A rise in new issuance activity could weigh on corporate bonds. The latest recovery means that risks are no longer adequately reflected in prices.

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Market news and expert views

Monthly report
September 2022

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The markets at a glance

Summary

Despite the prevailing uncertainties, the equity and fixed-income markets have staged a robust recovery over the summer months. This uptrend has mainly been driven by a temporary dip in commodity prices, which sparked hopes of lower inflation and less aggressive interest-rate increases by the major central banks, as well as by limited exposures and the closure of short positions by systematic investors and hedge funds. Diminishing volatility and low trading volumes in recent weeks added fuel to the rally. The positioning has now been adjusted. And from early September at the latest, issuance and placement activity should pick up again significantly, which will likely put pressure on the secondary market.

All in all, we continue to view the market environment as difficult and uncertain. There is still no sign of the situation easing for the four key parameters that are particularly relevant to the market (growth, inflation, monetary policy and market structure). In fact, the pace of growth has continued to slow in recent weeks, with China reporting particularly disappointing macroeconomic data. Pressure on corporate earnings is stemming primarily from the cost side, as illustrated by the reporting season for the second quarter. However, in some isolated cases, there were also reports of challenges on the sales side.

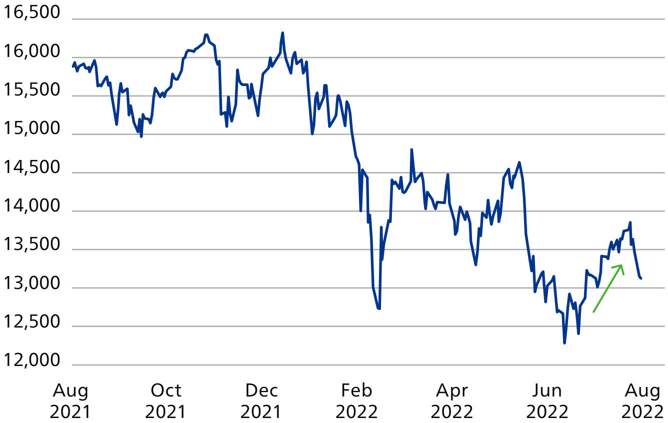
Inflation in the US fell slightly for the first time in months, but remains at a high level. Meanwhile, in the eurozone, the rate at which prices are rising is set to increase further. The central banks remain focused on bringing down inflation. While uncertainty persists and there is a lack of clarity about the key parameters, conditions will continue to be subdued and a broad-based recovery for risk assets is unlikely. We therefore confirmed our slightly defensive risk positioning (RoRo meter at level 2).

Economy, growth, inflation

Economic growth in the eurozone continues to slow down. Sentiment indicators such as consumer confidence, business confidence and purchasing managers' indices weakened further, both in the manufacturing sector and in the service sector. At present, the macroeconomic environment is still being supported by pent-up demand following the coronavirus pandemic. The tourism sector is a prime example here. However, the labour market remains tight, as evidenced by acute shortages of workers, historically low unemployment rates and high levels of vacancies. This could indicate that companies might be reluctant to resort to mass redundancies if economic conditions deteriorate further, thus providing welcome support to household incomes.

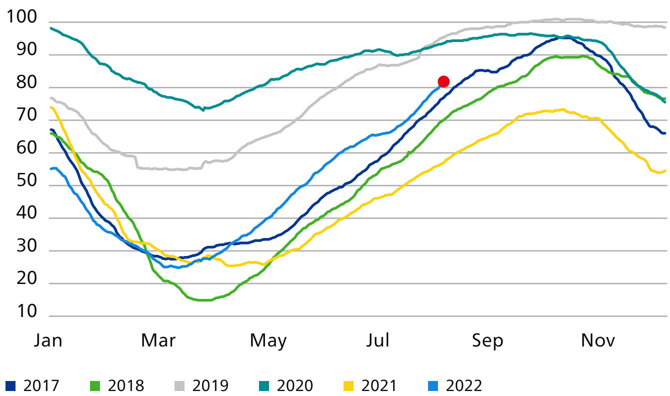
With regard to the energy supply situation in Germany ahead of the coming winter, recent data on gas inventories offered a modicum of relief. At over 80 per cent, inventory levels are above the seasonal average for the past five years. Dependency on imports from Russia, meanwhile, has continued to decline. Based on our latest simulations, it should be possible to avoid gas supply shortages in Germany, assuming normal winter temperatures. However, in the event of a cold or very cold winter, rationing would still be necessary. The two-pronged approach of saving gas (at companies and in private households) and, potentially, using oil as a substitute for gas (e.g. for power generation and industrial processes) thus remains relevant going forward. Moreover, the winter of 2023/24 looks likely to be even more challenging in terms of gas supply than the coming winter. European gas futures have more than tripled in price since mid-June and are trading well above the highs recorded in early March. Meanwhile, rising electricity prices represent an additional enormous burden looming over European companies and consumers.

Recovery staged in the summer months
DAX one-year chart (points)



Sources: Bloomberg, Union Investment, as at 23 August 2022.

Gas storage facilities now at over 80 per cent of capacity
German gas inventories since 2017
(%)



Source: Union Investment, as at 23 August 2022.

The markets at a glance

Monetary policy: focus remains on tackling inflation

Following their decisions on interest-rates in July, the central banks effectively went on a summer break. The next monetary policy decisions by the US Federal Reserve (Fed) and the European Central Bank (ECB) are not expected until September. Minutes of the latest meetings and recent statements by members of the banks' governing bodies clearly indicate that curbing inflation remains the number one priority for monetary policy. The inflation environment has changed very little of late. Concerns about the outlook for inflation, which prompted the Fed and the ECB to raise interest rates decisively in July, have not lessened noticeably. Both central banks emphasised after their last meetings that they would adopt a more data-driven approach going forward, taking decisions from one meeting to the next. Looking ahead to the next monetary policy decision in September, Isabel Schnabel, a member of the ECB's Governing Council, stated that – in her opinion – the outlook had not changed fundamentally compared with the July meeting. In the eurozone, year-on-year inflation climbed to 8.9 per cent in July. The focus remains on energy and food prices, but inflationary pressure is also spreading to other goods and services. We still expect that inflation will continue to rise in the coming months – not least because mitigating factors in Germany such as the fuel tax rebate and subsidised rail travel cards for €9 per month will be discontinued – and that the rate of inflation will not start to fall until 2023. We therefore anticipate that the ECB will raise interest rates by 50 basis points at the start of September.

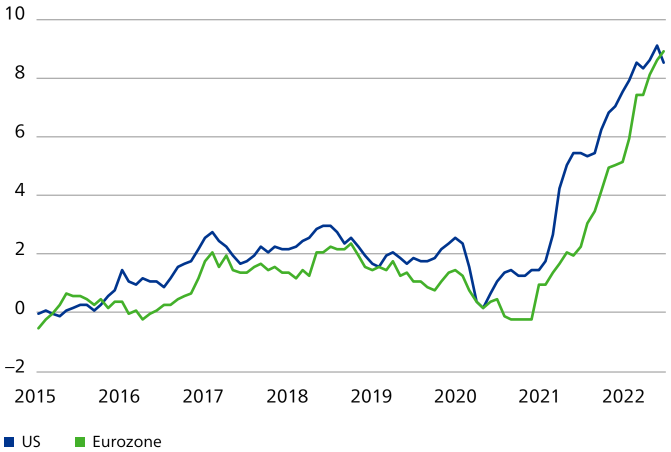
The Fed is expected to follow suit one week later as inflation in the US also remains at a high level, despite the fact that prices in the country have not risen much further of late.

Fixed income: flattening of the curve for German Bunds set to continue

As risk aversion has subsided in the capital markets, yields on safe-haven bonds have risen again. The partial inversion of the US yield curve has gathered pace, reflecting the profile of risks to the economy. In the eurozone, a sharper rise in yields on short-dated paper than on long-dated paper has resulted in a slight flattening of the German yield curve. But the curve is still relatively steep compared with that of other countries. This flattening is likely to continue given that the ECB is expected to put up its key interest rates. Moreover, the short supply of – and demand for – safe-haven paper (eligible collateral) is bolstering short-dated German government bonds. In the eurozone periphery countries, attention is increasingly turning to the parliamentary election due to take place in Italy at the end of September. An alliance between the Eurosceptic parties Fratelli d'Italia, Lega and Forza Italia currently looks the most probable outcome. The related increase in political risk is likely to lead to a moderate rise in spreads in Italy and other periphery countries in the coming weeks. Turning to corporate bonds, the expected pick-up in issuance activity following the summer hiatus may cause the technical situation to deteriorate again. We believe that as a result of the recent sharp drop in spreads, economic concerns are no longer adequately reflected in prices. Following the recent narrowing of spreads, bonds from emerging markets have also lost some of their appeal, although they have been receiving support from inflows of funds again.

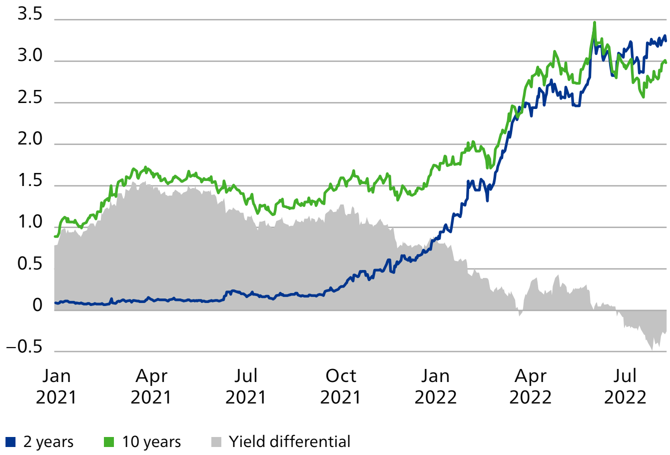
- **Change:** We are steering clear of investment-grade corporate bonds and have adopted a neutral stance with regard to emerging market paper.
- **Positioning:** Fixed-income investments are unattractive overall at present. Government bonds from the US are among our favourites. We are avoiding investment-grade corporate bonds. Our view of the remaining bond classes is neutral.

High water mark in the eurozone not yet reached
Inflation levels over time since the start of 2015
(%)



Source: Bloomberg, as at 23 August 2022.

The US yield curve has inverted
US government bond yields since the start of 2021
(%)



Source: Bloomberg, as at 23 August 2022.

The markets at a glance

Equities: US corporate profits fall for first time since 2020

The equity market rally that began in mid-June has continued in recent weeks, with the US stock markets leading the way. The pace of the increase in inflation rates has begun to ease for the first time, raising hopes that the Fed will not hike interest rates quite as quickly as previously feared. Reduced pressure from interest rates means that there is once again greater scope for higher valuations in the equity markets, especially for growth stocks, which have faced a significant burden in the year to date. However, the second-quarter reporting season presented a mixed picture. Overall, companies in the US S&P 500 index have seen their profits fall for the first time since the start of the coronavirus pandemic. Corporate profits in Europe, however, are still rising on the whole despite the fragile economic situation and soaring energy prices. This resilience is partly attributable to the high proportion of revenue that European companies generate outside Europe, which is enabling them to recognise currency gains due to the euro's current weakness. High inflation is underpinning revenue growth too. At the same time, however, the equity market only partly reflects the wider economic situation in Europe. For example, the commodity, energy and financial sectors' role in the stock markets is much more significant than their contribution to gross value added. And it is the companies in these sectors that are benefiting from the increase in commodity prices and higher interest rates. With uncertainty persisting in the capital markets, there are likely to be further setbacks in the equity markets following their recovery. China's economic data has weakened, thereby removing a key source of support for shares from emerging markets. The recent rally was therefore much less pronounced for EM shares than for shares from industrialised countries.

- **Change:** None.
- **Positioning:** Equities from industrialised countries hold little appeal on the whole. EM equities are weighted neutrally.

Commodities: global oil market now largely in equilibrium again

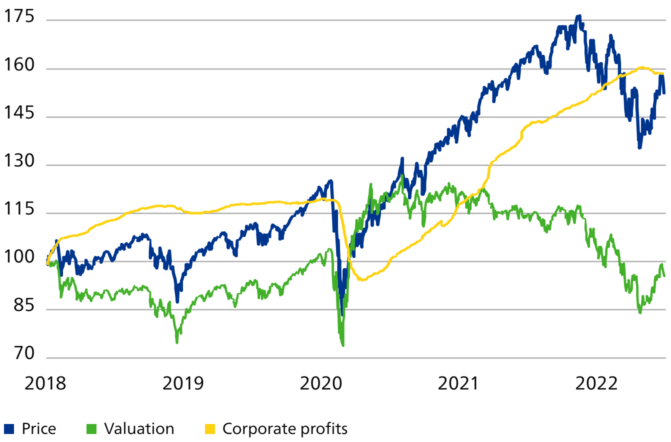
Our preferences have shifted within the commodities asset class owing to China's weak economic data and the significant correction in oil prices and in refinery margins. Since mid-August, we have shifted back to a neutral position with regard to energy commodities but are avoiding industrial metals. Although spending on infrastructure has increased further in China in recent times, investment in construction, another commodity-intensive sector, has tailed off noticeably.

Since mid-June, the price of crude oil has dropped by around 25 per cent on the back of the usual seasonal lull in demand for oil combined with increased oil output from OPEC members and the US. Refinery margins have also contracted sharply. Overall, the oil market has more or less returned to equilibrium and prices are at a fair level. And, in the coming months, gas is increasingly likely to be substituted with oil for electricity generation and in industrial processes in view of the shortage of gas and high gas prices in Europe.

On the precious metal front, gold continues to be pulled in different directions by high inflation and a firm US dollar. This situation is likely to persist for the time being. Our view of precious metals therefore remains neutral.

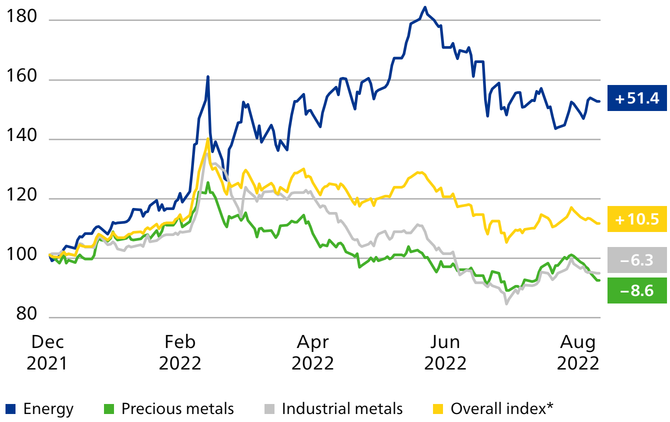
- **Change:** None.
- **Positioning:** We are a little underweight in the commodities asset class as a whole and are exercising particular caution when it comes to industrial metals. Our stance on precious metals and energy commodities is currently neutral.

S&P 500: corporate profits roll over
(indexed, %)



Sources: Bloomberg, Union Investment, as at 22 August 2022.

Price trends by segment
Indexed as at 30 December 2021 (%)



* MS RADAR ex agriculture & livestock
Source: Bloomberg, as at 23 August 2022.

The markets at a glance

Currencies: US dollar below parity with the euro

Following the substantial appreciation of the US dollar up to the middle of July, which was mainly driven by monetary policy at the Fed and weaker economic growth in Europe, the trend towards a stronger dollar has started to weaken again slightly in recent weeks. As the ECB has now also raised interest rates for the first time in the eurozone, it seemed as if differences in monetary policy would have less of a bearing. Although the greenback briefly reached parity with the euro six weeks ago before moving away from it again, it has gradually returned closer to this threshold in recent days and actually broke through it at the start of the week. In the medium term, the appreciation of the US dollar is likely to face stronger headwinds. This is because we believe that the Fed's cycle of interest-rate increases is set to reach a provisional end in December, whereas our expectation is that the ECB will implement further rate hikes in 2023. However, the economic slowdown in the eurozone and the US will probably prompt market participants to become even more risk-averse. The continuing strength of the US dollar means we are now pulling back from our previous positioning, which presupposed an appreciation of the Japanese yen against the US dollar.

- **Change:** We expect the US dollar to remain strong and are therefore closing our position with respect to the Japanese yen.
- **Positioning:** We continue to anticipate that the Japanese yen will appreciate against the euro.

Real estate: US office market

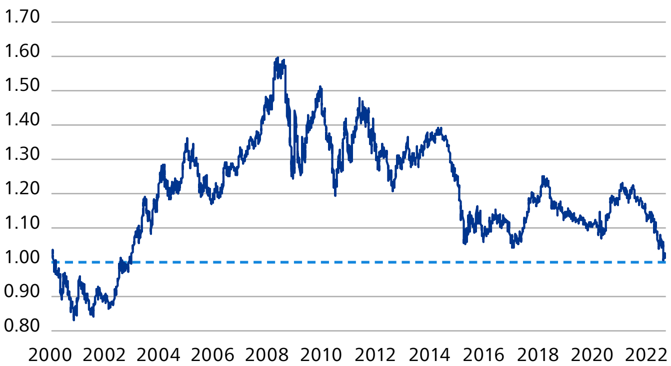
The US economy had already returned to its pre-pandemic shape by the end of the second quarter of 2021 and now domestic demand and the labour market look robust as well. However, the persistently high level of inflation and the Fed's monetary policy mean that its economy is still facing risks.

This uncertainty has had an adverse impact on demand for office space of late, not least because the current discussion around flexibility and hybrid working are prompting some businesses to hold back from signing leases for now. As construction activity is still at a relatively high level, the average vacancy rate across the eleven largest US office rental markets went up by almost 40 basis points year on year. At the end of June 2022, it stood at 13.7 per cent. San Francisco recorded a particularly sharp spike in vacancies due to the increase in construction activity of recent years coupled with a pronounced fall in demand for office space.

Despite this trend, average rents for the eleven largest US office rental markets actually rose slightly year on year. Rents in Dallas, for example, were up by 1.5 per cent and in both Chicago and Atlanta by 1.2 per cent.

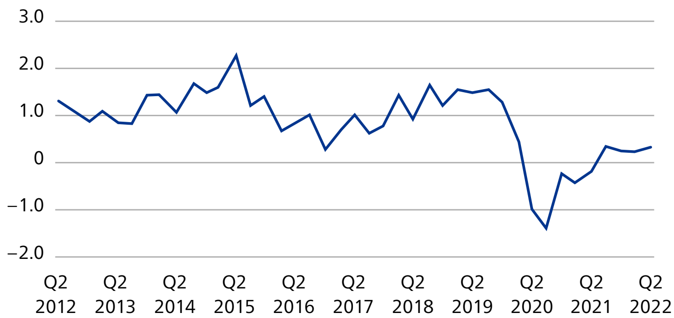
Initial yields were still virtually unchanged on the prior-year period. The volume of transactions returned to its pre-crisis level and is being driven in particular by healthy demand for high-quality properties under lease to tenants of strong credit standing ('trophy assets'). The real estate market in the US continues to offer robust conditions for investment, both on its own terms and by international comparison.

Euro weakened by economic concerns and the energy crisis
US dollars to the euro since 2000



Source: Bloomberg, as at 23 August 2022.

Quarterly change in prime office rents in the US
Average (%)*



*Average of the eleven biggest US office markets.
Source: CoStar, as at 30 June 2022.

Our assessment at a glance

Our current risk assessment

- Economic growth in the eurozone continues to slow, a trend that is reflected in various sentiment indicators. The US government paved the way for new long-term stimulus measures by passing the Inflation Reduction Act.
- Inflation remains high and, particularly in the eurozone, looks set to increase further. Monetary policy therefore remains clearly focused on bringing down inflation. We expect both the Fed and ECB to raise interest rates by 50 basis points in September.
- Risk assets are likely to face stronger headwinds again following the summer rally.
- Our general risk assessment (RoRo meter) remains at level 2 (slightly defensive).

RoRo meter

Source: Union Investment, as at 23 August 2022. Last changed from 3 to 2 on 1 July 2022.

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:** Narrower spreads and the challenging market conditions make investment-grade corporate bonds look unattractive. Our view of emerging market corporate bonds is neutral.
- **Equities:** Corporate profits fall for first time since 2020 in the US, in Europe they are being supported by the ailing euro. Low growth in China has removed one source of support.
- **Currencies:** The combination of higher risk aversion in the markets and concerns about economic growth is creating an environment in which the Japanese yen is likely to appreciate against the euro. The US dollar will probably remain firm.
- **Commodities:** Prices are at a fair level following the falls in the price of crude oil and oil-based products. Oil stands to gain from substitution effects due to the high price of gas and electricity in Europe. The weakness of China's economy is taking its toll on industrial metal prices.
- Despite the low rates of interest, we are parking funds in **cash** in the short term.
- Our assessment of **absolute return strategies** is mildly favourable.
- On the **real estate** front, we are slightly overweight in the US and Asia-Pacific regions at present.

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

Not favoured **Neutral** **Strongly favoured**

Appeal of different asset classes

	Change
Fixed income	←
Eurozone core government bonds	=
US government 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 23 August 2022.

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.

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

Source: Union Investment, as at 20 August 2022. Assessment is valid up to 31 October 2022.

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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READ THE PROSPECTUS BEFORE INVESTING

Unless otherwise stated, all information, descriptions and explanations are dated **26 August 2022**.

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