At present, we regard high-yield bonds as the most attractive sub-asset class in the fixed-income market because we do not currently foresee a deterioration in credit ratings and these assets are not adversely affected by the ECB tapering its asset purchases.

Christian Kopf,
Head of Fixed-Income Fund Management

Market news and expert views

Monthly report
May 2022

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Union Investment

The markets at a glance

Summary

The blocking of Russian gas supplies to Poland and Bulgaria has led to setbacks in the stock markets. Rising interest rates are also taking their toll on prices. We believe that Moscow's decision is intended as a clear warning to western European countries, but do not anticipate the imminent imposition of a wide-ranging gas embargo by Russia. Any such raising of the stakes would have a far-reaching adverse impact on the economy and capital markets. However, there is simply too much to lose on both sides. In addition, the surge in yields that we have seen in recent months is unlikely to continue at the same rate. Our economists predict that inflation rates will plateau in the months ahead. The major central banks' route to monetary policy normalisation should also become clearer. These two factors will probably cause yields to drift upwards a little further, but with greatly reduced momentum.

Equities from industrialised countries are regaining some appeal in this environment. Sentiment has recently deteriorated, the corporate reporting season is going well and the negative factors are unlikely to increase markedly, which means there is potential for a rally after the adjustments of recent weeks. The increase in equity positions is a short-term measure and does not indicate a fundamental reassessment of the situation. In the commodities asset class, we increased the weighting of precious metals and, in return, scaled back the position in industrial metals. The overall proportion of commodities has not changed.

In our opinion, the capital markets remain subject to substantial uncertainty. No signs of a fundamental improvement in conditions have yet emerged in recent weeks. Against this backdrop, we are placing increased emphasis on tactical positions and have confirmed the neutral risk positioning (RoRo meter at level 3).

Economy, growth, inflation

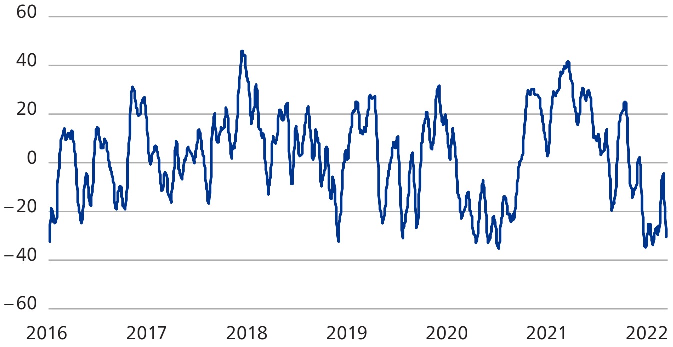
There is no let-up in the war in Ukraine, which continues to be a major source of uncertainty both in the capital markets and in the real economy. Nonetheless, leading indicators are not yet pointing to an economic slump in either the US or the eurozone. In fact, the latest indicators – such as the ifo Business Climate Index for Germany – show a weakening of the economy but were actually fairly stable overall. However, closer economic ties with Russia, greater geographic proximity and the higher dependency of some European economies on energy imports from Russia mean that economic growth is likely to suffer more in Europe than in the US this year. The US economy is in a much more robust shape, and has been for a while, putting it on a stronger footing.

In the near term, the divergence of economic growth east and west of the Atlantic will therefore increase further. However, in 2023, the divergence in terms of growth is expected to diminish again somewhat, provided that the war in Ukraine does not escalate further. It is important to note that the negative influences on the economy in our baseline scenario for Europe are not severe enough to choke off economic growth entirely.

The global economic situation also partly depends on the further trajectory of the coronavirus pandemic in China. To contain the spread of the virus, China is likely to increasingly impose strict lockdowns at short notice in the next few weeks. This will hold back growth, especially in the service sector. However, the likelihood of succeeding with the zero-COVID policy has risen due to the countermeasures. Interruptions to production and international supply chains should thus be limited. Meanwhile, inflationary pressure remains high in almost every corner of the world. A substantial decline in inflation rates is not expected until 2023.

US investors in a cautious mood = countercyclical purchase signal

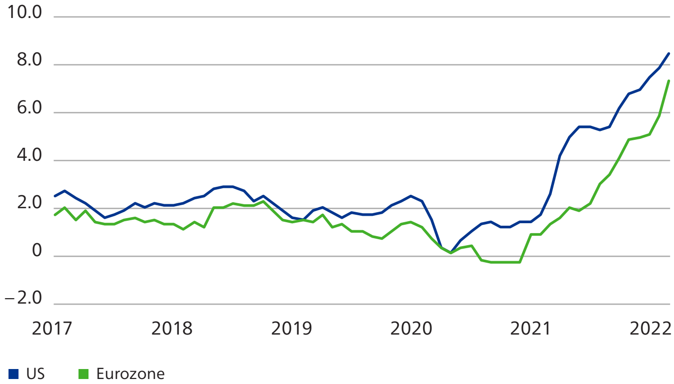
AAII* bull/bear indicator in the US (%)



* AAII = American Association of Individual Investors; proportion of investors with an optimistic outlook vs. proportion of investors with a pessimistic outlook.
Sources: Refinitiv, Union Investment; as at 24 April 2022.

High inflation has an adverse impact, but rates should top out soon

Annual inflation rate since the start of 2017 (%)



Source: Bloomberg, as at 27 April 2022.

The markets at a glance

Monetary policy: aiming for a swift return to neutral interest rates

Scope for monetary policy action is more limited in the eurozone than in the US, where generous fiscal measures under the American Rescue Plan have helped the economy to return to its pre-pandemic growth path. Disposable income will remain stable thanks to the solid labour market and an upward trend in wages and salaries (especially at lower income levels). This means that consumer spending should remain supported even though households are no longer receiving government transfer payments. On this basis, the US Federal Reserve (Fed) is able to take a more robust approach to fighting inflation than the European Central Bank (ECB).

It benefits from the fact that the US housing market, which plays an important role in this context, is less sensitive to interest-rate increases than it used to be, because a large proportion of mortgages now have a fixed interest rate rather than a variable rate. So far, no tangible slowdown has materialised in the construction sector as a result of interest-rate hikes. The difference in the nature of inflation in the US also makes things easier for the Fed. The turbocharged reopening of the economy after the coronavirus pandemic initially created an imbalance between supply and demand in the US, which fuelled inflation. Demand-driven inflation is easier to control through monetary policy, because the central bank can take steps to slow down demand, whereas it has little influence on rising commodity prices.

The Fed's signals have been very clear: It wants to swiftly transition to a neutral base rate that does not drive growth. However, we believe that the expectations for interest-rate hikes that have been priced in by the markets for 2022 are overly ambitious and expect the base rate to be raised by 'only' 200 basis points in total. Europe is a different story because here inflation is being driven up primarily by rising commodity prices, i.e. by supply-side factors. Consequently, the ECB's ability to counteract this trend is limited.

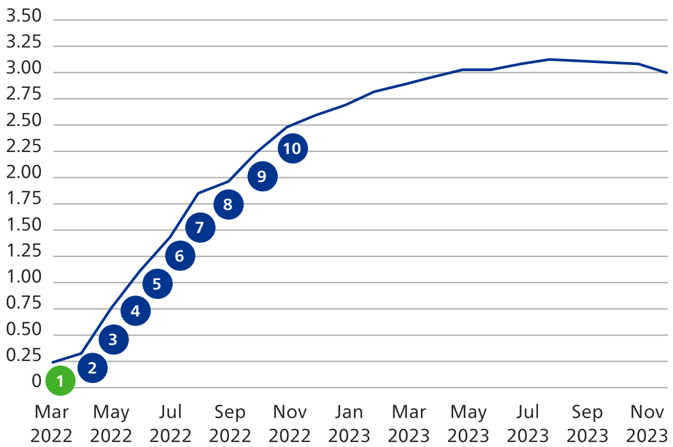
Fixed income: rise in yields already well advanced in safe havens

With inflation rates still running at a high level and central banks focusing ever more intently on combating inflation, the trend towards higher yields in the bond markets is continuing. In addition to the anticipated hikes in key interest rates, talk of the termination or tapering of asset purchase programmes has been putting downward pressure on bond prices in recent weeks. We expect to see further rises in yields over the coming months, particularly on short-dated bonds (two-year Bunds forecast to be yielding 0.7 per cent at the end of 2022; two-year US Treasuries 2.8 per cent).

In the case of long-dated bonds, the majority of the rise is thought to be already behind us (ten-year Bunds forecast to be yielding 1.0 per cent at the end of 2022; ten-year US Treasuries 2.9 per cent). Following the rally in March, risk premiums in the spread segments have recently gone up again on the back of weaker equity markets, reinforcing the increase in yields in safe havens. From our point of view, high-yield bonds remain the most attractive sub-asset class in the fixed-income market in terms of valuations because we do not currently foresee a deterioration in credit ratings and these assets are not adversely affected by the ECB tapering its asset purchases.

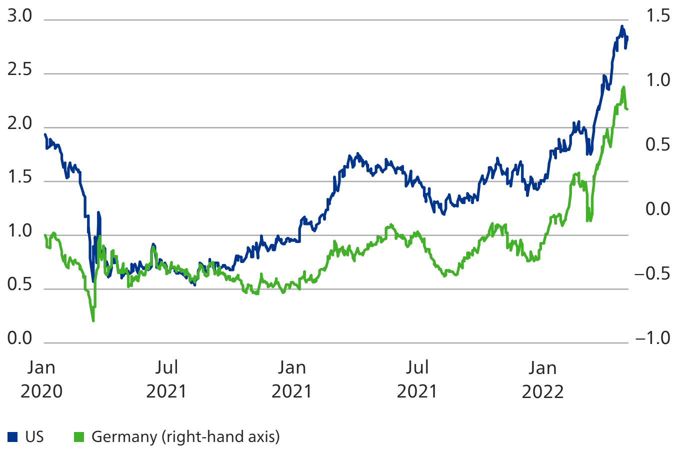
- **Change:** None.
- **Positioning:** Our approach to fixed-income investments is slightly cautious overall. We are taking a neutral view of government bonds from eurozone core countries, the US, and the emerging markets. High-yield corporate bonds are our current favourites. By contrast, we are steering clear of investment-grade corporate bonds and government bonds from the eurozone periphery.

Fed is lining up a series of interest-rate hikes
Implied key interest rate as derived from Fed Funds Futures (%)



Sources: Bloomberg, Union Investment, as at 27 April 2022.

Scope for yields to rise probably now largely exhausted
Comparison of yields on ten-year government bonds since the start of 2020 (%)



Sources: Bloomberg, Union Investment, as at 28 April 2022.

The markets at a glance

Equities: tactical opportunities in industrialised countries

We are using the recent dip in prices of equities from industrialised countries as an opportunity to slightly increase exposures in this segment. The adverse influence of rising nominal and real interest rates should diminish going forward, which, in turn, should reduce the likelihood of a price correction. Investors are currently holding only small exposures and the negative sentiment provides a countercyclical purchase signal. Notwithstanding concerns about economic growth, supply chain issues and input costs, the reporting season has started well, both in terms of the retrospective view of the first quarter and with regard to outlooks for the coming months. However, some question marks remain in relation to margin growth and customer demand in certain sectors over the medium term. The coronavirus situation in China also remains a risk factor, although signs of improvement have been emerging recently with regard to both infection levels and the containment measures imposed by the government to curb the spread of the virus. Nonetheless, it does not seem advisable to take up an active position in the emerging markets against the backdrop of the situation in China and the greater impact of higher energy and food prices on consumers in the emerging markets.

- **Change:** Increase in the exposure to equities from industrialised countries.
- **Positioning:** Slight preference for equities through exposure to stocks from industrialised economies. Our exposure to equities from the emerging markets is neutral.

Commodities: correction in precious metals has probably run its course

Concerns about global car production recently caused the prices of quasi-industrial precious metals to drop. This correction has most likely come to an end now, as investors have adjusted their positioning significantly. Gold is the only metal in which investors are still holding considerable long positions. Robust demand for exchange-traded commodities (ETCs) and weak economic growth should keep precious metals supported. By contrast, industrial metals have fared well in recent weeks, despite the renewed spread of coronavirus in China and the stringent lockdowns imposed there in response. This commodity segment also still offers a relatively high geopolitical risk premium. We have therefore decided to swap out short positions in precious metals for short positions in industrial metals.

The oil price continues to be buffeted by news from Ukraine and China. Overall, global oil supply has remained solid, but there are significant differences at regional level. For example, the strategic oil reserves released by the US government are being used entirely for exports that are destined primarily for Europe, where shortages of oil products such as diesel are currently particularly severe. The results are high 'crack spreads' (difference between the price of crude oil and prices of refined oil products) and huge discounts on Russian oil. The halt of Russian gas supplies to Poland and Bulgaria is also sparking fresh uncertainty in the market, although both countries had recently already reduced their imports from Russia to a minimum. We ultimately regard this step by Russia as a political signal to Germany, because the Kremlin would be able to suspend a huge amount of the country's gas supply by turning off the Nordstream 1 pipeline.

- **Change:** We are avoiding industrial metals and have returned to a neutral stance towards precious metals.
- **Positioning:** We are taking a slightly cautious approach to commodities from the energy and industrial metals sectors.

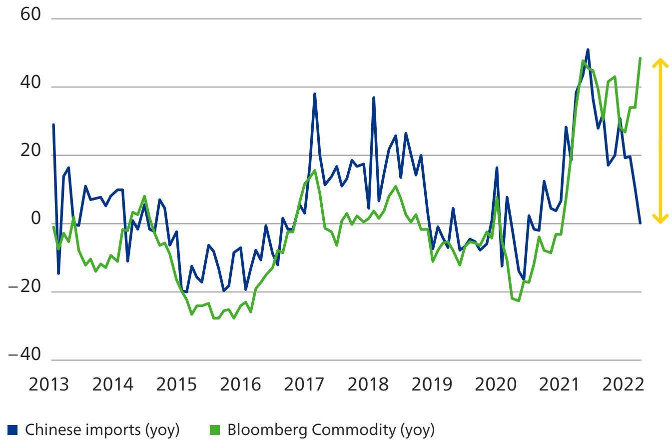
Inflation is also taking its toll on the equity markets

S&P 500 p/e ratio (12-month forward) and US real yields

Sources: Bloomberg, Union Investment, as at 27 April 2022.

Commodity market has priced in a risk premium

Data shows high correlation



Source: Bloomberg, as at 27 April 2022.

The markets at a glance

Currencies: Japanese yen expected to appreciate

Robust growth, a much more restrictive monetary policy approach by the Fed compared with other central banks, and the conflict in eastern Europe have continued to push up the US dollar in recent weeks. On a trade-weighted basis, the greenback has appreciated by around 6.5 per cent since the start of the year and by nearly 13.5 per cent since the end of May 2021. Compared with many other currencies such as the euro and the Japanese yen, sentiment towards the US dollar is very negative. It is likely that markets have already priced in the anticipated interest-rate hikes by the Fed to a large extent in both longer-dated US bond yields and US dollar exchange rates. Pound sterling is in a similar situation. This means that adverse pressures on other currencies, especially the Japanese yen, are more likely to diminish. Rising yields in the US paired with persistently ultra-expansionary monetary policy by the Bank of Japan (yield curve control) have caused the Japanese currency to depreciate by around 10 per cent against the US dollar since the start of March. Looking ahead, global concerns about economic growth should generally support the yen as a safe haven while weighing on cyclical currencies like the euro.

- **Change:** None.
- **Positioning:** We have positioned ourselves in expectation of an appreciation of the Japanese yen against the US dollar and the euro.

Depreciation of the Japanese yen continued
Japanese yen to the US dollar since early 2021

Source: Bloomberg, as at 28 April 2022.

Real estate: office market in Germany

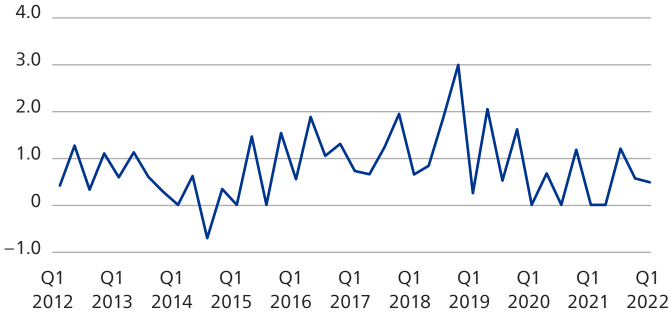
Following a contraction in 2020 due to the coronavirus crisis, the German economy recovered strongly in 2021, recording growth of 2.9 per cent. And despite uncertainties in connection with the war in Ukraine, Union Investment expects Germany to achieve growth of 1.6 per cent in 2022. This should keep the recent upturn in office lettings supported. Berlin, Düsseldorf, Frankfurt, Hamburg and Munich are the five biggest German office markets and at the end of the first quarter of 2022, their total lettings were already up by nearly a third on the end of the first quarter of 2021. Munich recorded the steepest increase at 54.4 per cent.

The average vacancy rate across the five office hotspots was up by around 90 basis points year on year at 5.6 per cent. Following a pronounced rise in vacancy rates across all locations over the course of 2021, these now remained broadly stable compared with the preceding quarter. The supply of high-quality office real estate in prime locations remains relatively limited. Competition among those bidding for these properties thus led to rental price increases in nearly all locations. Berlin and Munich saw particularly steep rental price growth of 3.9 per cent and 3.7 per cent respectively. On average, rental prices went up by 2.3 per cent across the five German office hotspots.

Modern properties under long-term lease to tenants of strong credit standing remain popular with investors. As a result, the average prime yield across Germany's top five locations fell by 10 basis points year on year to 2.6 per cent at the end of the first quarter of 2022.

The anticipated rise in employment in Germany will have a positive impact on demand for office space over the coming quarters. Given that the pipeline for new construction projects is only moderately stocked, vacancy rates are likely to decline again, which should result in rental price growth. Initial yields should remain stable going forward thanks to strong demand from investors.

Quarterly change in prime office rents in Germany
Average (%)*



*Average of the five biggest German office markets.
Source: JLL, as at 31 March 2022.

Our assessment at a glance

Our current risk assessment

- The war in Ukraine, high inflation rates and the prospect of rising key interest rates continue to weigh on the capital markets.
- We have therefore lowered our economic growth forecasts once again and now anticipate growth of just 1.6 per cent in the eurozone in 2022.
- While prices in the US are being driven up by strong demand, inflation in Europe is mainly being fuelled by soaring energy prices.
- The US Federal Reserve plans to raise interest rates by 50 basis points in May. Interest-rate hikes by the ECB are not expected before the autumn.
- Our general risk assessment (RoRo meter) remains at level 3 (neutral).

RoRo meter

Source: Union Investment, as at April 2022. Last changed (from 4 to 3) on 21 January 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:** The upward trend in yields on long-dated bonds should be coming to an end soon. In the government bond segment, we remain cautious about paper from the eurozone periphery. We currently prefer high-yield paper over investment-grade corporate bonds.
- **Equities:** Following a recent dip in share prices, we are favouring equities from industrialised countries. The positive reporting season is proving to be a source of support.
- **Currencies:** The Japanese yen seems to be depreciating excessively. We therefore expect a reversal of this trend. The yen could also benefit from potential threats to economic growth.
- **Commodities:** The correction in precious metals has probably run its course. The current prices of industrial metals include a substantial risk premium. Lockdowns in China make it more likely that prices will drop.
- Holding **cash** is currently unattractive due to low or even negative interest rates.
- Our assessment of **absolute return strategies** is mildly favourable.
- Within the **real estate** asset class, regions currently have equal weightings.

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

Not favoured **Strongly favoured**
Neutral

Appeal of different asset classes

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 27 April 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.

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

Source: Union Investment, as at 1 March 2022. Assessment is valid up to 30 June 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 **2 May 2022**.

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