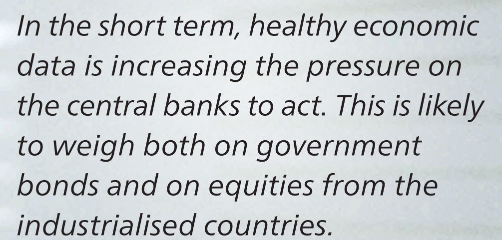


In the short term, healthy economic data is increasing the pressure on the central banks to act. This is likely to weigh both on government bonds and on equities from the industrialised countries.

Michael Herzum, Head of Macro & Strategy

Market news and expert views

Monthly report
March 2023

We work for your investment

Union Investment

The markets at a glance

Summary

Equities, bonds and commodities are exhibiting divergent behaviour in the current market environment. Whereas bond yields have risen and commodity prices have fallen of late, equities appear oblivious to the tightening of funding conditions. Central banks have maintained a restrictive tone in response to stubbornly high inflation rates. This has caused bond and commodity prices to drop, but not share prices. For the latter, these factors seem to have been outweighed by robust economic data, additional purchases by systematic investors, share buybacks, and the closure of short positions. Equities have now been on quite a run as a result, and so we view their current pricing as ambitious and believe a short-term setback is likely. These market expectations are reflected in our allocations to equities, fixed-income paper and commodities in a multi-asset portfolio. At the same time, the anniversary of Russia's invasion of Ukraine is likely to have raised the level of geopolitical risk, at least temporarily, and this is another argument against adopting a bullish stance.

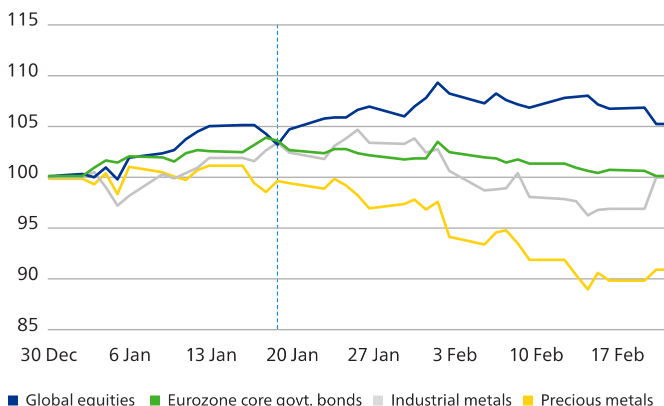
If, however, we look slightly further into the future, the latest developments can be viewed positively overall. The global economy is performing better than expected, an energy crisis has not materialised and inflation has peaked. There is still some lingering uncertainty about which key factors will affect the capital markets in 2023, as evidenced by the cautious tone of the outlooks from the current corporate reporting season. However, the trends are pointing in the right direction. Time continues to work in favour of risk assets. We have therefore confirmed the neutral risk positioning (RoRo meter at level 3).

Economy, growth, inflation

In the western hemisphere, the economic data has stabilised on both sides of the Atlantic. Our own leading indicator is showing an improvement – particularly for the US – and currently signalling upward momentum for the US economy. This is supported not only by the property market data but also by good news on the consumer front. The outlook is not entirely free of risk, as can be seen from a number of surveys in the corporate sector. The survey conducted by the regional Federal Reserve Bank in Philadelphia, for example, reflects the heightened level of uncertainty among businesses. Overall, however, the prospects for US growth have brightened. Our economists have therefore raised their 2023 forecast for gross domestic product (GDP) from 0.3 per cent to 1.0 per cent. We continue to anticipate a phase of economic weakness, although it should cause only a brief dip into negative territory. Inflation may remain stubbornly high for a time in this environment but it has now peaked. This was underscored by the data for January. The US consumer price index rose by 6.4 per cent compared with January 2022, whereas the year-on-year change in December 2022 had been slightly higher at 6.5 per cent. This was the seventh fall in succession.

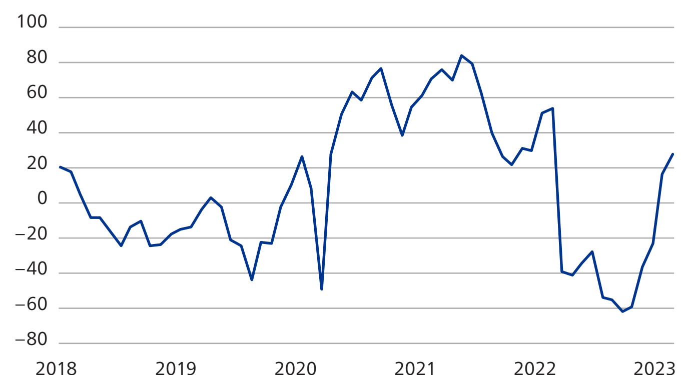
We continue to expect economic output to decrease in the eurozone during the winter months, albeit also to a lesser extent than originally anticipated. There are various reasons for this. Energy shortages did not materialise, the supply situation continues to improve and China's abandonment of its zero-COVID strategy is helping to stimulate foreign trade. Our research team is anticipating GDP growth of 0.2 per cent for 2023, and does not see a return to the trend growth rate until the end of 2024.

Divergence of the markets since mid-January
Indexed performance since the end of 2022



Source: Bloomberg, as at 22 February 2023.

ZEW: analysts are more optimistic about the future again
Centre for European Economic Research (ZEW) index for Germany, since the beginning of 2018



Source: Bloomberg, as at 22 February 2023.

The markets at a glance

Monetary policy: continued pressure to act

With growth surprisingly robust and inflation still stubbornly high, the central banks remain under pressure to act. This explains why the US Federal Reserve (Fed) and the European Central Bank (ECB) tried to convey a hawkish tone at their meetings in February. They did not really succeed, however. Many market players appear not to believe that the central banks will continue to ratchet up interest rates, despite the ECB committing to raising benchmark rates by a further 50 basis points in March and the Fed stating that “ongoing rate increases” are to be expected.

After the Fed’s meeting, we factored a further interest-rate hike in March into our forecast and now expect a terminal rate at the end of the cycle of interest-rate rises of 4.75 to 5 per cent. The hike in March is not necessary in terms of the fundamentals, but the Fed seems to have firmly resolved to go ahead with it. Our economists believe that inflationary pressures are set to diminish over the course of the year, and that inflation is now on a sustained downward trend as a result. We forecast annual rates of 3 per cent and just under 4 per cent for overall inflation and core inflation respectively by mid-2023. The average increase in US consumer prices for 2023 is therefore likely to be around 4 per cent.

We continue to anticipate that the ECB will raise its key rates by 50 basis points in March and a further 25 basis points in May. Our forecast of a terminal rate of 3.25 per cent (for the economically important deposit rate) is therefore unchanged. We do not foresee interest-rate cuts in either the eurozone or the US in 2023.

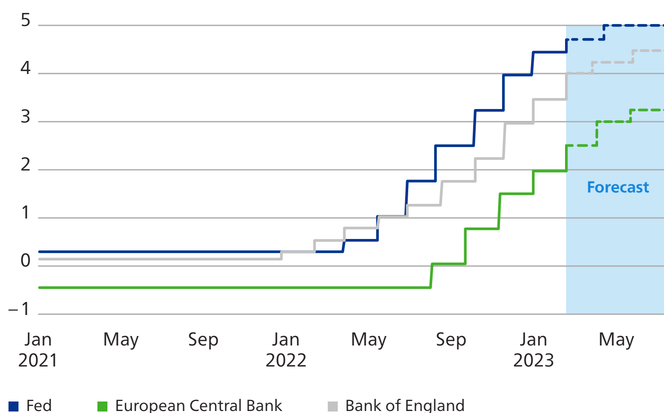
Fixed income: interest-rate cuts by the Fed priced out for 2023

In the bond markets, yields on safe-haven government bonds have risen again across all maturity segments in recent weeks. Persistently high inflationary pressure in the eurozone drove yields on two-year Bunds up to a new high of 2.9 per cent. By contrast, yields on longer-dated Bunds and US Treasuries have not yet returned to their highs of recent months. We are not expecting yields to rise significantly over the coming months. In the US, the interest-rate cuts that market participants had anticipated for the end of the year were priced out again following a number of recent statements by members of the Fed.

We are maintaining our cautious stance with regard to eurozone and US government bonds and are instead focusing on investment-grade corporate bonds and hard-currency bonds from the emerging markets. Yield premiums in both these segments have already fallen considerably, but have probably not quite bottomed out yet. Activity in the primary market has calmed down somewhat of late following a flurry of new issues at the start of the year. However, there are still new issue premiums available to be earned. The recent improvement in macroeconomic conditions lowered expectations among investors regarding probabilities of default. This helped the high-yield segment to significantly improve its return. Nonetheless, we are of the opinion that it is not valued very attractively in relative terms and are therefore maintaining our neutral weighting.

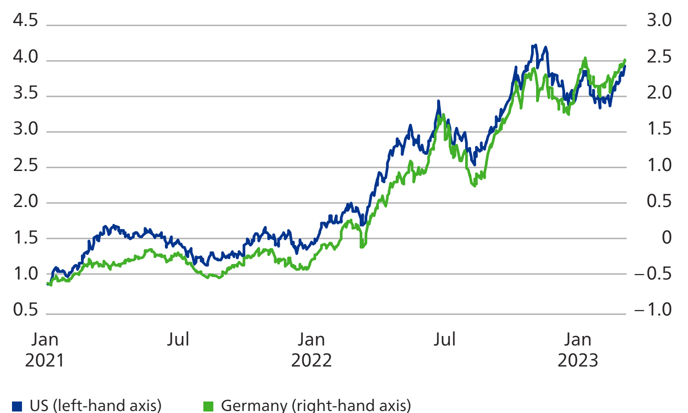
- **Change:** None.
- **Positioning:** We are exercising caution with regard to paper from the eurozone core and periphery and to US Treasuries, and are instead favouring investment-grade corporate bonds and government bonds from the emerging markets. Our overall weighting for fixed-income investments is neutral, however.

Investors see the Fed as having reached the end of its cycle of interest-rate hikes
Comparison of base rates with forecast rates (%)
since the start of 2021



Sources: Bloomberg, Union Investment, as at 22 February 2023.

Yields have recently returned close to their highs of 2022
Yields on ten-year government bonds (%)
since the start of 2021



Source: Bloomberg, as at 22 February 2023.

The markets at a glance

Equities: price gains have created potential for correction

The equity markets remained on an upward trajectory after a buoyant start to the year. However, the pace of share price gains has slowed down noticeably of late. The tailwind for equities came from better-than-expected macroeconomic data and corporate results and from hopes that the US Federal Reserve might start to lower interest rates again in the second half of the year. In addition, many investors had started the new year with relatively small equity exposures while many hedge funds had been heavily positioned on the short side. Rising share prices subsequently prompted these market participants to bulk up their holdings and close out or reduce short positions. There has also been a sharp rise in corporate share buybacks. As a result, the equity markets have become decoupled from fixed-income and commodity market trends in recent weeks. We expect a degree of convergence again in the coming weeks. And as we consider the upside potential, particularly in industrialised countries, to be more or less exhausted for the moment. we have made tactical adjustments to reduce our exposure to equities. The situation in China remains a crucial factor for shares from the emerging markets. Although the easing of Beijing's zero-COVID policy has now been priced in to a large extent, it continues to support share prices, not least because the Chinese New Year holidays have not resulted in the dramatic spike of infections that many had feared.

- **Change:** None.
- **Positioning:** We are cautious about stocks from industrialised countries and hold a neutral view of EM equities.

Commodities: metal prices expected to recover

Commodity prices have fallen sharply in recent weeks, even though economic data has, for the most part, exceeded expectations. Saudi Arabia raised its list prices for oil exports to Asia, a move that has historically often had a signalling effect for prices in the wider commodity markets. But neither this nor strikes in the Peruvian mining sector did much to halt the nosedive. In the precious metals segment, record volumes of central bank purchases shored up the gold price, while the quasi-industrial precious metals palladium and platinum and most industrial metals came under substantial pressure. We anticipate a recovery in the coming weeks. This will be driven by demand in connection with the end of the zero-COVID policy in China in the short term and, over the long term, by greater demand for metals as part of the transition to a green economy.

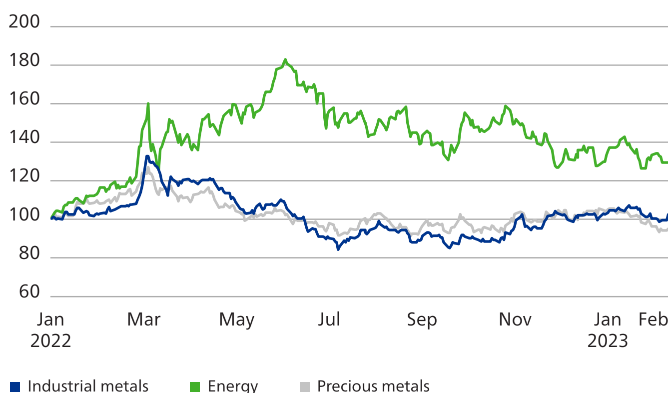
The situation in the North Atlantic energy market has been improving lately. This was reflected, for example, in the fact that the price of diesel at the fuel pump dropped below the price of petrol for the first time in months. Imports from Asia and North America played a significant role in easing pressures in this market. Moreover, gas prices in North America and Europe are also continuing to fall, mainly due to the relatively warm weather. In the last 20 years, US gas prices have been lower only in 2012, 2016 and 2020. For the moment, we are maintaining a neutral exposure to the energy sector.

- **Change:** None.
- **Positioning:** Industrial metals and precious metals are among our favourites. Our positioning with regard to energy commodities is neutral.

European equities have become more expensive again
Price/earnings ratio of the STOXX Europe 600 since the start of 2022

Source: Bloomberg, as at 22 February 2023.

Revival in demand from China suggests that metal prices will rise
Indexed performance (%) since the start of 2022



Source: Bloomberg, as at 22 February 2023.

The markets at a glance

Currencies: yen still favoured

Things are changing in Japan. Over the past 30 years, inflation rates in the country rarely climbed above 2 per cent, and if they did, they remained there only very briefly. However, recently, they have risen to as much as 4 per cent. This fuelled speculation that the Bank of Japan (BoJ) – the odd one out among the central banks – might soon call time on its ultra-expansionary monetary policy with negative interest rates and yield curve control (YCC). In addition, the top job at the BoJ will change hands in April. The Japanese government has nominated Kazuo Ueda as the successor for Haruhiko Kuroda, whose name has become inseparably linked with the bank's ultra-loose approach. This personnel change will shift the tone of the debate about a monetary policy adjustment from "if" to "when", which should bolster the Japanese yen.

Following a period of weakness that set in at the start of the fourth quarter of 2022, the US dollar has stabilised again in recent weeks thanks to the macroeconomic environment and restrictive signals from the Fed. Although the interest-rate cuts that market participants had previously anticipated for the second half of 2023 have now been priced out, the greenback will continue to face monetary policy headwinds. This is because the Fed is likely to reach the end of its cycle of interest rate hikes sooner than the ECB or the Bank of England, while Japan has not even started to raise rates. We have thus retained our positioning in expectation of the Japanese yen strengthening against the US dollar and the euro.

- **Change:** None.
- **Positioning:** We are long on the Japanese yen against the US dollar and euro.

Real estate: European office markets

The European office real-estate markets delivered a largely robust return in 2022 despite conditions that were anything but favourable.

In the twelve most important European office property markets, lettings were up by an average of 15.4 per cent year on year. Indeed, only Luxembourg and Brussels were unable to match the figures for 2021, whereas ten of the twelve hotspots registered significant increases. This greater demand for space was reflected in a year-on-year fall in vacancy rates in various locations, including Stockholm and Lisbon. The average vacancy rate across the twelve office hotspots remained unchanged year on year at 8.8 per cent.

2022 saw prime rents perform very encouragingly across all major European office markets. The fierce competition for the limited amount of modern and flexible office space that is available in central locations was a key factor here. The many companies that have switched to hybrid working are less keen on the more traditional office buildings with individual cubicles and closed-off spaces. This excess demand for space offering greater flexibility pushed prime rents up to an average of 7.9 per cent.

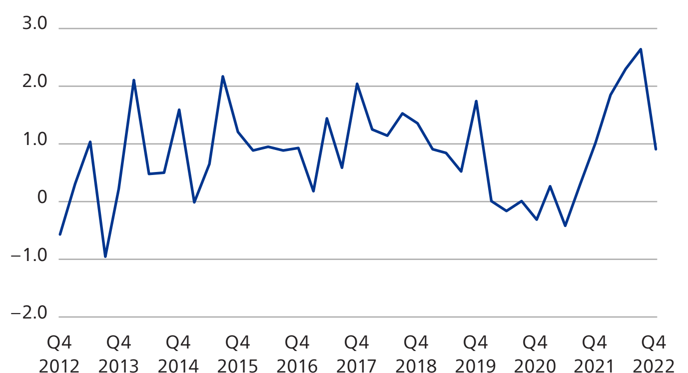
The investment market for office real estate performed rather weakly in 2022, particularly in the second half of the year. Over the course of 2022, the much higher financing costs caused initial yields for European office real estate to rise by around 60 basis points to an average of 4.0 per cent.

There is likely to be a moderate rise in initial yields this year too. However, demand for high-quality, flexible, centrally located office properties in major European cities will remain high and lead to a further rise in prime rents.

Signs of an end to Japan's ultra-easy monetary policy
Movements in the exchange rate of the Japanese yen since the start of 2022

Source: Bloomberg, as at 22 February 2023.

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



*Average of the twelve European office hotspots.
Source: JLL, as at 31 December 2022.

Our assessment at a glance

Our current risk assessment

- Economic data from the industrialized countries in the western hemisphere has been better than expected of late. The probability, however, is that the overall weakness will persist.
- Inflation may remain stubbornly high for a time in this environment but it has now peaked.
- Both these factors are keeping up the pressure on the central banks to act. The Fed is likely to raise interest rates for a final time in this cycle in March. We think the ECB will have implemented two further hikes by May.
- Our general risk assessment (RoRo meter) remains at level 3 (neutral).

RoRo meter

Source: Union Investment, as at 21 February 2023. Last changed (from 2 to 3) on 15 November 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:** As yields continue to rise, we are steering clear of government bonds from the eurozone and the US. Corporate bonds and paper from the emerging markets remain our favourites.
- **Equities:** We are cautious in respect of equities. Particularly in the industrialised countries, we are expecting headwind from the central banks. Prices now look ambitious again following the strong gains made at the beginning of the year.
- **Currencies:** The Japanese yen remains our favourite against both the US dollar and the euro.
- **Commodities:** Our preference is for industrial and precious metals as they are due a recovery following a significant correction.
- In the short term, we are parking some funds in **cash** as cash holdings are earning decent interest again. However, over a medium-term horizon, other asset classes offer better opportunities in our opinion and we will therefore invest this liquidity again in due course. Our assessment of **absolute return strategies** is mildly favourable.
- The outlook for **real estate** has improved a little in the US but deteriorated slightly in Germany.

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

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

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 21 February 2023.

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 2022. Assessment is valid up to 31 May 2023.

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 **24 February 2023**.

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