The economic outlook for 2021 remains positive despite the renewed escalation of the pandemic. In the near term, fresh lockdowns and certain event risks keep us from taking an even more bullish position.

Dr Frank Engels,
Head of Portfolio Management

Market news and expert views

Monthly report
January 2021

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The markets at a glance

Summary

We are looking ahead to the new year with optimism. Widespread availability of a coronavirus vaccine (albeit not until mid-2021), rocketing economic growth from the second quarter and continued monetary and fiscal policy support should make 2021 a year of opportunities. The capital markets hold potential in the near term too.

But there is also lingering uncertainty. On the back of very upbeat market conditions in November, especially in the stock markets, sentiment indicators and other technical barometers have risen to levels which typically suggest that market consolidation is needed. In addition, the end of the year typically brings an increased risk of liquidity drying up. The pace of the economic recovery has slowed compared with the very buoyant third quarter. And last but not least, the markets will be facing event risks (despite agreement being reached on the European recovery fund) in connection with Brexit and the Senate run-off election in the US state of Georgia.

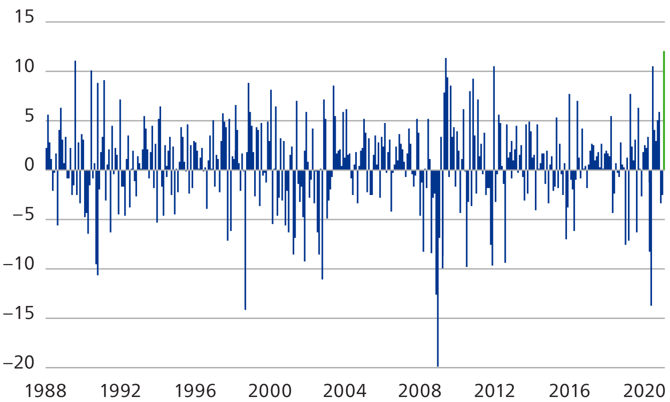
We are taking a cautiously constructive position in consideration of these factors and confirmed our slightly bullish positioning at the last scheduled meeting in 2020. The risk strategy remains neutral (RoRo meter at level 3). At the same time, we are maintaining our opportunity-oriented positions on the equity side (in emerging markets (EMs)) and on the fixed-income side (in corporate bonds). In early December, we made an adjustment on the fixed-income side and have since shifted our preference from periphery paper to high-yield corporate bonds. The overriding objective of this was to substitute lower-yielding with higher-yielding paper. We also collected profits on our currency positions, which had performed very well. In addition, we now recommend a cautious approach to industrial metals because this commodity segment has already priced in much of the economic recovery that is yet to happen.

Economy, growth, inflation

Economic conditions remain positive despite the escalation of the pandemic. Asia in particular continues to recover rapidly. For instance, Korean export figures – which are often used as a leading indicator for global trade due to the openness of the country's economy – showed no sign of weakness at the start of December, despite stricter coronavirus containment measures in western sales markets. The last available data points for the eurozone from before the reintroduction and tightening of lockdowns also indicated strong momentum. Industrial output in the eurozone, for example, improved by 2.1 per cent month on month in October, narrowing the gap to the prior-year figure to just 3.9 per cent.

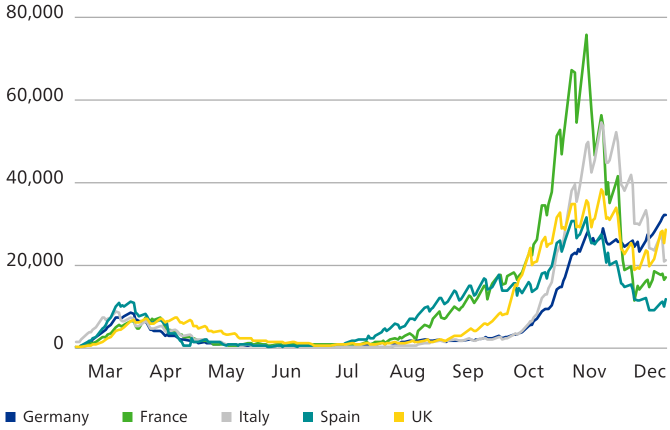
The economic recovery therefore generally remains intact but its pace is slowing slightly compared with the very buoyant third quarter. Our own leading indicators confirm this observation. The stricter and longer the lockdown measures are, the more pronounced the braking effect is likely to be. But this slowdown is definitely a temporary phenomenon that should be limited to the winter months. With the advent of spring and widespread availability of a vaccine, we expect to see catch-up effects with regard to consumer spending and capital expenditure that are pent up or on hold. Economic growth should therefore take off in the second quarter of 2021, meaning that the pattern is likely to be similar to that of 2020. Lockdowns in spring will be followed by a strong rebound in the summer. Overall, the prevailing conditions are those of an early-cycle environment.

A November to remember: record month-on-month gains
Month-on-month performance of the MSCI All Countries World index (%)



Source: Bloomberg, as at 30 November 2020.

Lockdowns in France and Italy prove effective
New cases per day (seven-day average)



Sources: Bloomberg, own calculations, as at 17 December 2020.

The markets at a glance

Monetary policy: ECB has delivered

As expected, the European Central Bank (ECB) expanded and extended its support measures at its meeting in early December. Public attention was focused on the €500 billion increase in the ECB's bond purchases under the pandemic emergency purchase programme (PEPP) and the extension of the programme until at least the end of March 2022. But other steps such as the recalibration of conditions for the third round of targeted longer-term refinancing operations (TLTRO III) and the announcement of four additional pandemic emergency longer-term refinancing operations (PELTROs) were just as important. The objective of these measures is simply to maintain favourable funding conditions for governments, banks, companies and households while the pandemic persists. European monetary policy thus continues to offer support but is not providing any additional stimulus.

The ECB's inflation outlook provides no reason to doubt that policy will remain very expansionary. The central bank expects that the rate of inflation will remain below 2 per cent even in 2023.

The US Federal Reserve stated unequivocally on Wednesday night that it will continue to purchase bonds until substantial further progress has been made towards its maximum employment and price stability goals. From today's perspective, this means that the Fed will almost certainly continue to buy bonds at least until the end of 2021. And in terms of interest rates, the Fed members currently believe that the present level will be appropriate until 2023.

Fixed income: attractive returns only at the top end of the risk ladder

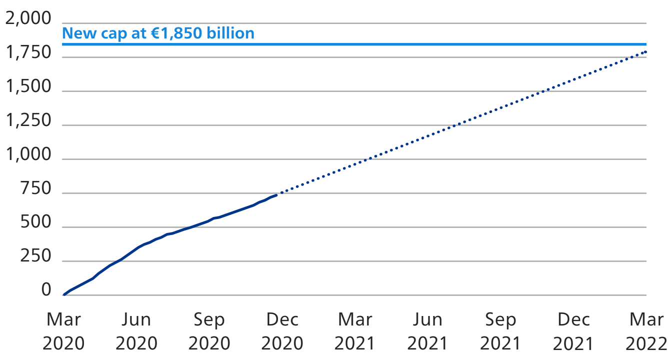
The central banks' expansionary monetary policy, plentiful liquidity and negative yields on safe-haven bonds continue to provide crucial support for paper with a risk premium, such as corporate and periphery bonds. But on the back of a strong rally in recent months, potential for spreads to narrow further is limited in the near term, because yields in investment-grade segments have already dropped close to or even below zero in many cases. Even yields on ten-year Portuguese government bonds recently dipped into negative territory. Spreads on Italian government bonds over German Bunds, which are deemed a safe haven, are close to their all-time low.

Investors hunting for returns are therefore forced to climb a step higher on the risk ladder. A few days ago, we departed from our positive view of periphery bonds. Instead, we are now recommending exposure to European high-yield bonds. An economic recovery should improve companies' profit levels and strengthen their credit quality.

- **Change:** None.
- **Positioning:** Safe havens are not attractive. Our preferences include investment-grade and high-yield corporate bonds. Our position in government bonds from emerging markets and eurozone periphery countries is neutral. All in all, we currently regard fixed-income investments as not very appealing.

ECB purchase programme topped up by a further €500 billion

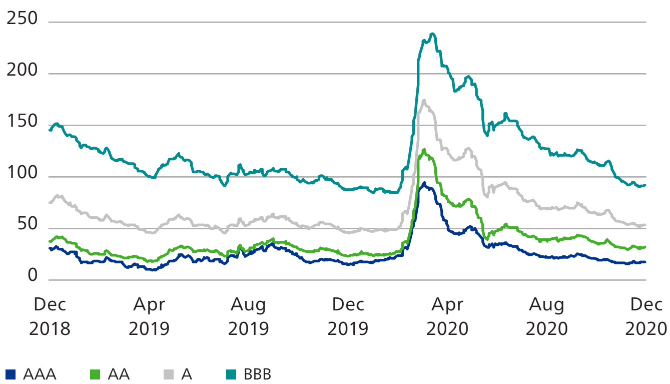
Total volume of paper purchased so far under the PEPP (€ billion)



Sources: Bloomberg, Union Investment, as at 15 December 2020.

Higher yields only in lower rating bands

Risk premiums on euro corporate bonds, by rating category



Source: Refinitiv, as at 15 December 2020.

The markets at a glance

Equities: emerging markets remain a favourite

Equities continue to be supported by expansionary monetary policy and the negative-interest-rate environment, and risk premiums remain high. So far, the markets seem largely unperturbed by the latest case numbers in the US and Europe and the renewed lockdowns imposed in many places. They are focusing instead on the launch of mass vaccination programmes, which are sparking hope that the coronavirus pandemic can be overcome. Some countries have already started to administer vaccines.

Unlike in western countries, infection rates in Asia have broadly remained at a low level and strict lockdowns are therefore unlikely to be reintroduced. Some countries, such as Taiwan, can even boast of not having recorded any new cases in months. This means that the region should enjoy steadier economic growth than more severely affected European countries or the US.

Another factor in Asia's favour is a new free trade agreement spearheaded by China, the Regional Comprehensive Economic Partnership (RCEP). China joined forces with 14 other countries in the Asia-Pacific region to form the largest customs union in the world. This arrangement opens up growth prospects that add to the appeal of the region.

- **Change:** None.
- **Positioning:** We favour equities and have a clear preference for emerging markets over industrialised countries.

Commodities: protection against coronavirus

The rally in the oil price that was triggered by the news on vaccine development continued. After a long and challenging meeting, the OPEC+ members extended most of their production caps. From January, the volume of market supply will increase by only 500,000 barrels per day. The cartel has agreed to meet at monthly intervals going forward. Reserve capacity is now roughly back at pre-crisis levels and additional oil volumes stored in ships have started to fall rapidly. The forward curves have normalised as a result.

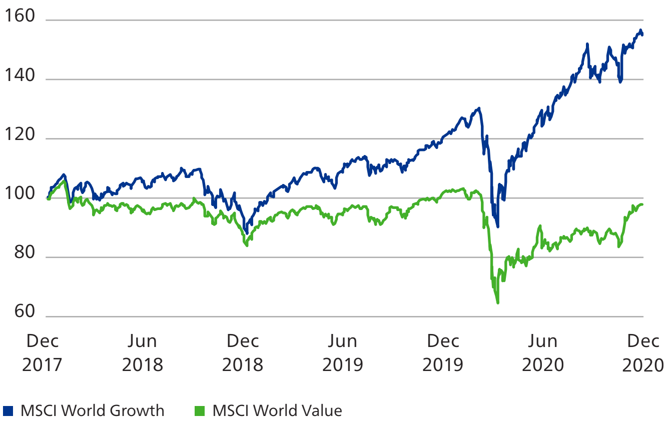
Marked price increases and a heavily overbought market mean that the upward potential of industrial metals has been exhausted. The momentum that was generated by lending support measures in China and drove up demand for physical metals is waning. We anticipate excess supply of key metals across the board in 2021. Production volumes of many metals are already outstripping demand.

Investors' interest in gold continued to fade in recent weeks. But the recovery of the global automotive industry and the resulting demand for platinum and palladium are keeping the precious metals sector well supported.

- **Change:** Industrial metals have lost appeal.
- **Positioning:** Our cautious approach to industrial metals means that commodities are currently not attractive. Our view of the other individual sectors in this market is neutral.

Re-opening of trade favourable for value stocks

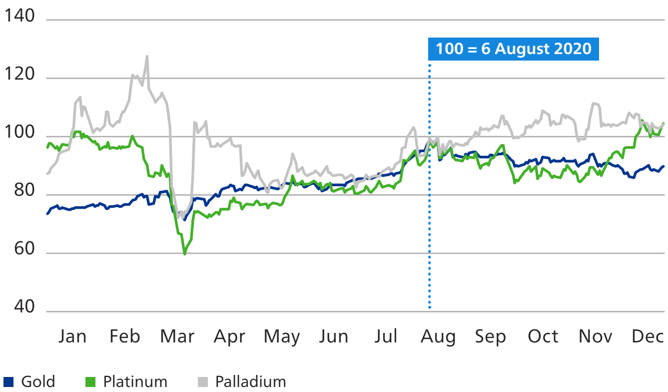
Indexed performance since 31 December 2017



Source: Bloomberg, as at 11 December 2020.

Recent uptick in industrial demand for precious metals

Performance indexed against the gold price peak in the year to date



Sources: Bloomberg, Union Investment, as at 16 December 2020.

The markets at a glance

Currencies: event risk vs. fundamental trends

After a favourable performance, we decided to close our active position in the euro (short against the US dollar) ahead of the EU summit. Moreover, the weakness of the US dollar in recent weeks seems to be partly attributable to real interest rates in the US, which were already in negative territory and dropped even further in response to the rise in the oil price. We expect this trend to level off for now. As the trade negotiations between the UK and the European Union remained challenging, we also closed out our active position in pound sterling (long against the Japanese yen). We believe that favourable and adverse influences will largely cancel each other out for most currency pairs in the coming weeks and are therefore taking a neutral stance in the currency markets.

- **Change:** None.

Japanese yen as a barometer for market risk
Japanese yen to the euro (year to date)

Source: Bloomberg, as at 15 December 2020.

Real estate: office markets in Asia-Pacific

The global spread of COVID-19 since March 2020 has also resulted in restrictions on public life and economic activity in countries in the Asia-Pacific region. But unlike other nations, many Asian countries have been successful in containing the spread of the virus. Nevertheless, it became clear at the end of the third quarter of 2020 that the real estate markets in the region were not immune to the impact of the pandemic.

Activity in Asian real estate investment markets was curbed by uncertainty and travel restrictions, especially in the second and third quarter of 2020. The total volume of commercial real estate transactions in the first nine months of 2020 came to €81.0 billion, which was around 28.0 per cent below the volume recoded in the corresponding prior-year period.

The average vacancy rate across the region's four main office hotspots – Seoul, Singapore, Sydney and Tokyo – increased by 3.5 percentage points to 8.4 per cent as new construction reached completion (in some places in substantial volumes) while prospective tenants deferred their property decisions. Seoul and Sydney saw the steepest rise in vacancy rates with increases of 4.7 percentage points and 6.9 percentage points respectively.

The weaker demand for office space and higher vacancy rates were also reflected in prime rents. At the end of the third quarter of 2020, average prime rents for the four main office hotspots were down by 2.9 per cent on the figure a year earlier. Seoul was an exception as high demand for modern office space drove rents up by 9.4 per cent.

So far, the coronavirus crisis seems not to have had a negative impact on pricing. Initial yields on office real estate were down by 10 basis points on average compared with the third quarter of 2019. While initial yields in Sydney and Tokyo held steady, Seoul and Singapore recorded contractions of 10 basis points and 30 basis point respectively.

Quarterly change in prime office rents in the Asia-Pacific region
Average (%)*

* Average of the four biggest Asia-Pacific office markets.
Source: JLL, as at 30 September 2020.

Our assessment at a glance

Our current risk assessment

- Economic conditions remain positive despite the escalation of the pandemic.
- Tighter lockdowns are likely to slow down economic growth. But we expect to see catch-up effects for consumer spending once coronavirus vaccines become widely available.
- After a strong rally in November, the current market already has plenty of aspects priced in. Liquidity will diminish at the end of the year and the lack of clarity about Brexit remains a source of event risk.
- Our general risk assessment (RoRo meter) thus remains at level 3 (neutral).

RoRo meter

Source: Union Investment, as at 15 December 2020. Last changed (from 4 to 3) on 4 November 2020.

Note: The investment strategy is established by first closely analysing the market environment. The result is reflected in a risk rating. For this, the Union Investment Committee (UIC) expresses a risk-on/risk-off decision at one of five levels (1, 2, 3, 4 or 5). It is to be interpreted as follows: a '5' indicates a strong appetite for risk while a '1' indicates a general withdrawal from risk assets.

Our view of the asset classes

- **Fixed income:** The ECB's purchases continue to support bonds with a risk premium. Our preference is for corporate bonds, whereas safe havens are unappealing.
- **Equities:** Negative interest rates, monetary policy and a positive outlook for 2021 are creating a supportive environment for equities. Asia is less severely affected by the impact of the pandemic. On this basis, we continue to favour EM equities.
- **Currencies:** The US dollar will probably continue to weaken in the medium term. But in the near term, political risks in Europe (Brexit) are taking centre stage.
- **Commodities:** The physical commodity markets are continuing to normalise. But we are taking a cautious approach to industrial metals, which we regard as overbought.
- The situation in the money markets is unchanged. Interest rates remain in negative territory, which means that holding **cash** is not a good idea.
- In light of low yields in the bond market, we are taking a positive view of **absolute return strategies**.
- Within the **real estate** asset class, the regions currently have equal weightings.

The → = ← signs indicate the change compared with the decision made at the UIC's previous regular meeting.

Not favoured **Strongly favoured**
Neutral

Appeal of different asset classes

Fixed income	=
Eurozone core government bonds	=
Covered bonds	=
Eurozone periphery government bonds	=
Investment-grade euro corporate bonds	=
High-yield euro corporate bonds	=
Emerging market government bonds	=
Equities	=
Industrialised countries	=
Emerging markets	=
Commodities	←
Currencies	
US dollar	=
Pound sterling	=
Japanese yen	=
Emerging market currencies	=
Absolute return	=
Cash	→

Source: Union Investment, as at 15 December 2020.

Note: The table above provides a **relative view of a multi-asset portfolio (excluding real estate)**. If one asset class becomes more strongly favoured, a lower level of investment in another asset class is required in return. The latter would then be classified as less favoured – or vice versa. Real estate is excluded from this analysis.

Real estate	
Germany	←
Europe (ex Germany)	=
US	=
Asia-Pacific	→

Source: Union Investment, as at 15 December 2020. Assessment is valid up to 30 May 2021.

Note: The table above provides a **relative view of the office real-estate markets** in light of current market prospects. Due to a lack of more frequently available data, it is only updated every six months.

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Unless otherwise stated, all information, descriptions and explanations are dated **18 December 2020**.

How to contact us

Union Investment Institutional GmbH
Weissfrauenstrasse 7
60311 Frankfurt
Germany

Tel: + 49 (0)69 2567 7652
Fax: + 49 (0)69 2567 1616

Email: institutional@union-investment.de
www.union-investment.com