Group Investment Strategy

Monthly Outlook

May 2024

UniCredit

Index

Summary

Waiting for backwinds

MACROECONOMIC UPDATE

Both the US and Eurozone are facing significant economic developments. In the US, signs of an impending downturn intensified as the economy hit its lowest point in almost two years in the first quarter of 2024. GDP growth slowed, primarily due to a growing trade deficit, which severely impacted growth momentum. While private consumption – a cornerstone of economic activity – showed some resilience, it fell short of expectations. Negative contributions from company inventories and net exports exacerbated the economic slowdown. Job growth decelerated, with April witnessing the slowest increase in non-farm employment in six months, accompanied by a rise in unemployment. Leading indicators, such as the ISM index, further hinted at a weakening US economy.

In the Eurozone, unexpectedly solid GDP growth in the first quarter of 2024 surprised analysts. This positive outcome was driven by improved economic performances in key economies. In particular, Germany and Italy saw growth propelled by better foreign trade, while France and Spain benefited from a revival in domestic demand. However, the Eurozone continues to grapple with the disinflation process: the overall inflation rate remained steady in April, concealing opposing movements in energy prices and core inflation.

CENTRAL BANKS

In its most recent meeting, the Federal Reserve (Fed) kept interest rates unchanged, citing stagnating progress toward its 2% inflation target and robust economic activity. Fed Chair Powell expressed uncertainty regarding the timing of rate cuts, emphasising the need for sustained progress towards the inflation objective, and aiming for a data dependent approach to monetary policy. Market expectations anticipate interest rate cuts starting in September, totalling 50 basis points (bps) for this year, with a prolonged reduction in balance sheet tapering expected into 2025. Meanwhile, in Europe, the European Central Bank (ECB) is expected to cut rates by 75 bps this year, starting from its next meeting in June, but implementing rate cuts gradually to manage risks associated with both growth and disinflation.

FINANCIAL MARKETS

Financial markets experienced a rebound in May following setbacks in April, driven by concerns of delayed rate cuts by the Fed. While the S&P 500 saw a slight dip, European indices demonstrated resilience, with the German DAX even reaching a new all-time high. Despite global uncertainties, companies largely exceeded profit expectations during the first quarter reporting season, providing support to market sentiment. Bond markets initially reacted negatively to revised rate expectations but stabilised as markets adjusted. Oil prices eased thanks to geopolitical developments, while gold experienced volatility amid shifting rate cut expectations. The euro strengthened marginally against the US dollar, reflecting evolving market dynamics and central bank actions across continents.

CIO's Letter

Waiting for backwinds

The first half of 2024 is slowly but surely drawing to a close, and the capital market trend so far this year is noticeably different from the scenario that was expected at the end of last year. At that time, there was talk of recession risks in the US. In addition, several interest rate cuts by the US Federal Reserve (Fed) were priced in until the end of 2024 – at times, up to seven cuts. Today, hardly anyone is talking about recession risks in the US. And in view of the robust US economy, which is also manifesting itself through a slower normalisation of inflation, a large proportion of the originally priced-in rate cut fantasies have been priced out again. Recently, some market observers have even been speculating about possible further interest rate hikes by the Fed.

The picture that emerges when comparing the performance of the bond markets with that of the equity markets since the beginning of the year is particularly remarkable. On average, euro government bonds have a negative overall performance – i.e., price changes plus interest income – of around -1.5%, while US government bonds even have a negative overall performance of almost -2.0% (see table "Development of selected financial market indices" at the end of the publication). European equities, on the other hand, have risen by almost 8% since the beginning of the year and US equities by almost 9% (see table). The performance in Europe is also impressive. The DAX rose by around 11.5% and the performance of the broad Italian stock market was even more pleasing (see table). At the same time, the yield on 10-year German government bonds rose from just under 2% at the end of 2023 to around 2.5% today, and the yield on the corresponding 10-year US Treasuries increased from below 4% to 4.5%. Yields on other euro government bonds have also risen, as the example of 10-year Italian government bonds shows, albeit to a lesser extent than German and US bonds.

How do these developments fit together against the backdrop that rising yields on the bond markets have generally been a burden on equity markets in recent years, and that the euphoria at the end of last year was fuelled primarily by hopes of rapid and substantial interest rate cuts by the major Western central banks (especially the Fed)? In our view, two things are of central importance.

Firstly, the inflation surprises in the US, which have led to the markets pricing out the Fed's imminent and significant interest rate cuts, paint a picture of a strong US economy. Despite the high level of interest rates in the US, the economy is booming, and US companies are still creating a surprisingly high number of new jobs – although momentum has recently slowed. This development emphasises that the Fed is currently in the comfortable position of not having to cut interest rates urgently and promptly. It can continue to wait and watch the economic data over the coming months. At the same time, a buoyant economy means high profits for US companies, and therefore good prospects for shareholders.

The second factor that is important for an assessment of the development on the equity markets despite high interest rates is a change in the monetary policy approach of central banks. In the past, their monetary policy decisions were primarily based on their own medium-term inflation projections, for example over periods of one to two years. Impending changes in monetary policy parameters such as interest rates were initially linked to changes in their own forecasts for inflation, economic growth, etc. The future path of interest rate decisions was therefore easy for investors to predict. However, this high level of predictability and transparency also meant that even minor changes in expectations were highly significant. The sometimes seemingly hesitant attitude of the central banks proved to be inadequate in times of post-pandemic inflation shocks.

A lot of time passed between the start of the inflationary spurt and central banks switching to a resolute anti-inflationary mode, as a temporary rise in the inflation rate was assumed based on their own inflation models. Central banks responded to criticism of their hesitancy despite already high inflation rates by changing their methodology. Instead of linking monetary policy decisions to (easily predictable) economic models, as in the past, central banks currently seem to be making their decisions dependent on the monthly **inflation statistics**[1] published. However, these statistics are volatile and contain erratic components (or are statistically **"noisy"**[2]).

As a result, monetary policy is becoming less predictable for investors. On the one hand, this increases uncertainty on the markets, but on the other hand, market participants are now apparently attaching less importance to the higher short-term uncertainty. This uncertainty does not result from an incoherent and divided central bank, but simply from the fact that in the current environment, central banks are placing more emphasis on ensuring that the cooling inflationary momentum also manifests itself in the volatile monthly data. In other words, investors seem less interested in being able to predict the exact start of the rate cut cycle. It is much more important that the expected path of inflation normalisation remains intact and that the economy does not cool down too much at the same time. Both conditions currently appear to be fulfilled, which is why the stock markets have been relatively relaxed despite the recent rise in yields.

The latest economic data shows that this view is entirely justified. The latest US labour market and economic data point to the desired slowdown, but without triggering any alarm signals regarding recession risks. The balance sheet reporting season for the first quarter also confirms the positive share price development in recent months. The major US companies listed on the capital market that have already reported for the first quarter have recorded average profit increases of around 5%. European companies, on the other hand, have reported slightly lower profits, but on average they have also reported significantly better figures than expected. If the **consensus estimates**[3] are correct, significant increases in corporate profits can be expected over the next few years. In the next two years (i.e., 2025 and 2026), the markets expect double-digit earnings growth rates in the US. Although the corresponding expectations for Europe are somewhat more restrained – just under 10% on average – such growth rates should also support share prices. An interesting detail is that German companies, which are sometimes viewed particularly critically, have comparably high profit growth expectations for 2025 and 2026. Only this year is the increase in profits in Germany likely to be noticeably lower than in the US.

Overall, the situation therefore points to favourable equity markets in the coming quarters. Nevertheless, we favour a balanced weighting of equities and bonds. This is due to two factors. Firstly, although our base scenario outlined above is positive, the risks indicated should not be ignored. In our view, one major risk results from the surprising strength of the US economy. The fact that the economy on the other side of the Atlantic is surprisingly resistant to high interest rates could be because the interest rate level is still not restrictive enough to cool down inflationary momentum quickly enough. In other words, it could be that the Fed is slowing down with its current monetary policy, but not yet strongly enough to push inflation down to the target level of 2% within an acceptable period. As outlined above, this would be a sign of the strength of the US economy. However, the additional interest rate hikes that would be necessary in this case would catch the markets unprepared and would likely to lead to temporary price falls, from which the European markets would probably not be able to decouple themselves.

Secondly, although annual earnings growth expectations of 8-10% suggest a return potential of a similar magnitude for equities, the markets have already (at least partially) anticipated this potential with their rally in recent months. In addition, bonds have a return potential that is likely to be lower than that of equities but is fundamentally interesting in risk-adjusted terms compared to equities (a risk scenario in which central bank interest rates remain high or even rise for longer could again be accompanied by rising yields and thus price losses though). In other words, investors should not ignore either equities or bonds in their investment considerations for balanced portfolios.

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[1] This approach is sometimes also referred to as "data dependent". However, this terminology is somewhat inadequate, as a model-driven methodology is also data-dependent. Rather, it has recently become a matter of making oneself dependent on short-term and sometimes disruptive data.

[2] The term "noise" originally comes from physics, where it is generally understood to mean a disturbance variable with a broad, unspecific frequency spectrum.

[3] The consensus estimate is the median in the distribution of the individual estimates. The median is the value that lies exactly in the centre of a data series ordered by size. It bisects the data series so that one half of the data lies below and the other half above the median in the ordered series.

In Focus

US presidential election: what the candidates plan to do in the event of re-election

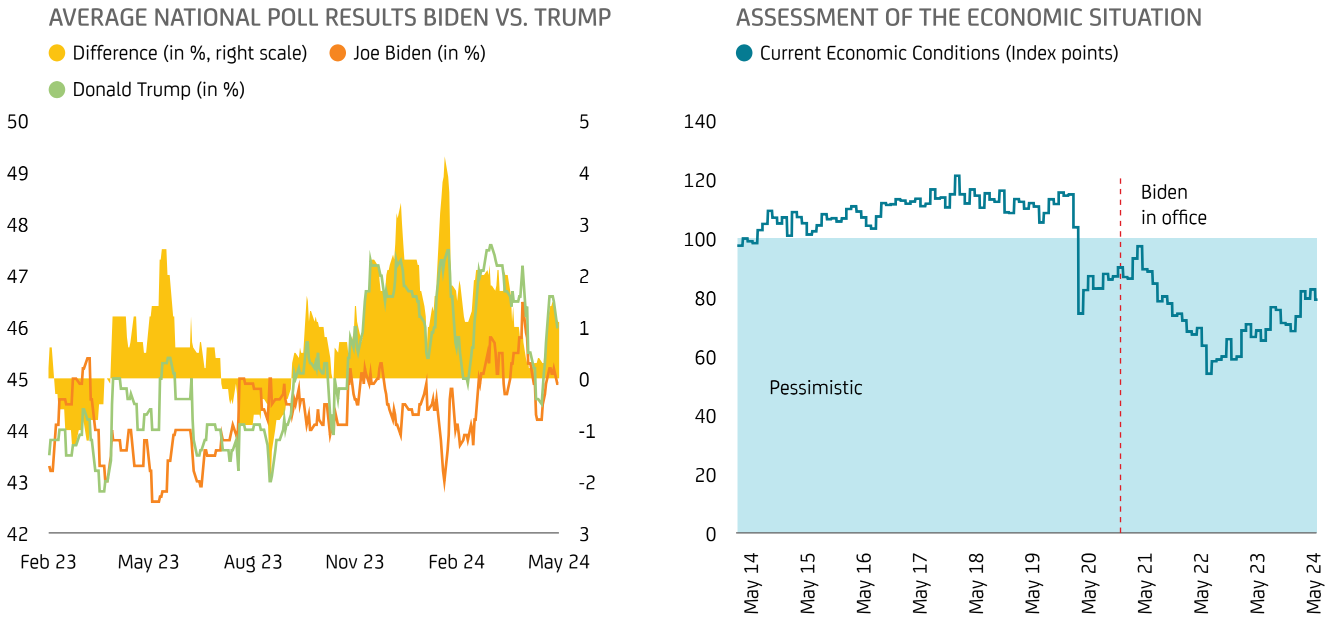
Investors are eagerly awaiting the first Tuesday in November, when the new US president will be elected. The Republican and Democratic primaries, which have been taking place since the beginning of January, have been decided. It will once again be a duel between the current and former US presidents: Joe Biden and Donald Trump. Earlier in February, we looked at how to deal with the increased uncertainty in the run-up to the US elections. In this In Focus section, we take a closer look at the political dimension. In particular, we highlight the implications of a potential Biden election victory, as well as the likely changes that a potential Trump victory could bring for the European economy.

DUEL BETWEEN BIDEN AND TRUMP STILL OPEN

So far, Biden has hardly been able to benefit from the fact that the US economy continues to perform robustly (see Economy and Markets section). In the latest polls, Biden and Trump are still close to each other and it is currently impossible to predict who will win in November (see chart 1). There is also a large group of undecided voters and, given the **US electoral system**[4], nationwide polls are of limited value anyway. US voters are likely to be most interested in how their personal economic situation is developing. Under Biden, however, they are stubbornly pessimistic about the economy (see chart 1). Nonetheless, economic issues are also likely to play the biggest role for investors regarding the election.

[4] The US President is not directly elected by the people. In the individual states, 538 electors are appointed, who belong to the so-called Electoral College. To be elected as the next president, a candidate needs 270 votes in this electoral college.

1. TRUMP'S LEAD OVER BIDEN HAS NARROWED RECENTLY, BUT US VOTERS REMAIN STUBBORNLY PESSIMISTIC DESPITE ROBUST ECONOMY



Note: The graph on the left shows the average value of numerous surveys. RealClearPolitics collects the surveys from various polling institutes and calculates an average value from them. This is intended to compensate for random outliers or systematic distortions of individual institutes. The current conditions of the University of Michigan (Current Conditions) in the chart on the right show how US consumers assess the current economic situation in the country. The index is calculated monthly based on a telephone survey of at least 500 US households conducted by the University of Michigan to calculate five different indices, including this one. Respondents are asked the following questions, among others. 1. whether their families' financial conditions are better or worse than a year ago 2. whether it is a good time to buy large household items and make other large purchases.
Source: Real Clear Politics, University of Michigan, Bloomberg, UniCredit Group Investment Strategy
Observation period: 01.01.2023-08.05.2024 (left chart) and 08.05.2014-08.05.2024 (right chart)

The following section will examine the priorities of the presidential candidates regarding the economy, but also in the various policy areas and in view of the geopolitical crises and challenges.

COMPARISON BETWEEN TRUMP AND BIDEN: WHAT POSITIONS DO THE CANDIDATES HOLD?

Taxes/tariffs: Biden is in favour of raising the corporate tax rate to 28%, bringing it closer to the 35% rate that applied before Trump took office. He also proposes taking action against tax avoidance by large multinational companies and increasing tax rates for the wealthiest Americans. He also considers the expansion of tax credits for low-income earners and families to be necessary and right. Trump, on the other hand, plans to extend the legislation he signed in 2017. This would extend the soon-to-expire cuts in income tax for individuals and the cuts in inheritance and wealth tax, possibly making them permanent. He wants to retain the corporate tax rate of 21%. However, the escalating national debt significantly restricts the fiscal room for manoeuvre. Trump is also pursuing a mercantilist[5] trade policy. He is proposing a general tariff of 10% on all US imports and 60% on imports from China.

Industrial policy and climate change: Rebuilding industrial capacity, particularly through **nearshoring[6]**, and further improving the security of supply chains are likely to be priorities for both governments. However, their approaches would probably differ significantly. With the Inflation Reduction Act (IRA), Biden has pushed through historic **investments of around USD370 billion[7]** over 10 years in the sustainable transformation of the economy and society, and triggered a boom in green energy production. The two other major economic stimulus programmes – the Infrastructure Development and Jobs Act and the CHIPS and Science Act – were passed by a broad majority of Democrats and Republicans and also have a long duration. Biden has defined ambitious new targets for reducing greenhouse gas and CO2 emissions. There is a threat of a rollback under Trump: he wants to abolish the IRA and has promised to boost domestic oil and gas production. It also seems conceivable that the unspent IRA funds under Trump could flow into industries and areas that do not correspond to the actual purpose of the programme.

China-Taiwan relations: There is a cross-party consensus in the US that China should be viewed as a rival and that trade barriers are necessary to safeguard not only national and economic security, but also the US's technological lead. Nevertheless, there are differences in approach between the governments. Although Biden reversed many of Trump's measures, he likely decided to retain his

[5]Mercantilism refers to an economic policy characterised by massive state intervention in the economy during the period of absolutism between the 16th and 18th centuries. It seeks to maximise the exports and minimise the imports through restrictive trade practices.

[6]Nearshoring is the relocation of operational activities to neighbouring or nearby countries.

[7]These include the promotion of renewable energies, purchase bonuses for electric cars, tax relief for heat pumps and solar systems as well as a levy on methane emissions.

predecessor's tariffs on Chinese imports for domestic political reasons. In mid-May, he drastically increased tariffs on e-cars, solar cells, semiconductors and medical products from China. His China policy takes account of the prevailing anti-China sentiment among the US population while also attempting to minimise the political costs. On the other hand, given Trump's announcement of prohibitively high import tariffs of 60% on Chinese goods, a new trade war is looming in a second Trump term. Perhaps the most obvious difference between Biden's and Trump's China policy is their stance on Taiwan. Biden has made it unmistakably clear that the US would defend Taiwan in the event of an attack by China and has advocated the strengthening of alliances in the Indo-Pacific region. Meanwhile Trump has branded Taiwan an economic competitor that is "ripping off" US companies. Trump's indifference to Taiwan has led China to speculate that the US could abandon the island if he wins the election.

Russia-Ukraine war: The US is considered the most important ally of Ukraine, which is under attack from Russia, and is by far the largest donor of weapons and equipment. After the US House of Representatives approved new aid for Ukraine at the end of April following months of domestic political deadlock, Biden immediately ordered new arms deliveries and warned that Russia could attack a NATO partner as a next step. Trump, who has repeatedly shown his admiration for Russian President Putin, warned that he would "encourage" Russia to "do whatever they want" to NATO countries if these allies did not fulfil their financial obligations to the bloc. He plans to reduce or even end the US's involvement in European defence. He has since toned down his rhetoric, but not without calling on the Europeans to do more to support Ukraine in its defence against Russia. At the same time, he has recently emphasised with unusual clarity that the "survival of Ukraine" is also important for the US.

Middle East conflict: The US and Israel are traditional allies. Although the incumbent US President remains firmly on Israel's side, he has recently increasingly criticised Israel's Prime Minister Benjamin Netanyahu for his handling of the Gaza war. Biden calls for a ceasefire and suspended arms deliveries due to concerns about Israel's Rafah offensive. He is under growing domestic political pressure, which could be dangerous for him in the run-up to the election. Many young voters, the majority of whom have tended towards the Democrats in the past, disapprove of his handling of the Gaza war. Trump, who often brags about his support for Israel, believes that Israel must "finish what it started" without specifying his statements. Trump has also so far failed to answer the question of how he would deal with the complex conflict situation in the Middle East if re-elected.

(Illegal) immigration: On the issue of immigration, Trump tends to be seen as an advocate of a restrictive immigration policy and a more nationalistic approach that restricts the admission of refugees and makes it more difficult for asylum seekers to obtain protection in the US. He has led Americans to believe that the US is being overrun by a wave of migration. In response, President Biden, who generally prioritises humanitarian considerations, has increasingly turned his attention to the southern border and is threatening to take executive action to stem the flow of people heading north. However, he is likely to remain in favour of comprehensive immigration reform, including a pathway to citizenship for undocumented immigrants.

Healthcare: While Biden's healthcare policy is likely to continue to focus on redistributive initiatives to expand access to healthcare, Trump would prioritise freedom of choice and transparency. The biggest issue of contention is the future of the Affordable Care Act (ACA, also known as Obamacare) from 2010, which Biden has promised to strengthen, and Trump has promised to abolish or replace. The focus is also on curbing price rises, particularly for medicines. Another point of conflict is abortion, after the US Supreme Court overturned the 1973 precedent of Roe vs. Wade in June 2022, which granted all women in the country the right to an abortion. A new Biden administration would likely work to restore nationwide access to abortion and expand reproductive rights. Under Trump, on the other hand, further restrictions on abortion and reproductive rights could be expected.

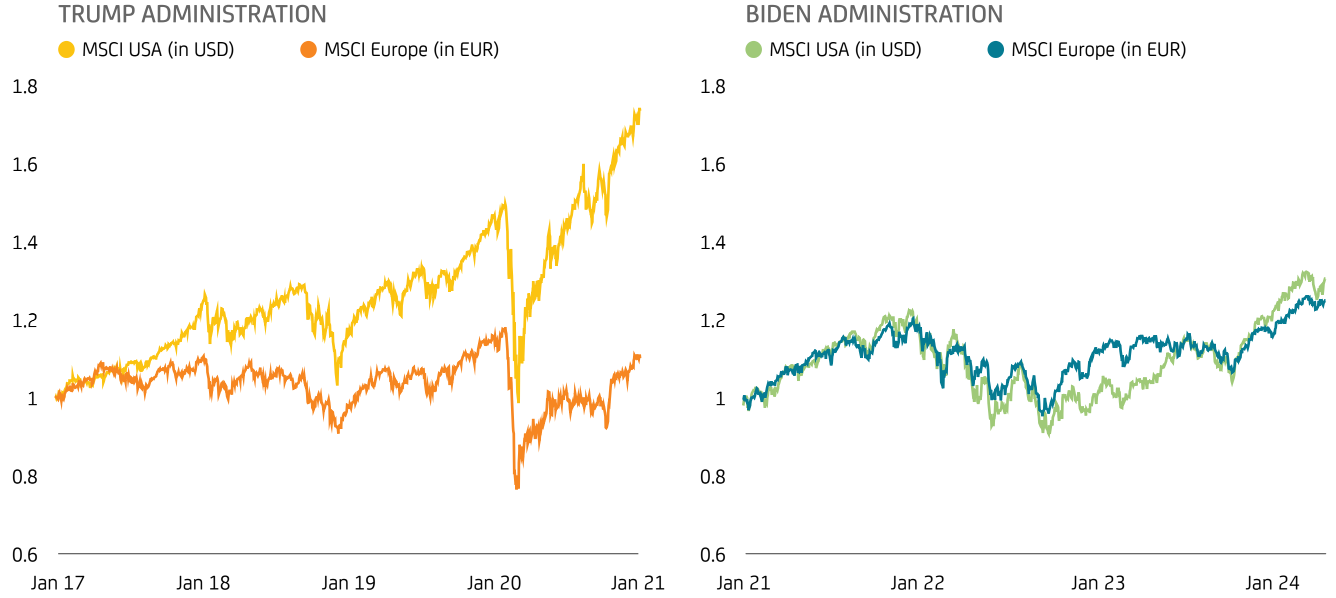
POSSIBLE IMPLICATIONS FOR THE ECONOMY AND MARKETS, ESPECIALLY IN EUROPE

At around EUR1.6 trillion, bilateral trade between the EU and the US reached an all-time high in 2023 (Source: European Commission). According to an analysis by Morgan Stanley, European companies generate around 25% of their market capitalisation-weighted revenues in the US.

Regardless of who is elected to the White House in November, the prospect of the protectionist US policy of recent years is likely to remain. Trump can be expected to pursue a fundamentally business-friendly policy, which could benefit not only US companies but also European companies – especially those with subsidiaries in the US. Nevertheless, the risks for parts of the European stock market could increase in the event of a Trump election victory in view of the expected tightening of the "America First" policy. The export-orientated European economy will have to face the challenge of this new economic nationalism regardless of the outcome of the election – and not just in trade and economic relations. For instance, in US climate legislation, subsidies and tax incentives are linked to production in the US.

A look at the markets shows that the broad US stock market was able to gain significantly during Trump's first term as US President (with high volatility). However, this is more likely to have been a consequence of the expansionary monetary policy at the time and strong global economic growth. Although Europe generally lags behind high-growth US equities, the underperformance of European equities was more pronounced in the Trump years than during the current Biden administration (see chart 2). However, even if the threat of new or higher tariffs on imports from the EU and China is likely to weigh on sentiment towards European (and Chinese) equities, we believe investors would be well advised to stick to their fundamental medium to long-term plans. Appropriate diversification of the portfolio, including across regions, remains essential.

2. US EQUITIES RECORDED A STRONGER PERFORMANCE UNDER TRUMP



Note: Time series indexed to the day Trump and Biden were sworn in on 20 January 2017 and 2021 respectively. Past performance, simulations and forecasts are not a reliable indicator of future performance. The indices cannot be purchased and therefore do not include any costs. When investing in securities, costs are incurred which reduce the performance. When investing in foreign currency, the return may also rise or fall as a result of currency fluctuations.
Source: Bloomberg, UniCredit Group Investment Strategy
Observation period: 20.01.2017-20.01.2021 (left chart) or 20.01.2021-08.05.2024 (right chart).

Macro & Markets

Central banks hold on to interest rate outlook

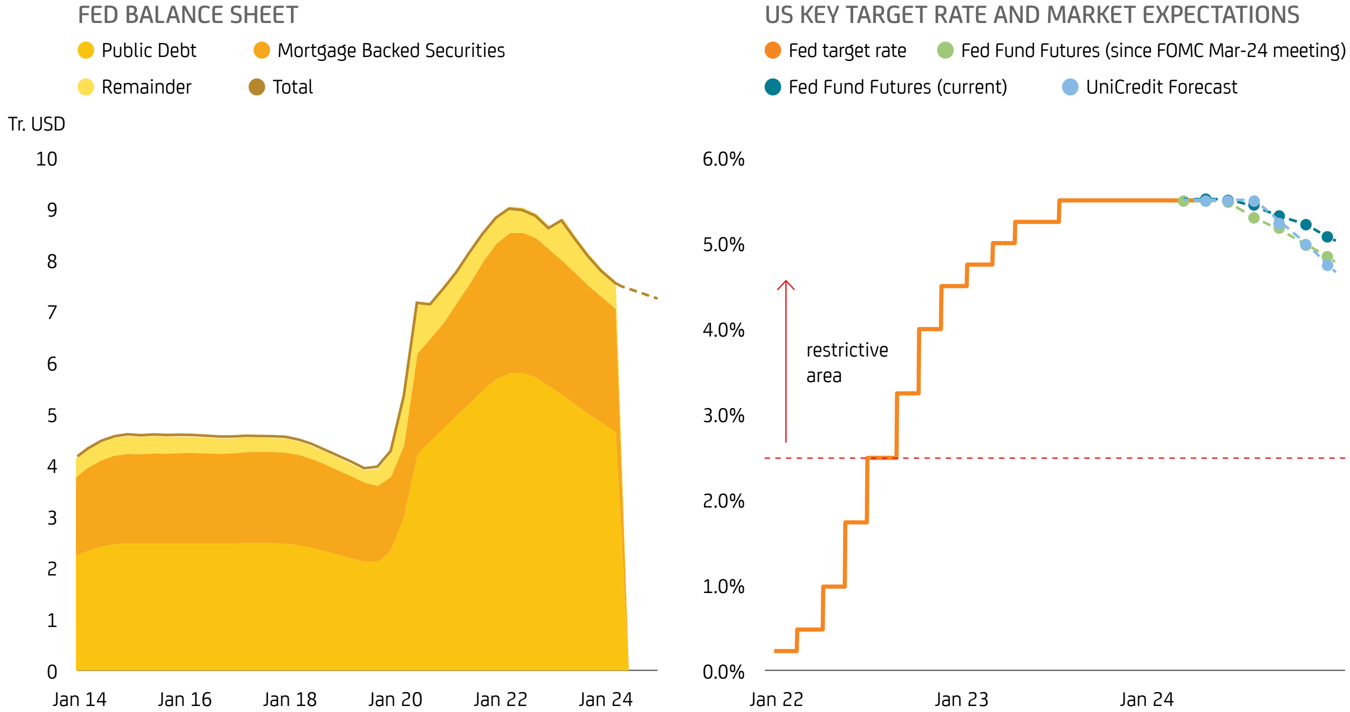
SIGNS OF US ECONOMIC DOWNTURN INCREASE, FED CONFIRMS INFLATION AND INTEREST RATE OUTLOOK FOR 2024

In the first quarter of 2024, the US economy fell to its lowest level in almost two years. Gross domestic product (GDP) grew at an annualised quarterly rate of 1.6%, which was weaker than expected. This is primarily due to the increased trade deficit, which dampened growth more than at any time since 2022. Private consumption remained the main pillar of the economy, although it was also weaker than expected. On the other hand, company inventories and net exports had a negative impact. In the labour market, the number of non-farm employees rose by only 175,000 in April, the slowest rate in six months, while the unemployment rate increased to 3.9% and wage growth slowed. The number of hours worked per week also fell slightly to 34.3 and the picture for leading indicators in the US has also clouded over recently. For example, the ISM purchasing managers' index (Institute for Supply Management) for the service sector fell below the 50 mark in April, indicating a slowdown in the economy. The price indicator favoured by the US Federal Reserve (Fed), the so-called **PCE deflator**[8], recently rose slightly to 2.7% year-on-year in March (from 2.5% in the previous month), after the last rise in consumer price inflation had already indicated this.

At its last meeting in May, the Fed left interest rates unchanged and announced that it would slow down the pace of quantitative tightening (reducing the central bank's balance sheet) from June. The decision to leave the key interest rate at 5.50% (upper end) had been widely expected. The post-meeting statement said that "no further progress toward the Committee's 2% inflation objective has been made in recent months" after three months of upward inflation surprises and continued robust economic activity and employment. During the press conference, Fed Chair Powell said that it will likely take longer than expected to achieve the "greater confidence" (regarding inflation moving towards 2% on a sustained basis) that the Fed's Monetary Policy Committee needs to see before it can cut rates. Unlike in March, Powell did not say that rate cuts were likely this year. Instead, he said, "There are paths that lead to rate cuts and there are paths that don't lead to rate cuts," declining to give probabilities for each path. In his baseline scenario, however, he still expects inflation to slow this year, although he now appears to be less confident than before. Nevertheless, he emphasised that the next interest rate move "will probably not be an increase". With regard to the central bank balance sheet, the Fed is sticking to its reduction plan (see chart 3). The announcement of a slowdown in balance sheet reduction was largely expected by market participants, even if the reduction in the monthly repayment ceiling for government bonds from USD60 billion to just USD25 billion was somewhat greater than generally anticipated. We continue to assume that the interest rate cuts this year, likely starting in September, will amount to a cumulative 75 basis points (bps). We also expect the slower pace of balance sheet reduction to continue at least until the end of this year and probably into the first half of next year (see chart 3).

[8] The PCE deflator is an alternative indicator for measuring inflation in the US that is based on data on personal consumption expenditure and therefore covers a larger sample than the basket of goods on which consumer price inflation is based.

3. FED SLOWS PACE OF BALANCE SHEET REDUCTION, UNICREDIT EXPECTS THREE RATE CUTS BY THE END OF 2024



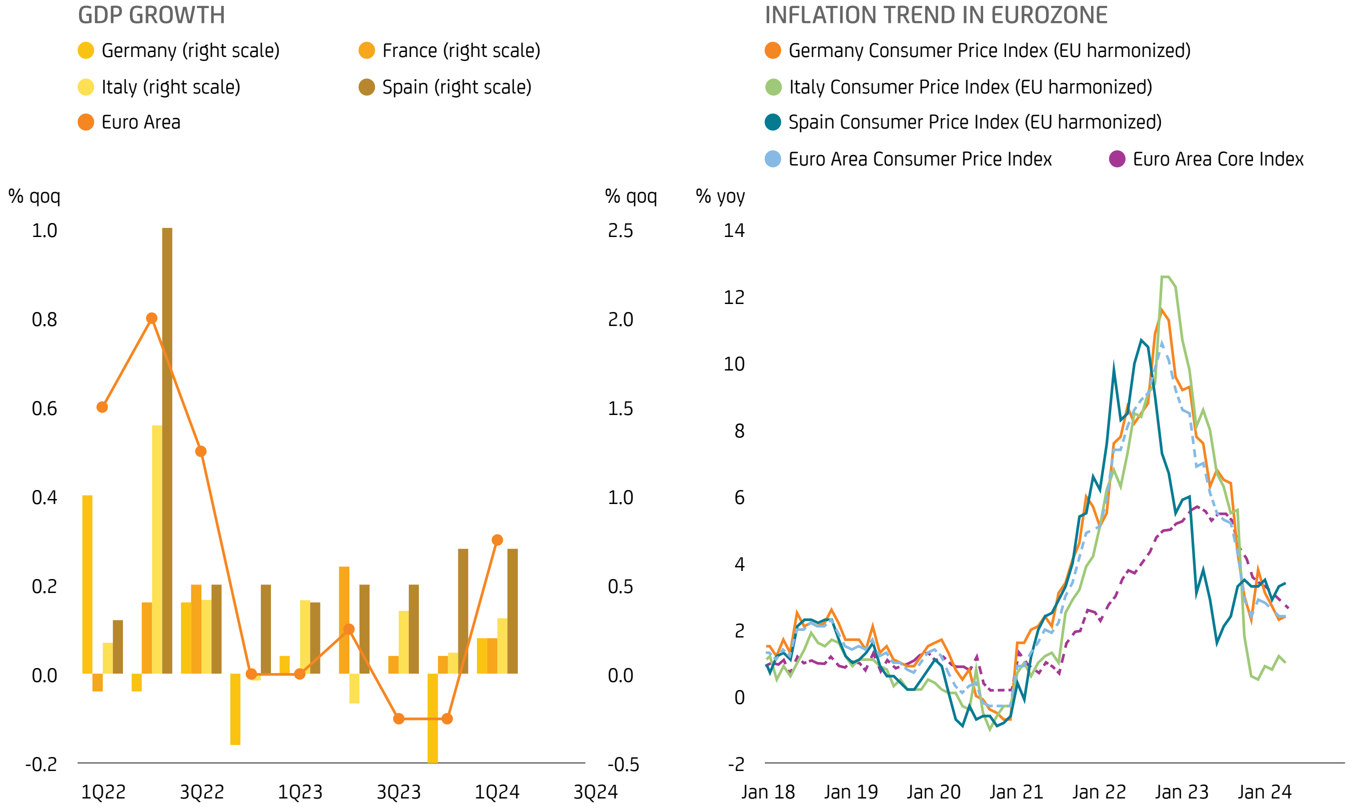
Source: Federal Reserve, Bloomberg, UniCredit Research, UniCredit Group Investment Strategy

EUROZONE ECONOMY RECOVERS MORE THAN EXPECTED, DISINFLATION CONTINUES

The eurozone economy surprised with unexpectedly solid GDP growth of 0.3% in the first quarter of 2024 compared to the previous quarter (see chart 4). This is due to better economic development in Germany (0.2% compared to the previous quarter), Italy (0.3% compared to the previous quarter), France (0.2% compared to the previous quarter) and Spain (0.7% compared to the previous quarter). Growth in Germany and Italy was primarily driven by an improvement in foreign trade, while France and Spain benefited from a revival in domestic demand. On the inflation side, the overall rate in the eurozone remained unchanged year-on-year at 2.4% in April, in line with consensus expectations (see chart 4). However, this stability concealed clear and opposing upward and downward movements. On the one hand, energy prices rose in April, which was largely driven by an increase in fuel prices. On the other hand, core inflation (overall rate excluding energy and food) fell to 2.7% in April (compared to 2.9% in March) and was therefore only slightly above expectations. It is encouraging to note that inflation in services in particular, which is a key driver of the core rate, declined. Although the final data is not yet available, it is likely that a combination of falling transport costs and falling costs for hotel accommodation and restaurant visits explains this decline.

After the European Central Bank (ECB) left key interest rates unchanged at its last meeting in April, and held out the prospect of a first rate cut in June when new growth and inflation forecasts are available, this data is likely to support the central bank's outlook. The ECB's chief economist recently commented favourably on the latest data from the eurozone, which confirms his view that inflation is once again approaching the target of 2%. Other ECB representatives such as Bundesbank chief Nagel and the head of the Austrian National Bank Holzmann, on the other hand, warn against cutting interest rates too quickly, as structural factors in particular (e.g. continued high wage growth, which is possible due to demographics) could maintain the underlying inflationary pressure. We continue to assume that the ECB will cut key interest rates by 75 bps this year, with a first rate cut probably in June, but will only implement the cuts slowly due to the uncertain development of disinflation.

4. EUROZONE: GROWTH PICKS UP IN THE FIRST QUARTER, INFLATION CONTINUES TO FALL

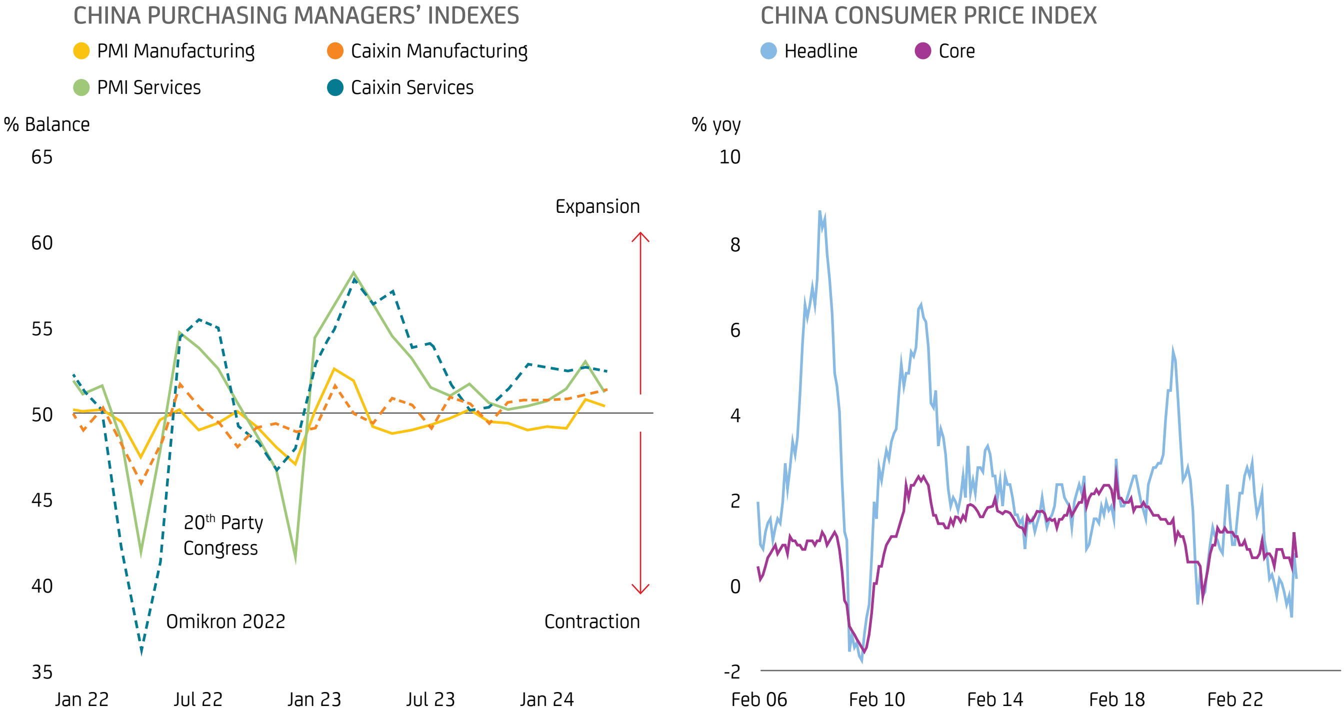


Source: Eurostat, Bloomberg, UniCredit Group Investment Strategy

CHINA: SOLID GROWTH AT THE START OF THE YEAR, BUT WEAK RECOVERY IN CONSUMPTION

China's real GDP growth rose to 5.3% year-on-year in the first quarter, driven by robust production in the manufacturing sector and an expansion of growth in the service sector. Manufacturing output growth was 6.4% year-on-year, driven by a recovery in exports and sustained construction activity related to infrastructure and manufacturing investment supported by stimulus programmes. The upturn in the service sector slowed somewhat in the first quarter, but people appear to be consuming more again since the lifting of the zero Covid policy. Domestic tourism in particular has since led to a pronounced seasonal pattern in consumer spending and service activity. Accordingly, the purchasing managers' indices for the services sector remained in expansion territory in April (see chart 5). Despite the signs of improvement, there is broad consensus that domestic demand in China has not recovered sufficiently since the cancellation of the zero Covid policy, especially consumer spending. The latter is also reflected in the weak consumer price inflation rates (see chart 5). However, we consider it unlikely that Chinese policymakers will heed the call for stronger policy support for consumption (e.g. through cash distributions or the privatisation of state assets to pass on existing wealth to households). Without further government support measures, however, it seems questionable whether China will be able to achieve its self-imposed growth target of around 5% this year.

5. CHINA'S RECOVERY CONTINUES, INFLATION REMAINS AT A LOW LEVEL



Source: NBS of China, Bloomberg, UniCredit Group Investment Strategy

FINANCIAL MARKETS TURN FRIENDLY AGAIN AFTER SIGNIFICANT SETBACKS IN APRIL

April was a difficult month for both the equity and bond markets. A combination of persistently high US inflation data and solid US GDP growth in the first quarter fuelled fears across the markets that the Fed in particular might not loosen its monetary policy as quickly as previously hoped. Both the equity and bond markets therefore reacted negatively. However, they largely recovered again at the beginning of May. The S&P 500 fell slightly in the reporting period (1 April to 10 May), while the Euro Stoxx 50 trended sideways and the German DAX index even reached a new all-time high on 10 May (see table). In the reporting season for the first quarter, companies were largely able to exceed profit expectations (albeit at a low level) and the economic environment remains fundamentally favourable. The bond markets also initially suffered in April due to the change in interest rate expectations. In the meantime, the markets were expecting only one and a half interest rate cuts in the US this year, and the date of the first interest rate cut by the Fed was postponed well into the second half of the year. As a result, yields on 10-year government bonds rose to around 4.7%. Bund yields followed this trend, rising to over 2.6%. Recently, however, bond yields in both the US and the eurozone fell again across the various maturities, and bonds were able to regain some ground.

On the commodity markets, the price of Brent crude oil fell by around 4% in the reporting period and most recently traded at around USD85 per barrel (see table), having previously risen significantly for a long time due to fears of further escalation in the Middle East. Recent signs of a possible agreement on a ceasefire in the region meant that a large part of the geopolitical risk premium contained in the futures prices was priced out again towards the end of the reporting period. The precious metal gold rose by more than 5% in the reporting period, but suffered significant price losses in the meantime as markets increasingly realised that the Fed would likely initiate the interest rate cut cycle later and that this could be less extensive. However, the prospect that the Fed could be right with its predetermined interest rate path and the three rate cuts it contains this year have recently supported the gold price. In this environment, the EUR-USD exchange rate rose to just under 1.08 (as at 10 May, see table).

Asset Allocation – How we manage our portfolio mandate

Asset		Investment Universe	Investment View: Underweight	Investment View: Neutral	Investment View: Overweight
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	●	○	○
		Emerging Market Bonds (Hard Currency)	○	●	○
		Emerging Market Bonds (Local Currency)	○	○	●
	Commodities	Oil	○	●	○
		Gold	○	●	○

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

NEUTRAL GLOBAL EQUITIES

Supported by resilient growth prospects and expectations of central banks' rate cuts.

NEUTRAL EUROPEAN EQUITIES

The macro picture is improving, beating consensus estimates. The job market is solid, while falling inflation is resulting in higher real income. ECB on track to start easing rates in June. European equities offer good opportunities for value and quality investors.

NEUTRAL US EQUITIES

GDP growth remains robust, but the sticky inflation is increasing uncertainty on the timing and magnitude of the Fed's easing cycle. Valuations are high and the concentration of mega caps in the S&P500 is extreme.

NEUTRAL EMERGING MARKET EQUITIES

In Asia we remain strategically cautious on Chinese equities. However, cheap valuations may favour a moderate tactical catch-up on the back of some fiscal and monetary stimuli. In Latin America, a more patient Fed may limit the size of the Brazil's easing cycle. Geopolitical risk is increasing due to the Middle East tensions. Overall, valuations are cheap for EM equities. Countries and sectors selectivity among EMs is strongly recommended.

OVERWEIGHT ON PACIFIC EQUITIES

Wage growth is a positive factor for Japan, which is emerging from a long phase of deflation. In addition, the increase in corporate profits and the reform of the Tokyo Stock Exchange are encouraging intense share buyback activity. Extreme weakness in the Japanese yen may have an impact on inflation, given that Japan is a strong importer of food and energy, and on interest rates. Despite the recent performances, equities valuations are not expensive.

OVERWEIGHT ON GLOBAL BONDS

They present an attractive risk-reward profile, given their current yields and expectations of rate cuts from the major central banks. In detail, we reiterate our strategic preference for "high quality bonds", such as Euro investment grade corporate and Euro government bonds.

OVERWEIGHT ON EURO INVESTMENT GRADE CORPORATE BONDS

Tight spreads but they continue to be supported by the resilience of the economic cycle and the persistent search for yield by investors. Overall, IG companies' fundamentals are expected to remain strong thanks to healthy balance sheets, better-than-expected earnings, strong cash balances and low levels of leverage relative to long-term averages.

UNDERWEIGHT ON HIGH YIELD CORPORATE BONDS

Their spreads, especially for lower-quality bonds, do not yet fully discount the risk of a material economic slowdown. In addition, the asset class is relatively less liquid.

NEUTRAL EMU GOVERNMENT BONDS

Supported by falling inflation and by the ECB being well on track to start easing rates in June.

NEUTRAL NON-EMU GOVERNMENT BONDS

Sticky US inflation with risk of a delay / size reduction of the Fed easing cycle.

NEUTRAL ON EMERGING MARKET BONDS IN HARD CURRENCY

Interesting carry but we prefer focusing on "high quality bonds". We stay defensive and selective.

OVERWEIGHT ON EMERGING MARKET BONDS IN LOCAL CURRENCY

Falling inflation, especially in Latin America, and attractive carry. However, they might be affected in the short term by a more patient Fed / stronger US dollar.

UNDERWEIGHT ON MONEY MARKETS

Interesting yields, but we prefer to invest in fixed income asset classes such as government bonds and Euro corporate IG given expectations of Fed and ECB rate cuts.

NEUTRAL ALTERNATIVES

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

NEUTRAL COMMODITIES

Low oil inventories, OPEC+ production cuts, geopolitical tensions and higher economic growth have reversed the trend in oil prices. The IEA now estimates that improved demand is pushing global oil markets into a slight supply deficit. In addition, the recovery in manufacturing explains the price increase in industrial metals, except for iron ore.

NEUTRAL GOLD

It is benefiting from increased central bank purchases – particularly by the People's Bank of China after the freezing of Russian central bank foreign reserves decided by US and the EU – and expectations of lower rates, as well as geopolitical uncertainties.

CURRENCIES

Superior US growth and a patient Fed willing to avoid backtracking given the stickier inflation should continue to support the US dollar in the coming months.

How to invest

Investment ideas in the current scenario

EQUITY INVESTMENTS

OUR IDEA: CYBERSECURITY

The megatrend of digitalization and its recent acceleration has created complex ecosystems and heightened the vulnerability of our digital lives. Businesses, governments, and individuals are increasingly relying on technology for everyday activities, leading to exponential growth in digital networks and widespread sharing of sensitive data. The pandemic further accelerated foundational technology adoption, created new digital security needs, expanded the installed device base, and increased data generation. Meanwhile, the recent rise of emerging technologies is expanding the attack surface for cyber threats, burdening legacy systems, and exposing digital defence gaps. As a result, cyberattacks have evolved into more sophisticated forms, now ranking among the top global business risks, and carrying severe consequences for the companies involved ranging from financial damage including direct costs of ransom payments, fines, and legal fees, to reputational damage including indirect costs linked to the loss of trust from customers and investors. In 2022 the global cost of cybercrime was estimated at USD8.44 trillion, according to the IMF. The impact and dramatic rise in cyberattack also raised concerns among authorities that chose to enact stricter regulatory requirements and compliance standards to protect the privacy and security of individuals' data. For example, the European Union's General Data Protection Regulation (GDPR) and the California Consumer Privacy Act (CCPA) impose heavy fines on companies that fail to adequately protect customer data.

The steady increase in digital investments across both the public and private sector is expected to drive a strong and prolonged spending cycle for digital security solutions. In 2022 the global spend on cybersecurity solutions totalled nearly USD170 billion. Analysts forecast a roughly 12.6% increase per year until 2030, leading to an industry size of approximately USD440 billion by 2030. Within these estimates, the trillion-dollar cloud transformation alone is set to generate an opportunity worth at least USD100 billion for cyber security solutions, acting as a massive secular tailwind to the industry. As of 2023, this field was still largely unpenetrated considering that 80% of the data breaches involved data stored in the cloud.

Many of the cybersecurity companies operate with a Software-as-a-Service ("SaaS") business model. This means that the software that they offer is based on the cloud and provided to customers on either a pay-per-use or subscription agreement. Both alternatives provide a revenue floor and remove the peak-and-trough effect of the traditional on-premises model. Although, given that the industry is still in a development phase, many of the companies are making significant investments in the development and commercialization of new innovative products. As a result, traditional metrics like the price-to-earnings ratio may mislead some into thinking that the subsector trades at a notable premium to the broader tech industry. For this reason, revenue-based multiples are more suitable as they level out the effect of these efforts that negatively impact EBITDA and earnings. For instance, the top US player in the cybersecurity field trades at a P/E ratio of 46.5x 2025e, a 97% premium to the 23.6x of the US tech market. At the same time, it has a 54% premium at the EV/Sales level with a 9.7x ratio versus 6.3x of the index, justified by an expected 16.7% revenue growth rate CAGR over the next five years and premium profitability.

Strong momentum in end-market demand continues to translate into robust fundamentals for cybersecurity companies as security challenges remain a top priority on global companies' agendas. In addition, the unfolding of the potential of artificial intelligence (AI) is set be a game changer for the industry through its crucial and tangible role in the enhancement of the business. Thanks to advanced algorithms and machine learning, AI can analyse vast amounts of data in real-time, enabling immediate detection of potential threats and anomalies. This system will be much faster and more accurate than traditional methods and will reduce the burden on analysts resulting in operating efficiencies, streamlining of the organization and cost reduction. Overall, the theme offers investors an opportunity to diversify the portfolio and capitalise on a strong growth outlook and transformation journey, either leveraging on a pure-player exposure or by leaning on larger diversified software players.

BOND INVESTMENTS

OUR IDEA: HIGH-QUALITY CORPORATE BONDS

Stronger-than-expected US inflation data weighed on fixed income in April. In particular, the increases in US consumer prices in March (0.4% month-on-month, or 3.5% year-on-year from 3.2% previously) and in the "Personal Consumption Expenditures Deflator", one of the most important indicators followed by the US Federal Reserve (a 0.3% increase compared to February and 2.7% higher year-on-year), were the factors that most penalized the bond market. This data fuelled uncertainty around the start of central banks' rate cutting cycles, which have now been postponed to next autumn onwards.

The yield on the 10-year Treasury rose from 4.20% at the end of March to a high of 4.70%. The 10-year Bund rate rose 28 basis points to end the month at 2.58%. In contrast to the first quarter, in which there was a clear dichotomy between the negative performance of government bonds and the positive returns of other fixed income asset classes, in April the weakness in government bonds extended to corporate bonds and emerging market bonds as well. European investment grade bonds fell 0.80% during the month, while emerging market bonds lost 1.10%, hurt by profit-takings after extremely positive returns in the first quarter.

However, the outlook for bond markets remains moderately positive for the coming months. We believe that the rebound in US inflation is not structural, but linked to temporary factors that are destined to run out in the coming months – such as the rise in the price of oil, which has already partly reversed – and to statistical factors, due to the fact that year-on-year changes in prices are also being compared with very limited increases in the first half of 2023.

In addition, in balanced management, fixed income is once again a stabilising factor for portfolios – thanks to a positive yield to maturity and coupon flows – and a safe-haven asset in the event of a reversal in equity markets. In corporate bonds, we maintain a positive view on the outlook for investment grade credit, whose risk-adjusted yields are still attractive, despite a below-average level of spread versus government bonds. High-quality bond valuations may look expensive, but companies have strong fundamentals and positive earnings that justify the current levels and will allow them to weather any future market stresses.

Technical factors are also supportive of credit. Inflows into the asset class were once again positive in April, and the supply of new issuance was easily absorbed. Many of the new 2024 issuances have been brought forward to the first months of the year and for the coming months we expect a limited supply that will provide good technical support to the market.

Finally, historically, the end of a rate hike cycle has been a good time for buying high-quality corporate bonds. In previous hiking cycles, after rates peaked, investment grade corporate bonds generated positive returns in the following one to three years. Even if this year's planned rate cuts are delayed beyond current forecasts, any corporate bond reversals are likely to prove temporary and eventually fall to lower levels than they are now – with potentially attractive returns for investors.

DEVELOPMENT OF SELECTED FINANCIAL MARKET INDICES

From	**10.05.23**	10.05.19	10.05.20	10.05.21	10.05.22	10.05.23	10.05.19	**01.01.24**
To	**10.05.24**	10.05.20	10.05.21	10.05.22	10.05.23	10.05.24	10.05.24	**10.05.24**
Stock market indices (total return, in %)								
MSCI World (in USD)	**24.0**	-0.4	46.5	-7.9	7.8	24.0	78.6	**8.8**
MSCI Emerging Markets (in USD)	**13.0**	-8.7	51.2	-23.2	0.6	13.0	19.8	**5.6**
MSCI US (in USD)	**28.9**	4.6	46.6	-4.8	5.0	28.9	96.5	**9.8**
MSCI Europe (in EUR)	**15.8**	-7.4	33.1	-1.5	14.5	15.8	60.4	**10.7**
MSCI AC Asia Pacific (in USD)	**12.9**	-3.7	45.4	-21.4	4.5	12.9	29.2	**5.7**
STOXX Europe 600 (in EUR)	**16.0**	-6.5	34.2	-2.8	13.9	16.0	60.6	**10.6**
DAX 40 (Germany in EUR)	**18.6**	-8.9	41.2	-12.1	17.5	18.6	55.7	**12.1**
MSCI Italy (in EUR)	**35.5**	-16.4	44.3	-3.9	25.6	35.5	95.8	**17.7**
ATX (Austria, in EUR)	**22.5**	-23.3	54.7	-6.7	10.0	22.5	46.8	**9.8**
SMI (Switzerland, in CHF)	**5.1**	6.0	18.6	6.7	2.3	5.1	44.4	**8.5**
S&P 500 (USA, in USD)	**28.4**	4.1	45.3	-3.1	5.2	28.4	96.9	**10.0**
Nikkei (Japan, in JPY)	**33.7**	-3.6	48.6	-9.6	13.9	33.7	97.7	**15.1**
CSI 300 (China, in Yuan)	**-5.8**	12.7	28.6	-20.1	4.3	-5.8	9.6	**7.0**
Bond market indices (total return, in %)								
US Government Bonds 10Y (in USD)	**-5.2**	21.2	-6.0	-10.8	0.2	-5.2	-3.2	**-3.6**
US Government Bonds (ICE BofA, in USD)	**-2.2**	13.9	-4.2	-8.0	-0.5	-2.2	-2.1	**-2.1**
US Corporate Bonds (ICE BofA A-BBB, in USD)	**3.3**	7.8	6.9	-11.3	1.1	3.3	7.2	**-1.0**
German Bunds 10Y (in EUR)	**0.1**	5.1	-2.7	-10.2	-8.6	0.1	-15.5	**-3.0**
EUR Government Bonds 1Y-10Y (iBOXX, in EUR)	**2.4**	4.3	1.2	-9.5	-7.7	2.4	-9.3	**-1.7**
EUR Corporate Bonds 1Y-10Y (iBOXX, in EUR)	**5.3**	-0.8	5.3	-9.3	-3.3	5.3	-3.3	**0.1**
Bond yields (change in basis points = 0.01 percentage points)								
US Government Bonds 10Y (in USD)	**112**	-178	92	139	45	112	206	**64**
US Government Bonds (ICE BofA, in USD)	**99**	-186	42	194	85	99	231	**59**
US Corporate Bonds (ICE BofA A-BBB, in USD)	**39**	-78	-73	222	86	39	192	**43**
German Bunds 10Y (in EUR)	**28**	-48	32	122	129	28	255	**50**
EUR Government Bonds 1Y-10Y (iBOXX, in EUR)	**12**	-43	-7	127	142	12	224	**40**
EUR Corporate Bonds 1Y-10Y (iBOXX, in EUR)	**-26**	32	-79	207	150	-26	278	**29**
Spreads on government bonds (credit spreads, change in basis points)								
US Corporate Bonds (ICE BofA US Corporate Master)	**-60**	100	-129	52	4	-60	-33	**-15**
US Corporate Bonds (ICE BofA US High Yield)	**-169**	353	-426	126	26	-169	-89	**-22**
Euro Corporate bonds (ICE BofA Euro Corporate AAA-A)	**-46**	62	-80	67	1	-46	5	**-23**
Euro Corporate Bonds (ICE BofA Euro High Yield)	**-149**	245	-350	210	-25	-149	-63	**-56**
Money market rates (change in basis points)								
Libor (USD, 3 months)	**26**	-210	-27	123	394	26	306	**-1**
Euribor (EUR, 3 months)	**50**	6	-29	12	372	50	413	**-9**
Euro exchange rates (change in %)								
US Dollar (EUR-USD)	**-1.4**	-3.1	12.2	-13.3	3.8	-1.4	-4.0	**-2.5**
British Pound (EUR-GBP)	**-0.9**	1.6	-1.5	-0.7	1.4	-0.9	-0.2	**-1.0**
Swiss Franc (EUR-SFR)	**0.2**	-7.6	3.9	-4.2	-6.8	0.2	-14.1	**5.6**
Japanese Yen (EUR-JPY)	**14.6**	-6.2	14.7	3.8	7.9	14.6	36.2	**7.4**
Commodities (change in %)								
Commodity Index (GSCI, in USD)	**16.9**	32.3	4.1	-0.4	10.1	16.9	74.9	**14.6**
Industrial metals (GSCI, in USD)	**14.5**	-14.8	75.7	3.2	-14.2	14.5	46.5	**11.9**
Gold (in USD per fine ounce)	**16.9**	33.5	7.3	0.4	9.6	16.9	83.5	**14.4**
Crude oil (Brent, in USD per barrel)	**11.6**	-58.2	130.8	49.9	-25.4	11.6	18.0	**7.7**

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. Data as at 10.05.2024.

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