Returning to a Better Balance

Decoding the current economic environment and market dynamics

Group Investment Strategy

Monthly Outlook

August 2024

Index

Summary

MACROECONOMIC UPDATE

The US economy is losing momentum, with manufacturing and services sectors struggling, as indicated by the ISM surveys and reflected in labor market data. Consumers are spending less on services and more on essentials. Moreover, the persistently weak new orders indicate that production in the manufacturing sector is likely to stagnate in the coming months. Inflation continues to decline, driven by falling rents and car prices, suggesting potential interest rate cuts by the Federal Reserve (Fed).

For what concern the Eurozone, leading indicators suggest a marginal economic slowdown at the end of Q2, despite the positive trend continued. Germany's PMI indicates stagnation, while France continues to shrink, although at a slower pace; Italy and Spain still grow, with Spain notably strong. Inflation decreased slightly to 2.5%, with core inflation steady at 2.9%, driven by service prices. Disinflation is expected to continue slowly.

Finally, GDP growth in China slowed to 4.7% in the second quarter, below market estimates. Retail sales growth decelerated, though industrial production exceeded expectations, supported by robust foreign demand. The real estate market shows signs of stabilization, but consumer confidence remains weak. The Chinese leading indicators also painted a rather mixed picture in June. Among them a strong Caixin PMI for manufacturing and a declining services PMI, reflecting seasonal factors.

MONETARY POLICY AND CENTRAL BANKS

In his July speech to Congress, Fed President Powell reaffirmed the Fed's monetary policy, citing a robust labor market and solid economic expansion, albeit at a slower pace from the first quarter peaks. While noting modest progress in inflation, he stressed the need for more data to ensure a move towards 2%. Cautious about early easing, Powell might signal policy changes at the Jackson Hole symposium in August.

In July the ECB maintained its key rates unchanged and emphasized a cautious, data-driven approach. President Lagarde noted that the latest economic data support the disinflation trend, suggesting upcoming rate cuts. New forecasts in September may confirm this trend, with expected quarterly cuts until next year.

FINANCIAL MARKETS

June saw a positive mood in global financial markets, with the US economy expected to experience a soft landing and the eurozone showing signs of recovery, despite slower growth in China. The Fed maintained a dovish stance despite higher inflation, benefiting US technology stocks. In Europe, political events weighed on equities, but expectations of future interest rate cuts boosted bond markets, leading to lower yields in the US and the Eurozone. French elections caused temporary yield increases in French and peripheral bonds, but yields fell when populist parties didn't win. Oil price rose due to OPEC+ production cuts and stable demand, though China's weak growth later reduced gains. Gold price increased with expectations of a dovish US monetary policy, and the euro strengthened against the dollar.

CIOs' Letter

Following an eventful first half of the year, and in view of the developments around the US presidential election in November, we can confidently ask ourselves whether there will even be the often cited summer slump – as the coming months will probably not be short of headlines.

But let's first take a look in the rear-view mirror and review the past few months. It has almost been forgotten that there were many warnings of a possible recession in the US at the beginning of 2024. These warnings have now been largely silenced. As we explain in the "Economy and Markets" section, the momentum of the US economy continues to slow, leading to a normalisation of the labour market and inflation and thus increasing the prospect of an initial interest rate cut in the US in the second half of the year. The solid US growth has meant that the pronounced interest rate cut fantasies priced into bond prices at the start of the year have gradually been priced out again, leading to (temporary) price losses in bond portfolios. Incidentally, this development not only affected the US, but also Europe. In this country, the European Central Bank (ECB) has already cut interest rates once, and further interest rate cuts could follow. However, the extent of possible **interest rate cuts**[1] by the end of the year is likely to be significantly lower than expected at the beginning of the year.

[1]Interest rate cuts are also expected for the US after the summer break.

The opposite was true on the equity side. The robust economic situation has boosted the stock markets. In anticipation of rising GDP growth rates and moderately falling interest rates, companies' profit expectations have also risen. According to **consensus estimates**[2], annual profit growth rates of just under 10% are expected for companies in the major European equity indices in 2025 and 2026 and even slightly over 10% for those in US indices. The German economy, which has been battered in recent years, is also expected to grow again: Earnings growth rates for German equities are expected to be similar to those in the US on average over the next two years. Given the still moderate Price/Earnings valuations, the current share prices, which recorded a surprisingly strong increase in the first half of the year, partly reflect the earnings growth expectations for 2025, but the markets are similarly optimistic for 2026 as they are for 2025. These expectations could therefore motivate further share price increases. If the current market expectations for economic development and corporate profits prove to be too optimistic, this could lead to setbacks on the equity markets.

[2]The consensus estimate is the median in the distribution of individual estimates. The median is the value that lies exactly in the middle 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.

But it was not just the first half of the year that was characterised by remarkable developments; the past few days and weeks have also seen some interesting twists and turns. Following what was perceived as a weak debate performance by the incumbent US President Joe Biden in the TV duel with Donald Trump, the Republican Party candidate's election chances had increased. After the failed assassination attempt, the probability of Trump winning the election increased further. The markets began to price in the so-called "Trump trade", i.e., the most likely implications of a second Trump presidency. These were driven by the presumed central guidelines of a possible Trump administration: A looser fiscal policy (due to unfinanced tax cuts), a trade policy focussed on higher tariffs and less strict regulation in some economic sectors. Against this backdrop, US yields rose (a looser fiscal policy entails the need for further increases in government debt and thus increased issuance of US government bonds) and shares in companies from highly regulated industries such as the healthcare, energy and banking sectors rose.

Following Joe Biden's decision not to run for office again, there was a partial countermovement, as the markets are pricing in a slightly lower probability of a Trump victory. However, if we look at the election forecasting platforms based on market mechanisms, Donald Trump is still the clear favourite to win the election at the time of going to press. If these platforms are to be believed, his challenger is very likely to be the current Vice President Kamala Harris. However, it will be several weeks before a final nomination is decided. The Democratic Party's nominating convention will take place from 19-22 August. Until then, the likely candidate Kamala Harris looks set to dominate the headlines. Against this backdrop, the first reliable poll results on Harris' election chances will be awaited with great interest.

The question of a possible candidate for the office of Vice President is likely to be just as exciting. In this regard, it should be noted that the results from a handful of so-called **swing states**[3] such as Michigan, Wisconsin and Pennsylvania will be of great importance for the election of the president. Last but not least, the political agenda of a future US administration will be important for the markets. And this will be determined not only by the White House, but also by the majority in Congress. Most recently, the pressure on Joe Biden to withdraw from the race for the presidential candidacy had grown particularly strong due to the dwindling prospects of Democratic members of Congress – whether in the House of Representatives or the Senate (Congress) – in fiercely contested constituencies. With his latest move, donations to the Democratic presidential candidate's team, as well as to members of Congress, are likely to start flowing again. The race for the future of US politics appears to be wide open again.

[3]Swing states are US states in which the election result is expected to be close and has often switched from one party to another in the past. This is important as the vast majority of states often vote clearly along party lines.

This renewed openness regarding the outcome of the election means slightly increased uncertainty for the markets, which is reflected in the rise in classic uncertainty barometers such as the **VIX index**[4]. In our view, such uncertainty should not have any long-term negative implications for the markets because, as mentioned at the beginning, the economic outlook is not bad for either the US or Europe. Although the US economy is cooling down as expected because of the tight monetary policy, a recession is extremely unlikely. Fed Chairman Jerome Powell also recently emphasised to the US Congress that the economic risks are becoming more balanced. Consensus estimates already see GDP growth figures for the US rising more significantly again in the coming quarters. Europe is also likely to have overcome the lean period; similarly high growth rates to those in the US are expected for the eurozone in the coming quarters. Central banks are likely to finally enter the interest rate reduction cycle in the second half of the year and corporate profits are likely to rise. Neither Trump nor a Democrat-led administration is likely to reverse this trend. In our view, risk scenarios remain that the Fed will leave interest rates at the current high level for longer than expected or that the restrictive monetary policy conditions will result in a noticeable economic downturn.

[4]The VIX measures the implied volatility (i.e. derived from equity options), which has recently risen slightly.

What is particularly remarkable about the general economic and market situation is that it represents an almost perfect scenario for multi-asset portfolios. Moderate but stable economic growth with falling interest rates (due to easing inflationary pressure) should support both equity and bond markets. The coming months are likely to remain exciting due to the election developments in the US. Provided none of the risk scenarios mentioned occur, however, the tension on the markets should be limited.

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In Focus

Shift to the right in France averted, but uncertainty remains

More polarised than ever before in the country's recent history, France, the second largest economy in the European Union (EU), has been in a deep political crisis since the elections to the European Parliament. After President Emmanuel Macron called a new election to the **National Assembly**[5], in response to the disappointing performance of his party alliance Ensemble and the right-wing populist Rassemblement National (RN) of Marine Le Pen and her allies becoming the (temporarily) strongest political force in the country in the first round of the National Assembly elections, an absolute majority for the RN was averted by a broad democratic alliance in the second round of voting. The left-wing alliance New Popular Front surprisingly became the strongest force, ahead of Macron's centre camp. The RN only came third but was able to significantly increase its number of seats. The result of the parliamentary election therefore does not provide "clarity" for the time being – contrary to the intention that Macron had expressed after the dissolution of the National Assembly. He now faces the task of finding a stable governing majority in the fragmented French party landscape. However, we want to focus less on the political dimension of the latest developments and more on their implications for the economy and capital markets.

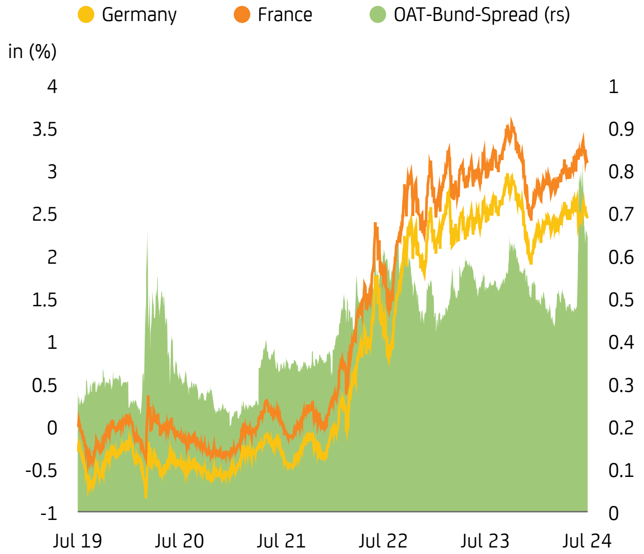
[5]The National Assembly is one of two French chambers of parliament. It is involved in legislation and can overthrow the government with a vote of no confidence.

MARKETS REFLECT CONCERNS ABOUT POLITICAL AND FINANCIAL STABILITY IN FRANCE

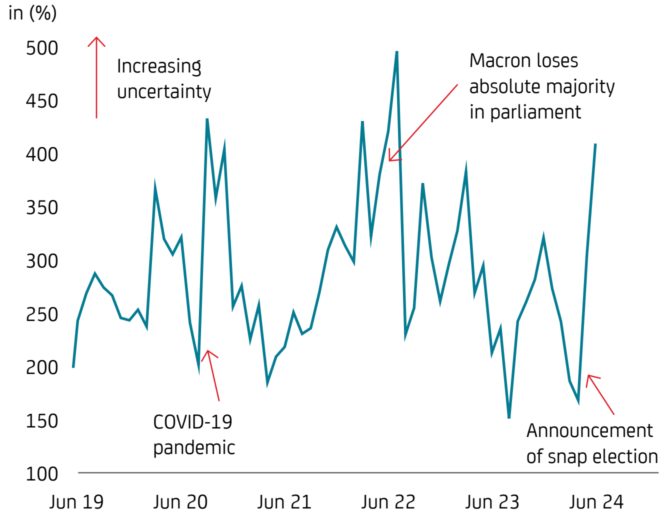
Unsurprisingly, concerns about political stability in France in the run-up to the early parliamentary elections caused economic policy uncertainty to rise to a two-year high in June. As a result, yields on French government bonds (OATs) rose significantly, particularly compared to those on German government bonds (Bunds). Specifically, before the announcement of the new elections, the yield spread on 10-year bonds (OAT-Bund spread) was around 45 basis points (bps) before almost doubling (see chart 1). It thus reached its highest level since the European sovereign debt crisis in 2011. Compared to the level after the first round of elections, however, the OAT-Bund spread has since narrowed significantly again, indicating that investor concerns have eased. The latest events have also left their mark on the stock market. Although the French benchmark index CAC 40 has recovered somewhat from its low following Macron's election announcement, it has lagged significantly behind the benchmark indices of other European countries (as of 19 July 2024, see table).

1. OAT-BUND-SPREAD ROSE TO THE HIGHEST LEVEL FOR YEARS

YIELDS ON 10-YEAR GOVERNMENT BONDS



ECONOMIC POLICY UNCERTAINTY INDEX, FRANCE



Note: OAT: Obligations Assimilables du Trésor (French government bonds), Bund: German government bonds, Spread OAT-Bund: Yield Differential between 10-year French and German government bonds.
The "Economic Policy Uncertainty Index", a measure of the level of uncertainty developed by Baker, Bloom and Davis, measures economic policy uncertainty based on the number of newspaper articles containing the words "economy" (or "economic"), "uncertainty" (or "uncertain") and one or more policy-related items.
Source: Bloomberg, Baker, Bloom & Davis, UniCredit Group Investment Strategy, observation period: 15.07.2019-15.07.2024 (left chart) and 30.06.2019-30.06.2024 (right chart)

The concerns of investors that a future government in France could trigger a new euro debt crisis have diminished significantly with the outcome of the election. Experience shows that the markets immediately penalise the prospect of an irresponsible expansion of public spending and a lack of financial discipline. In 2022, a crisis erupted on the UK bond market when the then Prime Minister Liz Truss presented a budget that provided for uncovered tax cuts and energy aid totalling several billion pounds, which market participants saw as "fiscal hara-kiri". Yields on British government bonds shot up dramatically, forcing the Bank of England to intervene. After less than 50 days in office, Truss was forced to resign. Following the Labour Party's landslide victory on 4 July, her career as a Member of Parliament in the House of Commons is now also over.

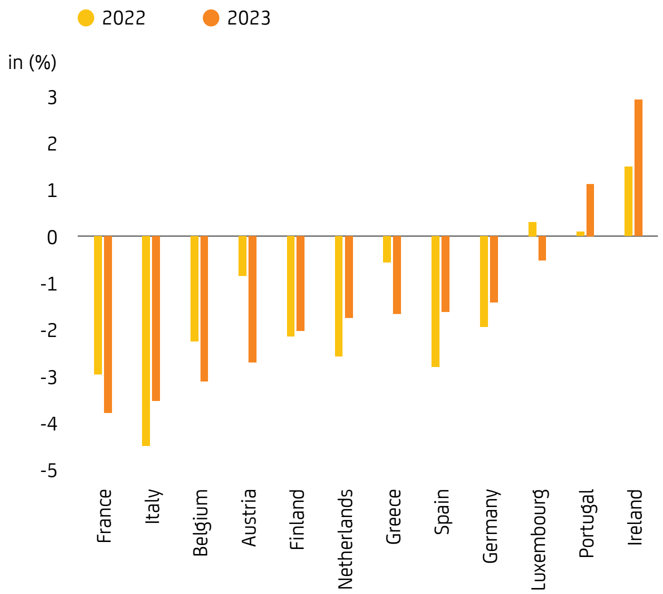
In fact, the sustainability of French debt is not a new topic of discussion. Macron has not yet succeeded in curbing the national debt. Even before the European elections, the rating agency Standard & Poor's downgraded France's credit rating by one notch from AA to AA-, fearing that the debt would be driven up by higher-than-expected deficits. France's national debt rose to almost 111% of gross domestic product (GDP) last year. At 5.5%, the country's budget deficit was well above the target value defined by the European Union (EU) of 3%. France's interest burden has more than tripled since 2021, to EUR57 billion this year. In 2023, the country also had the highest **primary deficit**[6] among the eurozone member states, while several peripheral countries were able to reduce their deficits (see chart 2). The fact that the European Commission is seeking to initiate an excessive deficit procedure against France emphasises the country's limited financial leeway. In addition, French economic growth has been rather weak over the past 10 years and, according to forecasts by the International Monetary Fund (IMF), per capita GDP will continue to lag that of the US and Germany over the next five years.

In addition to the poor fundamentals, the investor structure of French government bonds could also prove detrimental. According to IMF statistics, foreign non-banks (including hedge funds, insurance companies, money market funds and pension funds) now hold more than a quarter of total French government debt (see chart 2). Although the major French banks are permanently active on the market for government bonds, a rather small number of (foreign) creditors – unlike in Germany, for example – potentially have a major influence on the French bond market.

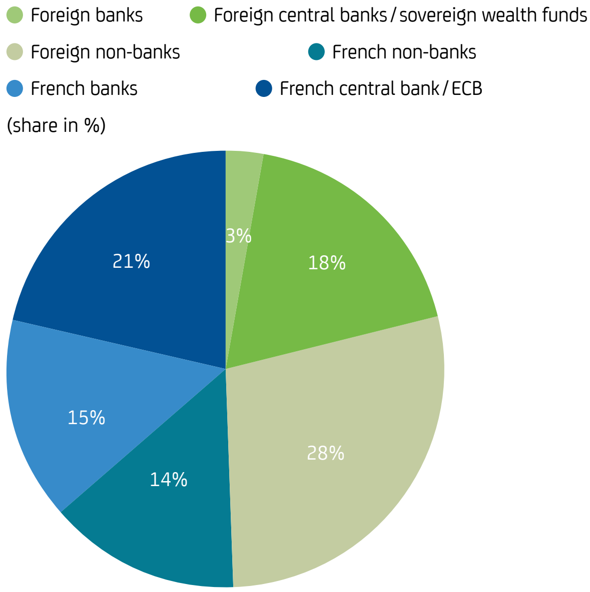
[6] The balance of government revenue and primary government expenditure (i.e. expenditure excluding interest payments): If revenue exceeds primary expenditure, a country generates a primary surplus; if primary expenditure is higher than revenue, this is referred to as a primary deficit.

2. FRANCE WITH THE HIGHEST PRIMARY DEFICIT IN THE EUROZONE, FOREIGN NON-BANKS HOLD MORE THAN 25% OF FRENCH GOVERNMENT DEBT

PRIMARY DEFICIT OF SELECTED MEMBER STATES



FRENCH GOVERNMENT DEBT HOLDERS (CENTRAL GOVERNMENT LEVEL)



Source: Macrobond, IMF, Barclays Research, Reuters, UniCredit Group Investment Strategy, as of 31.12.2023

However, it is also worth noting that the (monetary) policy framework of the eurozone has evolved and improved. Unlike around 15 years ago, the ECB has a "toolbox" at its disposal that effectively gives it the right to intervene in the bond markets at any time. With the "Transmission Protection Instrument" (TPI), which is even easier to use than the **predecessor concept**[7], the Eurosystem can purchase securities from individual countries in the event of unjustified, disorderly market developments to counter a deterioration in financing conditions that is not justified by country-specific fundamentals. The scope of purchases under the TPI, which take place on the **secondary market**[8] and are focussed on **public sector bonds**[9], depends on the severity of the risks to monetary policy transmission. Bond purchases are not limited ex ante, but the application of the TPI presupposes that the countries concerned fulfil the EU requirements for government budgets – a crucial point regarding France. ECB Chief Economist Philip Lane commented on the movements on the French bond market by saying that they did not appear "disorderly". This means that one of the necessary conditions for central bank intervention has not been met. Nevertheless, we believe it is not unlikely that the ECB will intervene if problems specific to France "spill over" to other member states.

[7]The instrument of outright transactions on the secondary markets for government bonds (OMT), which was introduced after the euro crisis in 2012 under ECB President Mario Draghi.

[8]The secondary market is the sub-market in the financial sector on which financial instruments that have already been issued are traded. It is the counterpart to the primary market, where new financial instruments are brought into circulation.

[9]Private sector securities may be taken into account if deemed appropriate.

CONCLUSION

While the **success of the Labour Party**[10] in the UK was unusually clear at the beginning of July and the Tories experienced the worst election result in their history, the risk of a massive political upheaval in France appears to have been averted following the second round of the early parliamentary elections. However, political uncertainty is likely to persist for the time being – and, with it, volatility on the French financial market. The latest developments have already been priced in and the OAT-Bund spread appears to have peaked. But a further, gradual deterioration in France's creditworthiness would justify higher risk premiums for French government bonds. This is because the new French government is facing major financial policy challenges despite several structural economic reforms. Further fiscal easing would put additional pressure on the country's strained finances, even if the radical spending plans of the left and right-wing political currents are likely to be off the table. Meanwhile, French equities could find it difficult to make up for this year's underperformance in a European comparison in view of the surprising victory of the left-wing alliance. The unclear situation in the French parliament could have a negative impact on companies' willingness to invest and consumer spending, slow down growth-promoting reforms and thus hamper the recovery on the French stock market.

[10]The new Prime Minister is Keir Starmer, who won an absolute majority with Labour with 411 of the 650 parliamentary seats. The Tories only won 121 seats and the Liberal Democrats 72.

Despite the challenges in France, we consider the risk of a new round of the euro debt crisis to be very low overall. The decisive factor is likely to be the extent to which a new French government is prepared to respect European fiscal rules and is also aware of the financing constraints imposed by the capital markets. This can be assumed despite the difficult majority situation in the National Assembly.

Macro & Markets

Economic normalisation continues, ECB leaves key interest rates unchanged

US: ECONOMIC DYNAMICS CONTINUE TO SLAVE – NORMALISATION IN THE LABOUR MARKET AND INFLATION UNDERMINE PROSPECT OF INTEREST RATE CUTS IN THE SECOND HALF OF THE YEAR

The US economy continues to lose momentum, as the decline in leading indicators in June shows. The survey of the Institute for Supply Management (ISM) survey for the manufacturing industry shows that the sector is still struggling and there is no real recovery in sight. The overall index fell slightly and remains below the **mark of 50 index points**[11] (see chart 3). Some support came from incoming orders, which recovered somewhat after a slump in May, but are still weak. The sub-indices for production, employment and inventories have all fallen, and the persistently weak new orders indicate that production in the manufacturing sector is likely to stagnate in the coming months. The ISM survey for the services sector also weakened unexpectedly significantly in June, with the overall index falling below the 50 mark again. This decline indicates that consumers are cutting back on their spending on services, which was above average after the pandemic, and are paying closer attention to their wallets in view of the delayed effects of the tighter monetary policy. At the same time, consumers are spending less on leisure activities and focusing more on essential goods such as healthcare services.

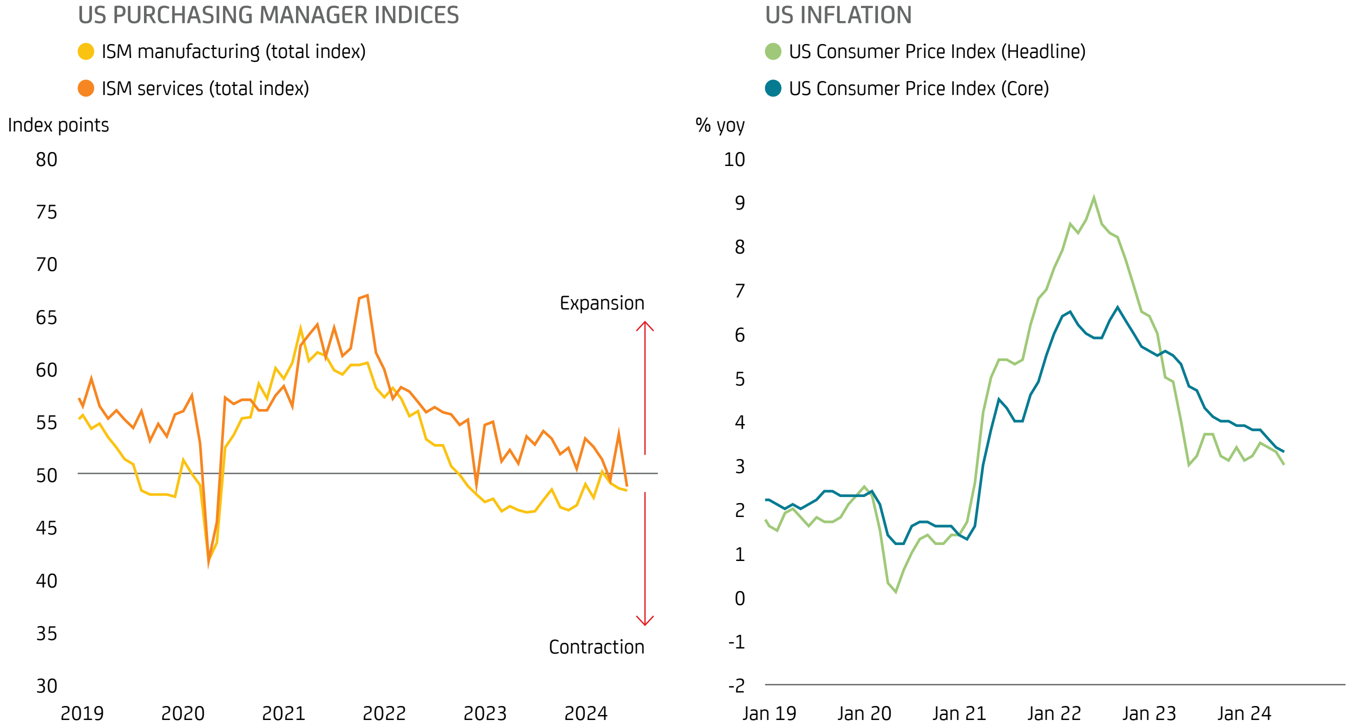
[11]Values below the 50 mark generally indicate a contraction in economic activity.

The slowdown in economic momentum is also reflected in the labour market. Although the number of people in employment outside of agriculture increased by more than 200,000 in June, this was boosted by an increase in the number of people employed in public administration and healthcare. In the private sector (excluding education and healthcare), the number of employees rose by only 54,000. The figures for April and May were also revised downwards. Compared to the same month last year, overall inflation fell again in June, from 3.3% in May to 3.0%, while the core rate (excluding energy and food) fell from 3.4% to 3.3% (see chart 3). The **disinflation trend**[12] is thus continuing towards 2%, driven primarily by two strong forces: residential rents and car prices. Both components are likely to continue to push inflation down in the coming months. Together with signs of a slowdown in the labour market, the June inflation data should boost the confidence of US Federal Reserve (Fed) officials that the time for interest rate cuts is approaching.

[12]Disinflation refers to a situation in which inflation rates fall over time but are still above zero.

In his semi-annual speech to the US Congress in July, Fed President Powell reaffirmed the Fed’s monetary policy course. According to Powell, the labour market remains robust and almost balanced, with no signs of overheating. The economy is also continuing to expand at a solid pace. In addition, he noted that the latest monthly inflation figures showed modest progress, but that further data in this direction is needed to gain more confidence that inflation will move sustainably towards 2%. This could indicate that the latest inflation forecast at the Fed meeting in June was a little too pessimistic. Moreover, higher inflation is not the only risk facing the Fed. Easing monetary policy too late or too little could unduly weaken the economy and employment. Nevertheless, Powell remains cautious when it comes to signalling an early start to monetary easing. We expect the symposium in Jackson Hole (August 22-24, 2024) to be used to announce the imminent turnaround in monetary policy.

3. US EARLY INDICATORS SHOW UNEXPECTED WEAKNESS, INFLATION RATES CONTINUE TO FALL



Source: ISM, BLS, Bloomberg, UniCredit Group Investment Strategy

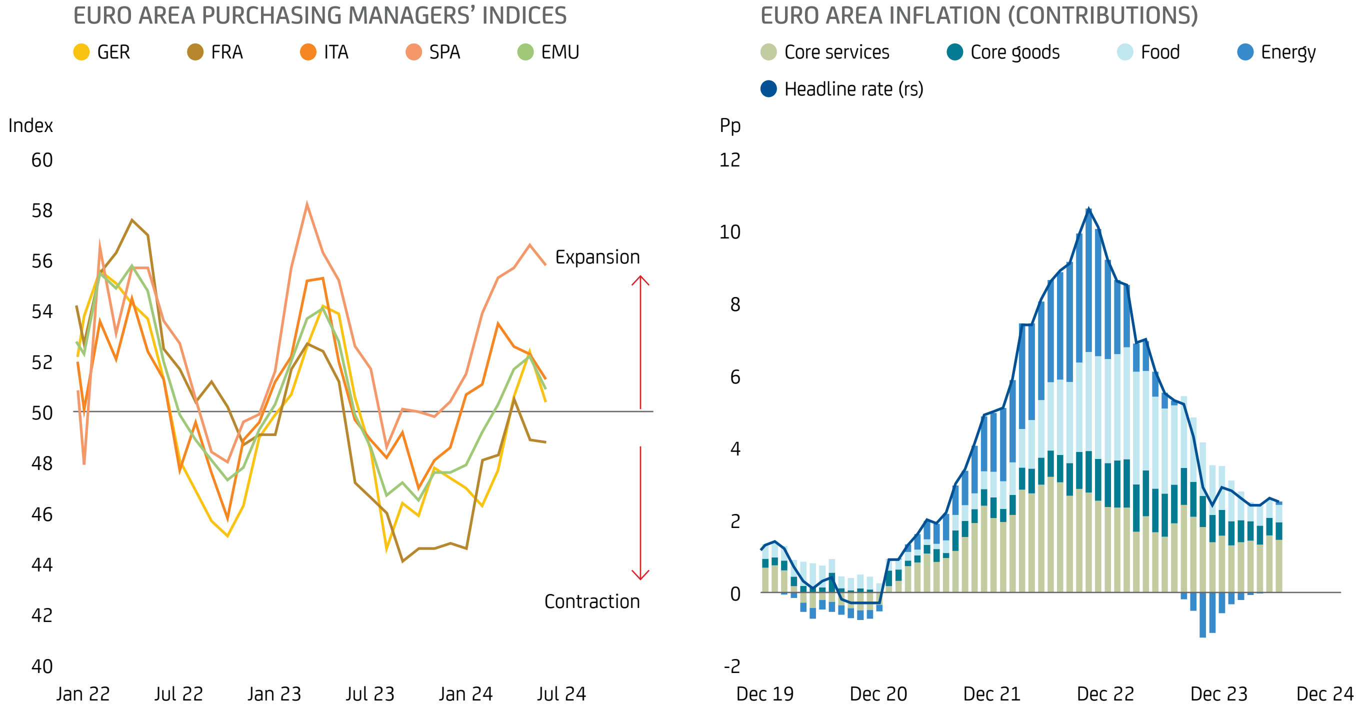
EURORAUM: UPTURN WEAKENS BUT REMAINS INTACT – ECB MAINTAINS LEAD LESSONS AND KEEPS ALL OPTIONS OPEN

Leading indicators suggest that the eurozone economy lost momentum towards the end of the second quarter. Nevertheless, we expect the upturn from the beginning of the year to have continued in the second quarter. At a country level, the Purchasing Managers' Index for Germany is just over 50 points, which indicates that the German economy stagnated in June (see Chart 4). In France, the economy continues to shrink, although the pace of decline has at least slowed; the overall index is just below 49 points. Italy and Spain are still well above the 50-point mark and show that the two southern economies are still growing significantly, even if the momentum here has weakened recently. In a European comparison, the Spanish index, in particular, remains at the upper end with over 55 points, meaning that the overall economic picture in the eurozone remained largely unchanged in June.

Meanwhile, the decline in inflation in the eurozone is continuing slowly. Consumer price inflation in the eurozone fell to 2.5% year-on-year in June, after rising to 2.6% in the previous month. The core rate remained at 2.9% in June. The main focus continues to be on the persistent stubbornness of service prices in the core rate (excluding food and energy, see Chart 4), where the continued high inflation in a number of components (including insurance, package holidays and hotels) is one of the main drivers. In contrast, deflation in the prices of durable goods is having a dampening effect on core goods. Even if the disinflation trend remains persistent, we assume that the easing wage pressure will also reduce core inflation and push overall inflation further towards 2% in the second half of the year.

As expected, the European Central Bank (ECB) left its monetary policy unchanged in July. It also reaffirmed its data-based approach and expressed caution regarding the prospects of further interest rate cuts. Importantly, however, ECB President Lagarde acknowledged that the new information "broadly supports" the June inflation assessment, meaning that the central bank remains on track for further rate cuts. A series of new macroeconomic forecasts will be published at the next meeting in September. As we assume that the ECB's inflation forecast will be largely confirmed, a further rate cut of 25 basis points (bps) in September seems likely. We maintain our view that the ECB has entered a slow easing cycle with interest rate cuts of 25 bps per quarter until the end of next year.

4. ECONOMY IN THE EUROZONE LOSES MOMENTUM, SERVICE PRICES REMAIN THE MAIN DRIVER OF INFLATION



Source: S&P Global, Bloomberg, UniCredit Group Investment Strategy

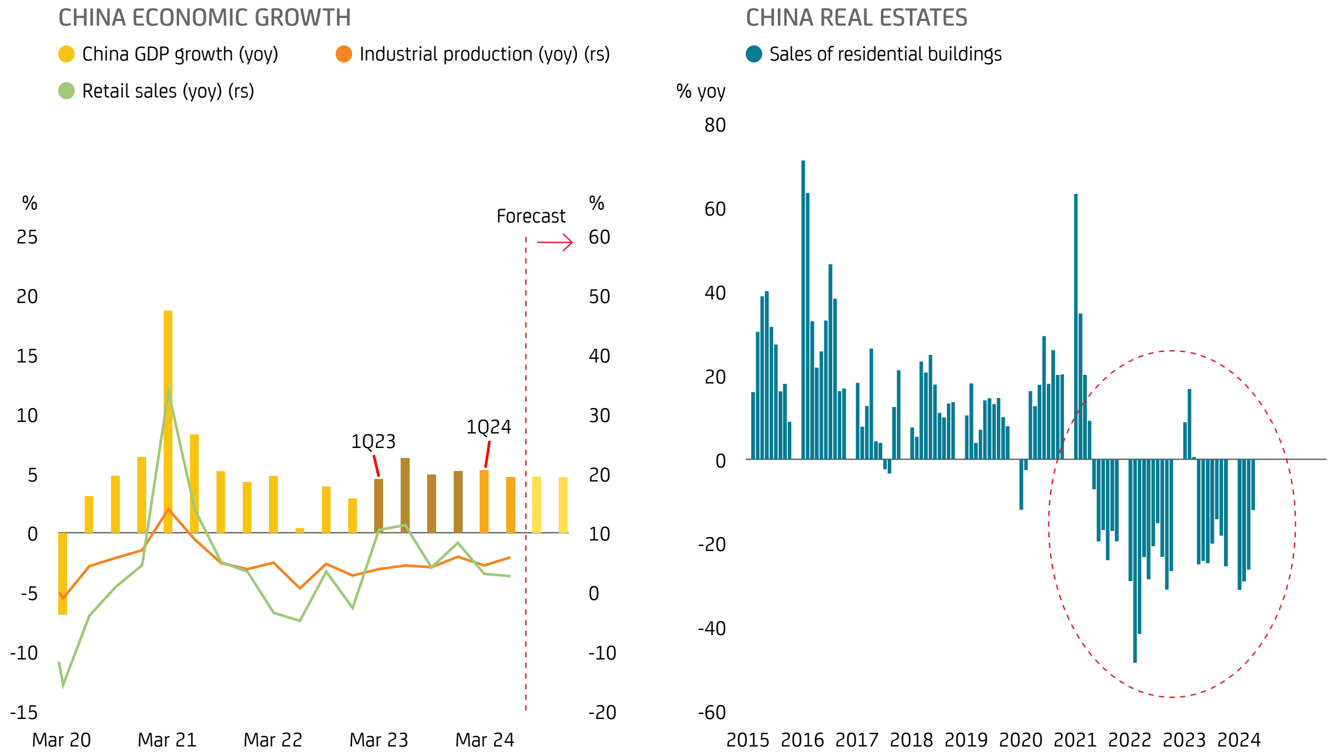
CHINA: ECONOMIC RECOVERY IN THE SECOND QUARTER FALLS SHORT OF EXPECTATIONS

China's GDP growth slowed in the second quarter from 5.3% in the first quarter to 4.7% compared to the same quarter of the previous year, well below market estimates of 5.1% (see Chart 5). The main reason for the decline was slower growth in retail sales. Domestic demand and consumer confidence remained weak, although seasonal effects (such as extreme weather events and flooding) also had a dampening effect. In contrast, growth in industrial production exceeded market expectations, underlining the uneven nature of the Chinese recovery. Relatively strong foreign demand supported the manufacturing sector: exports rose by more than 8% year-on-year in June, following an increase of around 7.5% in May. The secondary sector, which includes manufacturing and construction, grew by more than 5% year-on-year in the second quarter, compared to 6.0% in the first quarter, while the tertiary sector, which includes services, grew by just over 4%, compared to 5% in the first quarter.

Despite continuing weakness, the real estate market is showing the first signs of bottoming out. Prices for new condominiums continued to fall in June, but less sharply than in the previous month. The volume of residential property sales showed a similar, albeit less pronounced, trend. Stronger apartment sales supported property developer financing, meaning that the year-on-year decline in this segment in June was slightly lower than in May at around 12% (see Chart 5). There are signs of an upturn in demand in the main cities. Nevertheless, the real estate market has been in a clearly weak phase for three years now, which is also reflected in consumer confidence and consumption. The weak economic development since the pandemic continues to weigh on private households' consumption plans and thus also on demand for residential property.

The Chinese leading indicators also painted a rather mixed picture in June. The Caixin Purchasing Managers' Index for the manufacturing sector outperformed the official index in June, continuing the trend since the Chinese economy reopened at the beginning of last year. At just under 52 points, the index reached its highest level in six months, while the official purchasing managers' index from the National Bureau of Statistics remained unchanged at just under 50 points. The Caixin Purchasing Managers' Index for the services sector fell to just above 50 points in June, its lowest level since October 2023. The decline was largely seasonal, after the index had benefited from a sharp rise in domestic tourism in May due to Golden Week (off work). The official index for the services sector fell to just over 50 points, indicating a slowdown in growth.

5. THE UPTURN IN THE CHINESE ECONOMY IS LOSING MOMENTUM – PRIMARILY DUE TO WEAK DOMESTIC DEMAND AND THE CONTINUING CRISIS IN THE REAL ESTATE SECTOR



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

FINANCIAL MARKETS: PROSPECTS FOR SOFT LANDING SUPPORTED, BUT POLITICAL FACTORS HAVE RECENTLY WEIGHED ON MARKETS WORLDWIDE

June was characterised by a fundamentally positive mood on the global financial markets. The prospects of a “soft landing” for the US economy and a gradual recovery in the eurozone were supported by the continued solid performance of the global economy (despite somewhat weaker economic development in China). Although there were signs of a somewhat **hawkish**[13] monetary policy in the US, particularly due to the persistently higher US inflation figures, the latest figures and statements from Fed representatives indicate that the basic stance remains dovish and that the interest rate reduction narrative remains intact. In the reporting period (June 1 to July 19), technology stocks in the US in particular benefited from this, supporting the local equity markets. In Europe, on the other hand, the outcome of the European elections (mid-June) and the new elections in France (end of June) weighed on European equities (see table).

The expectation of interest rate cuts in the near future also left its mark on the bond markets. Demand for bonds continued in the reporting period, which was reflected in falling yields in both the US and the eurozone (see table). The new elections in France scheduled for the end of June led to a temporary rise in yield premiums on French government bonds and other peripheral countries such as Italy and Spain (see also the “In Focus” section). The fact that the right-wing populist Rassemblement National ultimately only came third in the second round of the new parliamentary elections in France, and that a left-wing alliance was also unable to gain a majority in parliament (meaning that the current government under Emmanuel Macro remains in office for the first time as caretaker), caused yield spreads to fall again significantly.

Oil prices rose sharply in June, supported by the confirmation of production cuts by OPEC+ (Organization of the Petroleum Exporting Countries plus Russia) until the end of 2025 and the prospect of stable demand for oil due to solid global growth prospects and positive monetary policy stimulus. The latter was somewhat called into question in July by China’s weak growth figures for the second quarter, as a result of which oil prices gave up some of their gains in the first half of July (see table). The price of gold rose significantly in the reporting period (see table), driven by the prospect of a more dovish US monetary policy and two further interest rate cuts in the second half of 2024. In this environment, the euro exchange rate was well supported and gained further against the US dollar after losing some ground in the run-up to the European elections (see table).

[13]Hawkish describes a monetary policy stance that aims to control inflation rather than stimulate economic growth. The opposite is dovish.

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)

EQUITIES

GLOBAL EQUITIES: NEUTRAL

The environment for the global equity markets has been favourable since the beginning of the year. The US economy remains robust despite signs of a slowdown, and it is becoming increasingly clear that the European economy has also bottomed out. Earnings expectations are correspondingly constructive. In addition, the prospect of a less restrictive monetary policy continues to provide support. High valuations in some areas, geopolitical risks remain not insignificant risks. We are maintaining a neutral weighting for global equities.

EQUITIES EUROPE: NEUTRAL

The recent more favourable macroeconomic data, which has often exceeded expectations, indicates that the European economy is gaining momentum. The labour market in the eurozone remains solid and cooling inflation is supporting real incomes. The still comparatively favourable valuations of European equities support this asset class, which offers correspondingly good opportunities for value and quality-oriented investors. We continue to favour a neutral weighting.

US EQUITIES: NEUTRAL

The robust macroeconomic environment in the US is positive for US equities, even though recent macro data suggests that growth is slowing. After the last encouraging PCE and CPI reports the Fed is expected to start the monetary easing as soon as September. US equity valuations remain high, and the S&P 500 equity index has an extreme market concentration. Overall, we maintain a neutral weighting.

EMERGING MARKET EQUITIES: NEUTRAL

In Asia, we remain strategically cautious on Chinese equities. The recovery remains sluggish, as witnessed from 2Q GDP growth, and mostly export driven. However, the fairly favourable valuations could argue for a limited tactical catch-up in view of fiscal and monetary stimulus measures. Overall, however, the valuations of emerging market equities appear comparatively favourable. We continue to favour a neutral weighting, although a selective approach to emerging markets by country and sector remains essential.

ASIA-PACIFIC EQUITIES (DEVELOPED MARKETS): OVERWEIGHT

Solid wage growth remains a supporting factor for Japanese equities. The fact that the Bank of Japan (BoJ) ended the era of negative interest rates and abandoned its yield curve control policy was also largely welcomed by the markets. The rise in corporate profits and the reform of the Tokyo Stock Exchange also encouraged extensive share buybacks. Both the number and the associated volume of share buybacks announced in the annual report are at their highest level since 2009. Valuations do not appear expensive despite the recent performance. However, as Japan is a major importer of food and energy, a sustained weakness of the yen could have an impact on inflation – and thus also on the BoJ's monetary policy. Overall, we remain overweight on Asia-Pacific equities.

BONDS

GLOBAL BONDS: OVERWEIGHT

Given current yields and the monetary policy shift by major Western central banks, global bonds continue to offer a competitive, attractive risk-return profile. With inflation continuing to cool we reiterate our strategic preference for "high quality bonds", such as Euro investment grade corporate and Euro government bonds. Long duration government bonds may play a precious "macro-hedging" role in the event of a significant economic slowdown (although this is not our baseline scenario). We are maintaining our overweight on global bonds.

EMU GOVERNMENT BONDS: NEUTRAL

After the ECB has started the interest rate pivot, we are maintaining our constructive view of this asset class against the backdrop of cooling inflation and in anticipation of further interest rate cuts in the second half of the year. Our neutral weighting for this asset class remains unchanged.

NON-EMU GOVERNMENT BONDS: NEUTRAL

The still robust US economy is supporting non-EMU government bonds, even though signs of a slowdown in the US economy have recently become more visible. The risk that the Fed could start its easing cycle later and the scope of interest rate cuts could be less extensive than expected remains despite the recent positive surprise in inflation data. We are maintaining a neutral weighting in this asset class.

EURO INVESTMENT GRADE CORPORATE BONDS: OVERWEIGHT

Credit spreads on euro-denominated corporate bonds, which continue to be supported by the resilience of the economic cycle and investors' ongoing search for yield, are at historically tight levels despite recent developments in France. Overall, the fundamentals of IG companies are expected to remain robust thanks to healthy balance sheets, higher-than-expected earnings, strong cash balances and low leverage levels compared to the long-term averages. Default rates could rise, but this is no cause for concern. We are maintaining our overweight for this asset class.

HIGH-YIELD CORPORATE BONDS: UNDERWEIGHT

The credit spreads of high-yield corporate bonds (HY), particularly those of companies with low credit ratings, still do not appear to fully reflect a possible noticeable slowdown in the economy. In addition, HY bonds are not sufficiently liquid and therefore still appear less interesting in the current phase of the economic cycle. HY bonds therefore remain underweighted.

EMERGING MARKET BONDS (HARD CURRENCY): NEUTRAL

Emerging market bonds in hard currencies generally offer an interesting carry (yield advantage over euro government bonds), but our focus remains on high-quality bonds. Credit and currency risk should always be considered when investing in emerging market bonds. We remain defensive and selective and continue to avoid countries with high foreign debt and current account deficits. Accordingly, we continue to favour a neutral weighting.

EMERGING MARKET BONDS (LOCAL CURRENCY): OVERWEIGHT

Emerging market bonds in local currency also offer an interesting carry. There is room for interest rate cuts, which could benefit this asset class. In addition, emerging market currencies appear undervalued and are likely to regain ground when the Fed starts to cut interest rates. It should also be noted that potential credit risks and foreign currency fluctuations, which are often higher in emerging markets, can affect potential returns. Emerging market bonds in local currency remain overweighted.

MONEY MARKETS: UNDERWEIGHT

Cash generally offers interesting returns, but we favour investments in higher-yielding fixed-income asset classes such as euro-denominated corporate bonds with good credit ratings, as we continue to expect interest rates in the US and the eurozone to fall (further). We are underweight in this investment segment.

ALTERNATIVES: NEUTRAL

Alternative investments continue to offer diversification potential for the portfolio. Real assets benefit from their role as instruments for hedging against inflation. We are maintaining a neutral weighting for alternative investments.

COMMODITIES: NEUTRAL

Low oil inventories, production cuts by OPEC+ (the major oil-producing countries and Russia, totalling 23 states), geopolitical tensions are supporting oil prices. However, OPEC+ will gradually phase out the cuts of 2.2 million barrels per day from October 2024. We continue to favour a neutral weighting in this asset class.

GOLD: NEUTRAL

Gold continues to benefit from increased central bank purchases – particularly by the People's Bank of China after the US and EU decided to freeze the currency reserves of the Russian central bank. The expectation of lower interest rates and geopolitical uncertainties also remain supportive factors. We are maintaining a neutral weighting.

CURRENCIES

EUR-USD

Last macro data, particularly the cooling of US inflation, validate our scenario that favors three rate cuts by December. As a consequence, the USD should remain penalized by markets' continuing to price in intense easing by the Fed in the remainder of 2024.

How to invest

Investment ideas in the current scenario

EQUITY INVESTMENTS

OUR IDEA: EDGE AI: THE CUTTING-EDGE OF INVESTMENT POTENTIAL

Generative artificial intelligence (AI) emerged as a transformative force in 2023. However, its integration has so far been limited to specific areas of the value chain. To truly embed AI into all facets of consumer life and corporate productivity, workloads need to be extended to devices at the edge of networks. This necessity brings 'Edge AI' into the spotlight as a crucial next step for creating a more robust AI experience.

Unlike 'traditional' AI, which relies on centralised computing activity carried in large data centres, edge AI involves deploying AI algorithms and models locally, directly on the user's hardware devices that act as data capturers and processors. This covers devices such as smartphones, wearables, and sensors. Examples include AI-powered smartphones that provide real-time, accurate conversational translations or a self-driving car that processes sensor data in real-time for tasks like lane-keeping, object detection and collision avoidance.

To capture the disruptive potential of edge AI compared with a centralised model, it is important to understand the two main types of compute activities for AI: training and inference. Training is about developing intelligence within the AI model and involves feeding it large data sets. The model analyses the vast amount of information provided and learns to recognise patterns and correlations, akin to an AI robot learning how to lift a weight. Once an AI model is properly trained, it becomes capable of making predictions, decisions and drawing conclusions from brand new data, without the need of being given the input for the desired output. This is similar to the AI robot performing the lifting task of an unfamiliar object for which it wasn't specifically trained. This process is known as inference. During this phase, the model is in motion and performs tasks in response to user requests.

Almost any real-world application of AI relies on inference and some of the most common examples include Large Language Models (LLMs) such as ChatGPT, predictive analytics and customer support. The state-of-the-art technology relies on conducting AI inferencing at a centralised level, but it comes with limitations associated with high infrastructure and data transfer costs, delayed response and network overload attributable to the back-and-forth of data from and to the device, and privacy concerns, as sending sensitive data over networks increases exposure to data breaches and cyberattacks. These limitations significantly reduce the breadth of possible applications that can be developed in an AI environment, forcing it to remain at a very basic level, not far from the current development stage. Edge AI provides a solution to these issues as it provides the ability to distribute the inference across the network among data centres, edge servers and hardware devices.

As investors have started to broaden out their exposure to the AI theme away from the Enablers, edge AI is likely to become one of the next beneficiaries of this dynamic. Despite having implications across a broad range of uses, the introduction of edge AI-enabled consumer products represents the mass-market opportunity for the diffusion of edge AI, and as a result we expect it to dominate the theme in the mid-term. Recently, several companies have made announcements regarding upcoming product launches, among which are new smartphones, referred to as "IntelliPhones", and AI PCs. In contrast to the criticised lack of innovation of the past few years, IntelliPhones are poised to fundamentally transform the way we interact with our phones and the kind of tasks we can perform with them. According to Bank of America, the device's context awareness will enable superior personal assistance, language processing, health monitoring and predictive health alerts, advanced image processing and object recognition, enhanced security, improved battery management, Augmented Reality/Virtual Reality experiences and other customisable uses. The companies involved have an opportunity to meaningfully improve their business by participating in and accelerating a multi-year replacement cycle, commanding premium pricing of new devices, and capturing new revenue opportunities with on-device features and "killer-apps". The introduction of such devices and services is a way for investors to plug into edge AI by choosing companies at the forefront of the application. Alternatively, exposure to the theme can be built through designers and manufacturers of edge-specific chips, sensors, and chip-making equipment and firms offering advanced software solutions.

BOND INVESTMENTS

OUR IDEA: SLOWING INFLATION SUPPORTS BOND MARKETS

Over the past few weeks, US and European inflation data have shown a gradual slowdown, reaching closer to central bank targets. In the US, the consumer goods' price basket grew by 3% in June compared to the same month last year. Core inflation, which excludes the most volatile components of the basket, is at 3.3%, the lowest values since April 2021. The prices of services in particular, which represent the component that has been most affected by the increases of recent months, have shown a further slowdown. On our side of the ocean, the data are even more encouraging: in June, Eurozone consumer prices grew by 2.5% compared to the same month of the previous year. This is not far from the European Central Bank's (ECB) target of 2%.

In addition to the restrictive policy of central banks, the prices of certain commodities have fallen from their peaks earlier this year, which has also contributed to the decline in inflation. Copper, in particular, is now trading on the London Stock Exchange below USD10,000 per tonne compared to almost USD11,000 at the end of May, and WTI oil is in the USD80 per barrel area compared to USD87 at the end of April. The price of agricultural commodities such as wheat and corn have also fallen sharply since the beginning of the year.

From a macroeconomic point of view, the new data published during the month confirm that the US economy is still robust with some signs of normalisation, while the European economy is weak but not struggling. In this context, inflation and economic growth may allow central banks to ease the monetary tightening that had become necessary to cope with the post-Covid price increase. The ECB, while not formally committing itself to the next moves, has already inaugurated the rate cut cycle at the monetary policy meeting in early June. Futures markets now estimate that the Federal Reserve will make its first rate cut at its meeting in the second half of September.

Bond markets have benefited from this macroeconomic backdrop. The yield on the 10-year Treasury declined from 4.60% at the end of May to a level below 4.20% in mid-July. The 10-year Bund rate recorded a similar movement and decreased by about 30 basis points to the 2.40% area. We believe that bonds issued by the most solid and safest issuers will continue to benefit from slowing inflation and the resulting monetary easing by central banks.

As for the European bond market, during the month of June it was also markedly influenced by the outcome of the European elections. Particularly in France but in other European countries as well, the elections have rewarded the parties with programs that promise a sharp increase in public spending and with nationalistic rather than community rhetoric. This has caused a widening of the spread between the yields of the securities of the most indebted and fiscally less cautious issuers and those of the most solid and rigorous states (e.g. Germany, Holland, Ireland). The subsequent surprise move by the French head of state, Emmanuel Macron, to call early national elections added uncertainty and increased the volatility of the spread between the yield on French and German government bonds. However, the result of the French elections did not decree a single winner and it is likely that the future government coalition will include the more moderate parties and that the spending assumptions will be revised from a more conservative perspective.

We believe that the current level of the OAT-Bund spread more accurately reflects the macroeconomic fundamentals of the French state compared to a few weeks ago – and that a return to a spread level similar to before the elections is unlikely, at least in the short term. Bonds in the most indebted countries may encounter new phases of volatility. As a result, for more cautious clients, we prefer to opt for safer issuers and shorter maturities.

In Eurozone corporate bonds, we saw credit spreads widen in June in connection with the results of the European elections and the subsequent French national elections. However, this increase has been momentary and the level of spreads has already returned to values seen at the end of May. Despite valuations, which remain relatively high from a historical perspective, we believe European credit can still offer good opportunities for our clients.

In particular, corporate fundamentals remain robust, with relatively low debt levels and, on average, ample levels of liquidity that will allow them to navigate future economic uncertainties or financial market tensions. Technicals are also supportive of credit. In the first part of the year, inflows into the asset class were very positive and the supply of new issues was easily absorbed. The selection of issuers in the corporate sector will remain central in a market that nevertheless remains volatile, especially given the uncertainty regarding macroeconomic variables and geopolitical tensions.

In conclusion, we maintain a constructive view on fixed income as a whole – in particular on government bonds with a higher credit standing and on investment grade corporate Euro debt. We also prefer a tactical management of duration, government and credit spreads.

In balanced portfolios, fixed income resumes its role as a stabiliser, thanks to its positive yield to maturity and coupon flow. In addition, in the event of heightened geopolitical tensions and possible declines in the stock markets, the bond component can be a safe haven asset and a valuable ally to protect against volatility.

DEVELOPMENT OF SELECTED FINANCIAL MARKET INDICES

From	**19.07.23**	19.07.19	17.07.20	19.07.21	19.07.22	19.07.23	19.07.19	**01.01.24**
To	**19.07.24**	19.07.20	19.07.21	19.07.22	19.07.23	19.07.24	19.07.24	**19.07.24**
Stock market indices (total return, in %)								
MSCI World (in USD)	**19.6**	6.8	32.2	-9.9	18.6	19.6	79.6	**13.4**
MSCI Emerging Markets (in USD)	**10.2**	3.1	27.5	-23.2	7.5	10.2	18.8	**8.5**
MSCI US (in USD)	**23.2**	10.9	35.3	-8.3	18.1	23.2	99.9	**15.9**
MSCI Europe (in EUR)	**13.4**	-2.1	21.9	-0.2	12.8	13.4	52.9	**9.1**
MSCI AC Asia Pacific (in USD)	**12.7**	6.4	25.5	-20.5	10.6	12.7	30.1	**9.9**
STOXX Europe 600 (in EUR)	**13.6**	-0.9	22.3	-1.7	12.7	13.6	53.1	**9.2**
DAX 40 (Germany in EUR)	**12.1**	5.7	17.1	-12.1	21.0	12.1	48.2	**8.5**
MSCI Italy (in EUR)	**26.7**	-8.1	17.8	-5.1	38.1	26.7	84.6	**17.8**
ATX (Austria, in EUR)	**20.9**	-21.1	48.7	-6.5	13.2	20.9	51.0	**12.4**
SMI (Switzerland, in CHF)	**12.2**	7.5	17.4	-3.6	3.1	12.2	42.9	**12.7**
S&P 500 (USA, in USD)	**23.2**	9.8	34.1	-6.2	18.0	23.2	100.7	**16.3**
Nikkei (Japan, in JPY)	**25.6**	10.2	23.8	-0.6	24.8	25.6	105.8	**20.8**
CSI 300 (China, in Yuan)	**-4.9**	23.3	14.4	-14.7	-7.5	-4.9	4.0	**5.3**
Bond market indices (total return, in %)								
US Government Bonds 10Y (in USD)	**0.7**	17.4	-2.9	-13.8	-2.5	0.7	-4.2	**-0.7**
US Government Bonds (ICE BofA, in USD)	**2.4**	11.4	-2.2	-10.8	-1.4	2.4	-2.4	**0.2**
US Corporate Bonds (ICE BofA A-BBB, in USD)	**6.3**	11.0	3.4	-14.8	2.3	6.3	5.8	**1.5**
German Bunds 10Y (in EUR)	**2.8**	1.5	-0.1	-13.6	-7.4	2.8	-17.0	**-1.9**
EUR Government Bonds 1Y-10Y (iBOXX, in EUR)	**4.0**	2.1	0.9	-13.1	-5.4	4.0	-12.2	**-0.7**
EUR Corporate Bonds 1Y-10Y (iBOXX, in EUR)	**6.6**	-0.3	3.5	-12.2	-0.6	6.6	-4.3	**1.3**
Bond yields (change in basis points = 0.01 percentage points)								
US Government Bonds 10Y (in USD)	**39**	-141	55	184	72	39	219	**37**
US Government Bonds (ICE BofA, in USD)	**4**	-148	33	241	103	4	240	**28**
US Corporate Bonds (ICE BofA A-BBB, in USD)	**-21**	-116	-13	279	71	-21	209	**17**
German Bunds 10Y (in EUR)	**-4**	-13	5	165	118	-4	278	**41**
EUR Government Bonds 1Y-10Y (iBOXX, in EUR)	**-9**	-19	-4	179	114	-9	266	**36**
EUR Corporate Bonds 1Y-10Y (iBOXX, in EUR)	**-55**	23	-46	278	98	-55	306	**18**
Spreads on government bonds (credit spreads, change in basis points)								
US Corporate Bonds (ICE BofA US Corporate Master)	**-34**	27	-53	61	-26	-34	-25	**-11**
US Corporate Bonds (ICE BofA US High Yield)	**-81**	163	-230	166	-121	-81	-98	**-25**
Euro Corporate bonds (ICE BofA Euro Corporate AAA-A)	**-32**	20	-33	88	-31	-32	12	**-22**
Euro Corporate Bonds (ICE BofA Euro High Yield)	**-96**	127	-189	306	-173	-96	-28	**-56**
Money market rates (change in basis points)								
Libor (USD, 3 months)	**-6**	-201	-14	260	286	-6	329	**-5**
Euribor (EUR, 3 months)	**0**	-7	-11	59	360	0	407	**-21**
Euro exchange rates (change in %)								
US Dollar (EUR-USD)	**-2,7**	1,9	3,0	-12,9	9,5	-2,7	-3,0	**-1,4**
British Pound (EUR-GBP)	**-3,0**	1,4	-5,7	-0,7	1,9	-3,0	-6,0	**-3,0**
Swiss Franc (EUR-SFR)	**0,6**	-2,8	0,8	-8,5	-2,9	0,6	-12,2	**4,6**
Japanese Yen (EUR-JPY)	**9,8**	1,4	5,3	9,3	11,2	9,8	41,9	**9,8**
Commodities (change in %)								
Commodity Index (GSCI, in USD)	**21.1**	24.5	-2.1	-6.1	15.5	21.1	59.5	**15.9**
Industrial metals (GSCI, in USD)	**5.2**	-3.6	42.3	-9.8	1.5	5.2	33.0	**3.6**
Gold (in USD per fine ounce)	**22.2**	27.0	-0.1	-5.2	15.3	22.2	68.4	**16.6**
Crude oil (Brent, in USD per barrel)	**5.5**	-30.1	59.0	56.3	-26.0	5.5	35.0	**8.2**

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