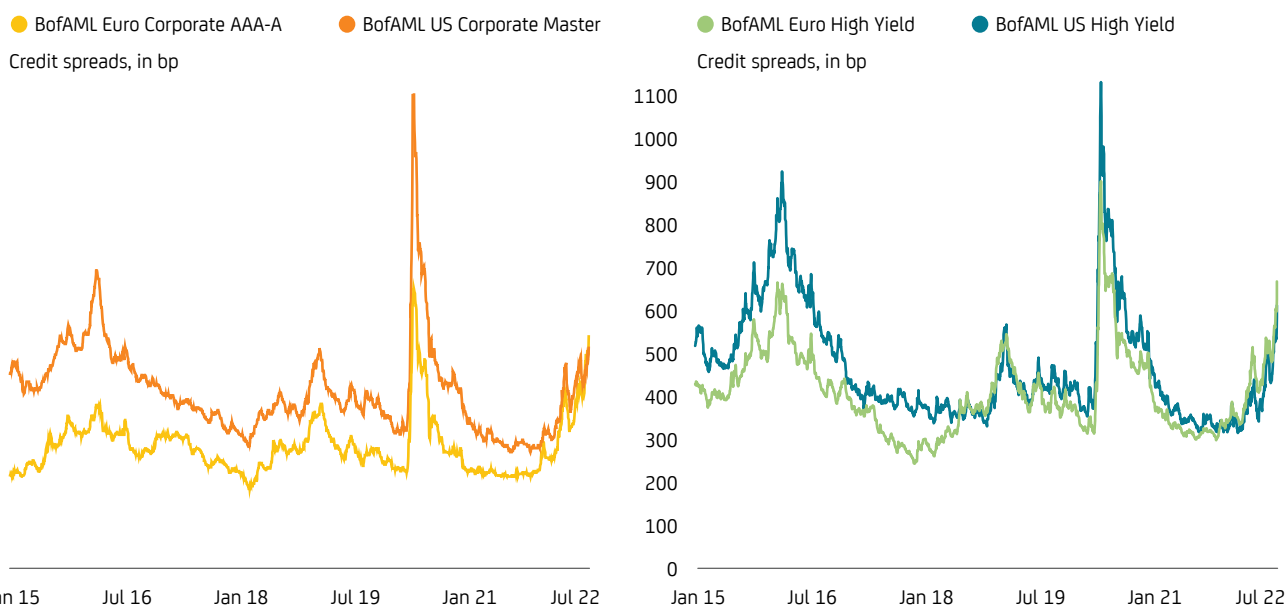
	YTD	YTD%AUM
Equities	188,920	1.1%
ETFs	326,001	4.4%
Long-only funds	-137,202	-1.5%
Bonds	-209,802	-3.0%
Commodities	18,813	4.6%
Money-market	-276,971	-4.1%

Source: BofA Global Research

Therefore, on the equity side, we stick to our neutral stance with a global geographic tilt, due to the recent downgrade to neutral from overweight of both European and Emerging Market (EM) equities. Sustainable equity buying opportunities may well rise over the medium- to long-term horizon, especially considering the growth companies, particularly “the long duration” tech companies once the Fed will reverse its tightening. On a short-term basis, we stick to our call for quality, focusing on pharma, consumer staples and energy industries and, more generally, on companies with higher pricing power and with high cash flow generation.

As for credits, we believe that, like equities, they are not yet fully pricing the hard landing scenario and we judge their spreads vulnerable to further widening – and their default rates to rising.

15. CREDIT SPREADS: VULNERABLE TO FURTHER WIDENING IN CASE OF RECESSION

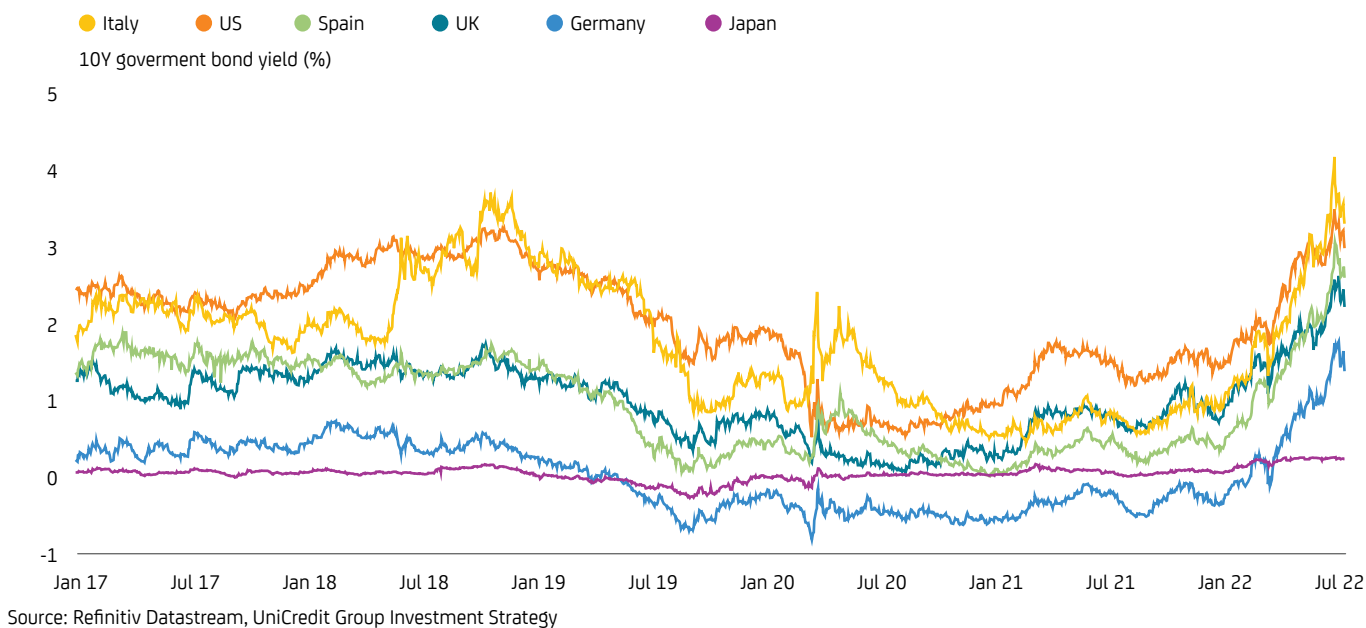


Source: Refinitiv Datastream, UniCredit Group Investment Strategy

On the contrary, we already see first entry points on US and European government bonds, where we have reduced the underweight versus the benchmark and gradually increased their duration.

We believe that markets are discounting an ECB action that is too aggressive in relation to the different nature of European inflation, which is mainly energy prices driven, and its higher geopolitical downside risks. Even in the US, where the core inflation (5.9% year-over-year in June) is well above the Eurozone core rate, we judge that the Fed will not fully deliver all the hikes as of its dot-plots, and we expect the US central bank to pause its tightening cycle in the first half of 2023 and to cut rates by end of next year.

16. FIRST ENTRY POINTS ON GOVERNMENT BONDS



To sum up, we expect a tough and volatile environment for financial investors in the short term but with the possibility of some tentative comeback of the negative correlation between government bonds and equities. At least, after the worst first half year in decades, the traditional global balanced portfolio could resume functioning. And government bonds may prove to be a precious macro hedge in case of a pronounced global slowdown, provided we see inflation peak and fall over the next months on a sustained basis. We will closely monitor the inflation dynamics, both in the US and Eurozone.

Stay tuned and ready to catch up on the next investment opportunities.

UniCredit Group Investment Strategy – Asset Allocation Stances

NEUTRAL ON GLOBAL EQUITIES

Lower global growth and negative earnings revision. Medium- to long-term investment opportunities due to the cheaper valuation.

NEUTRAL EUROPEAN EQUITIES

Rising risk of stagflation and a restrictive ECB. Also, the Eurozone is the most affected area from the Russia/ Ukraine war. In the longer term, the Eurozone should benefit from higher investments in the energy and defense industries.

NEUTRAL US EQUITIES

Strong job market, earnings resilience, hawkish Fed.

NEUTRAL EMERGING MARKET EQUITIES

Lower global growth and falling liquidity due to the Fed's restrictive policy and the strengthening of the US dollar. Countries and sectors selectivity among EMs is strongly recommended.

NEUTRAL PACIFIC EQUITIES

Exports supported by the weak Japanese yen but affected by lower global growth.

UNDERWEIGHT GLOBAL BONDS

Vulnerable to increasing inflation and rising interest rates.

OVERWEIGHT EURO INVESTMENT GRADE CORPORATE BONDS

We are increasing our selective and defensive tilt.

NEUTRAL HIGH YIELD CORPORATE BONDS

Carry play but vulnerable to the hard landing and lower liquidity scenarios. We are increasing our selective and defensive tilt.

UNDERWEIGHT EMU GOVERNMENT BONDS

Vulnerable to the ECB tightening but we are reducing the underweight and gradually increasing the duration of the government bonds portfolio.

NEUTRAL NON-EMU GOVERNMENT BONDS

Long-term investment opportunities in US governments bonds but the sticky US inflation suggests a gradual path.

OVERWEIGHT EMERGING MARKET BONDS

The search for yield supports our positive stance, but we are defensive and selective considering the Fed's tightening and inflation in EMs.

POSITIVE LIQUIDITY

To be used mostly as parking and hedging for uncertainty.

NEUTRAL ALTERNATIVES

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

COMMODITIES

Late cycle asset class, supported by a global recovery and, as for fossil energy and metals prices, by geopolitical tensions.

POSITIVE GOLD

Hedging for uncertainty.

CURRENCIES

Flight to quality in the current risk-off environment and a more restrictive Fed continue to support the US dollar.

Columns

Local CIOs in dialogue with the clients

Answers from Italy

WHAT IS HAPPENING TO THE OIL PRICE?

The prices of futures contracts on Brent (the oil extracted in Europe in the North Sea) and on the WTI (West Texas Intermediate, which is extracted in the south of the US), saw a correction of around USD20 a barrel from mid-June to mid-July. The current levels remain high in historical terms but the contraction in prices was important and very sudden.

The main reasons for this downward movement on futures are fears about the dynamics of prices in the coming months and, in particular, the current economic slowdown especially in Europe, and the erosion of household purchasing power caused by inflation – which is now a global phenomenon (and one that is also triggered by the increase in energy commodities prices!). These are all elements that may continue to negatively affect future levels of consumption.

On the other hand, the continued increases in short term rates by the Fed bite on speculative financial flows, which had partly contributed to fuel the bullish movement in commodities in the first part of the year. In fact, many global investors, due to the positive (downward) correlation between bonds and stocks, had increased their exposure to commodities, which represented the only element of portfolio diversification and presented a bullish movement. By acting in a coordinated manner on a global scale, flows have been important. This push factor could also run out because, given the levels reached in long nominal interest rates in the US and Europe, the correlation between equities and government bonds starts to turn negative – and high quality bonds can be used instead of commodities to stabilise portfolios.

As we know, the price is a result of demand and supply, and the latter in particular has strong inelasticities and criticalities. Estimates for global oil production in 2023 are 101 million barrels per day (bbl / d, each barrel contains about 159 liters of oil). The three main oil producers in the world are the US, Saudi Arabia and Russia. The US is in fact energy self-sufficient, and the latter two are the main exporters. Western sanctions and the ban on imports of Russian oil (which is extracted in the Urals, from which it takes its name, and is less valuable than Brent and WTI and is now sold at a discount of about USD30 per barrel) are reducing the supply.

Russia exports around five million bbl / d of oil all over the world, of which around three million bbl / d are to Europe alone. If the year-end ban on insurance for oil tankers carrying it around the world is also introduced, those quantities could almost completely disappear from the global market. The alternative is to introduce a maximum price for Russian oil (the average cost of producing Russian oil is about USD30, while Russia reaches fiscal balance at USD70). However, this measure appears difficult to implement worldwide – especially given the close economic relations that Russia has maintained with many Asian countries. On the other hand, the imposition of the maximum price on Russian natural gas is more possible, as given that gas travels in the pipelines and Russia, if Russia did not want to sell it in Europe at a price, it would not have alternative sales channels.

Meanwhile, Saudi Arabia has an unused capacity of around two million bbl / d. So an increase in Saudi production could at least partially offset the lack of Russian production. This is one of the objectives of President Biden's mission in the Middle East.

Alessandro Caviglia



CIO Italy, UniCredit SpA (Italy)

We must then consider some elements that could instead reduce the structural demand for oil. Recent surveys report that 40% of US consumers plan to buy an electric car in the next five years. In 2018, this percentage was 15%. Today, the transport sector accounts for 60% of global oil demand, so the energy transition will play a major role in price levels going forward. We are also seeing a correction in industrial metals. Some of these like nickel and copper are essential for the construction of electric motors. If those prices were to keep the trajectory, electric cars could be built at lower prices, thereby reducing the demand for oil.

In summary, the current and future dynamics that will impact the price of oil are multiple and highly complex. The volatility that derives from direct investment in energy commodities will certainly remain very high and difficult to manage within a portfolio of financial assets. We therefore prefer to consider the impact of these variables on macroeconomic scenarios and within our processes of allocation and selection of companies and sectors, rather than considering energy commodities an investable asset class in itself.

Answers from Austria

COVID: HOW ARE THE MARKETS REACTING?

For about two years, “COVID” was the dominant theme in all our lives as well as on the financial markets. During the first half of 2022, however, people around the world were spellbound by very different developments. Rising daily costs and inflation and, of course, the devastating development of the conflict between Russia and Ukraine. Of course, the low number of new infections and the low hospitalisation rates have helped to bring back a bit of normalcy. The risks of the pandemic do not seem to be unsettling investors in any way at the moment, or to be influencing their decisions. Are we all rejoicing too soon?

For the assessment, we must take two points of view. Regarding the epidemiological perspective, there are experts outside the financial markets who make their assessments and draw conclusions from the developments. However, recent increases in the number of infections in many countries, postponements of flights, and chaos at many airports because of numerous employees falling ill with COVID, suggest that we cannot yet declare the pandemic over. Viewed from an economic perspective, however, we see a more favourable picture than at the onset of the pandemic, in March 2020:

- Investors have learned to largely overlook this short-term negative factor of economic development. The downturn around March 2020 was followed by a countermovement that has continued to this day, although further waves of the virus hit us again and again. A negative economic development in the euro zone of -6.4% in 2020 was followed by a plus of 5.4% in 2021. In the US, the upswing was even stronger. After a decline in economic output of -3.4% in 2020, it increased by 5.7% in 2021 and was already above the pre-crisis level by the turn of the year.
- The fact that the negative effects on the economy could be compensated for or exceeded within a short period of time was also noted with pleasure by investors. In January this year, even before the escalation of the Russia-Ukraine conflict, many equity indices were significantly higher than before the outbreak of the pandemic.
- By testing out a wide variety of measures, politicians and experts have a better overview of which restrictions and fiscal support work better and which work worse. It can therefore be assumed that future decisions will be taken with the utmost consideration for economic interests in order to minimise the impact on growth. Lockdowns are likely to be the last resort in a long chain of possible measures.
- Where possible, companies have switched to the option of a home office, or many employees still work at home. The IT infrastructure has been created. These processes have become established, and no major investments are required to switch back to this form of working. This should only have a minor impact on operations in many industries.

Viewed in isolation, the risk should therefore be lower than at the beginning of the pandemic. China poses a major risk in this context, as its zero-COVID policy has the strongest impact on the economy and on global supply chains. Price corrections on the stock markets should therefore not be ruled out, but investors have a better knowledge of possible implications and are therefore better prepared than two years ago. Individual industries would probably be more affected, especially those where there is more interpersonal contact. For these reasons, a broad diversification across sectors, industries and investment regions should be considered when it comes to equity investments.

Oliver Prinz



Co-CIO Bank Austria and
Schoellerbank (Austria)

EUROPEAN PARLIAMENT WAVES THROUGH EU TAXONOMY – A WRONG SIGNAL?

In the EU, investments in gas and nuclear power should in the future be able to be classified as sustainable and climate-friendly **under certain circumstances**¹². The European Parliament waved through the corresponding plans of the EU Commission from last year on 6 July, after the members of the Environment and Economic Affairs Committees had still voted against them by a majority in mid-June. Instead of the required 353 members of parliament in Strasbourg, only 278 voted against the legal act on the so-called EU taxonomy. France, which relies on nuclear power as a key technology for a CO²-free economy and wants to continue exporting it to other countries, was the driving force. In return, Germany advocated for a green label for gas as a transitional technology. At midnight on 11 July, the last deadline expired for EU countries to stop the controversial project. The so-called legal act on EU taxonomy will thus enter into force on 1 January 2023.

The latter is a kind of seal of approval for private investments that aims to clearly identify which energy projects are green and sustainable and which are not. It aims to create more transparency, and help investors who want to invest sustainably and to direct their assets into sustainable economic activities to support the fight against climate change. The EU taxonomy is highly relevant for companies because it can influence the investment decisions of investors and thus have an impact, for example, on the financing costs of projects.

Environmental organisations from all over Europe were particularly critical of the EU Commission's plans. Their verdict on the European Parliament's decision was accordingly unanimous. "A fatal signal", said NABU, "a black day for climate protection and for democracy in Europe", from BUND. **Greenwashing**¹³ has now been "officially validated by law", was the assessment of the think tank E3G. Before gas and nuclear power actually receive a sustainability label, however, legal steps must still be awaited. Austria immediately declared after the European Parliament's vote that it would sue the EU over the controversial decision. Luxembourg announced that it would support the Austrian move. Spain and Denmark are also considering joining the suit.

In terms of the sustainable bond market, the launch of gas and nuclear activities is likely to lead to the issuance of corresponding sustainable bonds, such as green bonds for French nuclear energy, although the utility sector already relies heavily on this instrument to finance the transition to renewable energy. However, it remains to be seen whether investors will accept such bonds to finance gas and/or nuclear energy projects as sustainable. Statements from investor groups suggest that parts of the financial industry may even boycott the new sustainability labels in order not to risk being accused of "greenwashing". In any case, irrespective of the latest decision on the implementation of the EU taxonomy, investors will continue to be able to decide for themselves how taxonomy-compliant or sustainable they want to invest in and which exclusion criteria should be applied.



CIO UniCredit Bank AG
(HypoVereinsbank) (Germany)

¹²Investments in new gas-fired power plants are to be classified as sustainable until 2030, provided they replace dirtier power plants and are completely powered by more climate-friendly gases, such as hydrogen, by 2035. New nuclear power plants are to be classified as sustainable until 2045 if the unresolved question of safe final storage sites is resolved by 2050 at the latest.

¹³Greenwashing refers to the attempt by organisations to achieve a "green image" through communication, marketing and individual measures without having systematically anchored the corresponding measures in the operative business. While the term originally referred to suggested environmental friendliness, it is now also used for suggested corporate responsibility.

DEVELOPMENT OF SELECTED FINANCIAL MARKET INDICES

From	19.07.21	19.07.17	19.07.18	19.07.19	19.07.20	19.07.21	19.07.17	01.01.22
To	19.07.22	19.07.18	19.07.19	19.07.20	19.07.21	19.07.22	19.07.22	19.07.22
Stock market indices (total return, in %)								
MSCI World (in USD)	-12.0	11.7	5.4	6.8	32.2	-12.0	47.2	-19.6
MSCI Emerging Markets (in USD)	-23.2	2.7	2.6	3.1	27.5	-23.2	6.6	-18.8
MSCI US (in USD)	-10.8	15.8	8.2	10.9	35.3	-10.8	69.7	-20.0
MSCI Europe (in EUR)	-1.5	3.6	4.0	-2.1	21.9	-1.5	27.4	-11.1
MSCI AC Asia Pacific (in USD)	-20.5	6.3	0.6	6.4	25.5	-20.5	12.7	-17.7
STOXX Europe 600 (in EUR)	-3.0	3.6	3.9	-0.9	22.3	-3.0	27.4	-12.3
DAX 40 (Germany, in EUR)	-14.4	1.9	-3.4	5.7	17.1	-14.4	4.3	-18.4
MSCI Italy (in EUR)	-7.5	3.4	4.0	-8.1	17.8	-7.5	10.7	-19.2
ATX (Austria, in EUR)	-8.1	6.5	-7.3	-21.1	48.7	-8.1	6.5	-22.1
SMI (Switzerland, in CHF)	-4.6	2.4	14.9	7.5	17.4	-4.6	43.6	-12.2
S&P 500 (USA, in USD)	-8.7	15.6	8.3	9.8	34.1	-8.7	70.3	-19.0
Nikkei (Japan, in JPY)	-1.2	15.9	-3.7	10.2	23.8	-1.2	47.6	-5.9
CSI 300 (China, in Yuan)	-14.3	-6.1	13.6	23.3	14.4	-14.3	29.8	-11.7
Bond market indices (total return, in %)								
US Government Bonds 10Y (in USD)	-13.4	-2.8	10.2	17.4	-2.9	-13.4	5.8	-11.9
US Government Bonds (ICE BofA, in USD)	-10.5	-0.7	6.9	11.4	-2.2	-10.5	3.6	-9.3
US Corporate Bonds (ICE BofA A-BBB, in USD)	-14.5	-0.6	9.9	11.0	3.4	-14.5	7.2	-13.5
German Bunds 10Y (in EUR)	-13.2	3.6	7.7	1.5	-0.1	-13.2	-1.7	-11.2
EUR Government Bonds 1Y-10Y (iBOXX, in EUR)	-12.8	2.0	7.0	2.1	0.9	-12.8	-1.8	-11.2
EUR Corporate Bonds 1Y-10Y (iBOXX, in EUR)	-12.0	0.9	5.1	-0.3	3.5	-12.0	-3.6	-10.8
Bond yields (change in basis points = 0.01 percentage points)								
US Government Bonds 10Y (in USD)	178	58	-80	-141	55	178	70	146
US Government Bonds (ICE BofA, in USD)	235	86	-74	-148	33	235	130	192
US Corporate Bonds (ICE BofA A-BBB, in USD)	274	85	-76	-116	-13	274	154	233
German Bunds 10Y (in EUR)	159	-21	-64	-13	5	159	66	134
EUR Government Bonds 1Y-10Y (iBOXX, in EUR)	175	-4	-63	-19	-4	175	82	153
EUR Corporate Bonds 1Y-10Y (iBOXX, in EUR)	273	13	-64	23	-46	273	197	239
Spreads on government bonds (credit spreads, change in basis points)								
US Corporate Bonds (BofAML US Corporate Master)	62	13	-5	27	-53	62	45	57
US Corporate Bonds (BofAML US High Yield)	181	-5	48	163	-230	181	156	215
Euro Corporate bonds (BofAML Euro Corporate AAA-A)	92	15	-10	20	-33	92	84	79
Euro Corporate Bonds (BofAML Euro High Yield)	324	70	12	127	-189	324	342	300
Money market rates (change in basis points)								
Libor (USD, 3 months)	260	104	-9	-201	-14	260	143	253
Euribor (EUR, 3 months)	0	1	-5	-7	-11	0	0	0
Euro exchange rates (change in %)								
US Dollar (EUR-USD)	-13.9	0.5	-3.1	1.9	3.0	-13.9	-12.3	-10.6
British Pound (EUR-GBP)	-1.4	0.9	0.4	1.4	-5.7	-1.4	-4.6	0.8
Swiss Franc (EUR-SFR)	-8.6	5.7	-5.1	-2.8	0.8	-8.6	-10.1	-4.1
Japanese Yen (EUR-JPY)	8.7	1.5	-7.7	1.4	5.3	8.7	8.3	7.5
Commodities (change in %)								
Commodity Index (GSCI, in USD)	-6.1	-2.2	16.0	24.5	-2.1	-6.1	30.0	-6.8
Industrial metals (GSCI, in USD)	-8.3	3.2	-2.5	-3.6	42.3	-8.3	25.1	-17.1
Gold (in USD per fine ounce)	-5.3	-2.0	17.4	27.0	-0.1	-5.3	37.8	-6.1
Crude oil (Brent, in USD per barrel)	54.8	47.8	-15.0	-30.1	59.0	54.8	118.2	35.7

Please note: Past values and forecasts are not a reliable indicator of future performance. Indices cannot be purchased and therefore do not include costs. When investing in securities, costs are incurred which reduce the performance. The return on investments in foreign currencies may also rise or fall as a result of currency fluctuations. So-called synthetic bonds are calculated to reflect the performance of government bonds in a fixed maturity range. In each case, the most "suitable" real federal bond at the relevant time is used as a reference for the yield opportunity of the synthetic bond. The development of the expected yield to maturity is shown under the following conditions: servicing of interest payments and redemption in accordance with the terms and conditions and holding until maturity. In this respect, it is a yield opportunity. The yield opportunities reflect the different risk assessments of the investors for the respective products or countries (higher yield opportunity=higher risk assessment). The synthetic bonds cannot be purchased and therefore do not include any costs. In the case of currencies and commodities, acquisition and/or custody costs incurred are not included. Source: Refinitiv Datastream.

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