Union Investment

Active management is needed

20.06.2023 | In a market environment characterised by uncertainty, investors should specifically seek out opportunities, advises Dr Frank Engels, member of the Board of Managing Directors at Union Investment. He expects the key factors of inflation, monetary policy, economic activity and financial market stability to improve over the course of the year.

Dr Frank Engels,

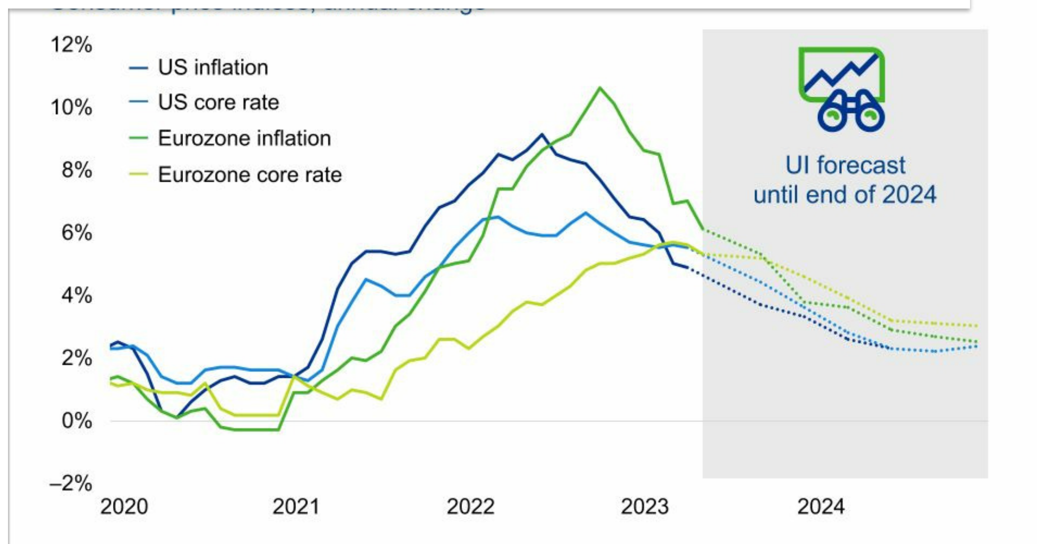
on the Board of Managing Directors of Union Investment responsible for portfolio management for securities

The most important facts for you in brief

- Peak in key interest rates no longer far away
- Time of sharp interest rate rises over, yield levels remain constant
- Corporate bonds particularly attractive in current environment
- Opportunities increase the longer the year goes on

Compared with the start of the year, progress in inflation is discernible. Price pressures have eased, albeit not to the same extent everywhere, and inflation has embarked on a sustained but shallow downward path. The USA is one step ahead in the fight against inflation. Here, the peak has clearly been passed not only in the overall rate but also in the less volatile core rate excluding food and energy. Core rates below four percent can therefore be expected again in the United States in the second half of the year.

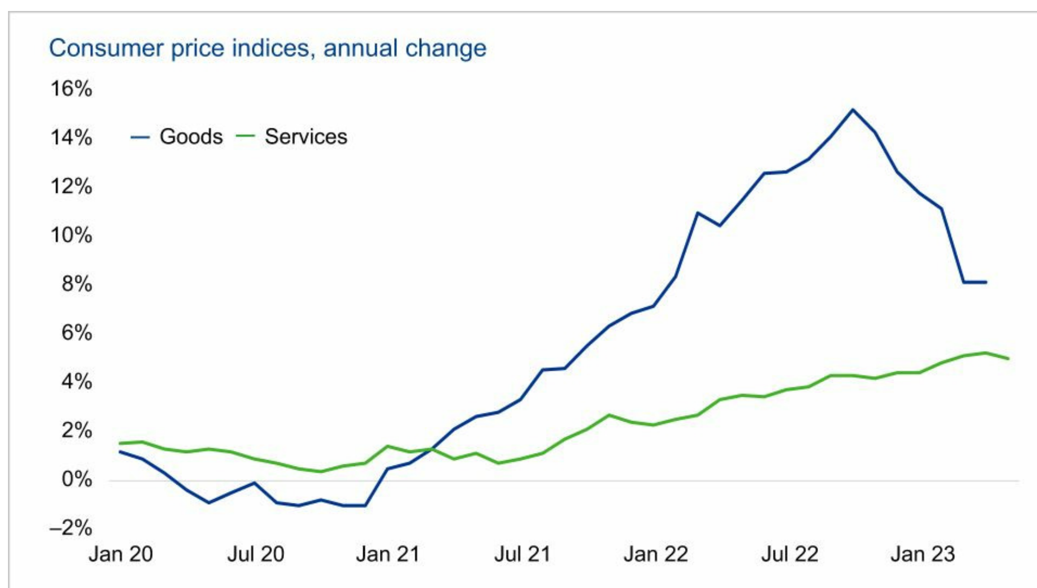
The U.S. is one step ahead in fighting inflation



Source: Bloomberg, Union Investement; as of June 02, 2023.

The U.S. is one step ahead in fighting inflation

Euro area: service prices on an upward trend



Source: Bloomberg, Union Investement; as of June 02, 2023.

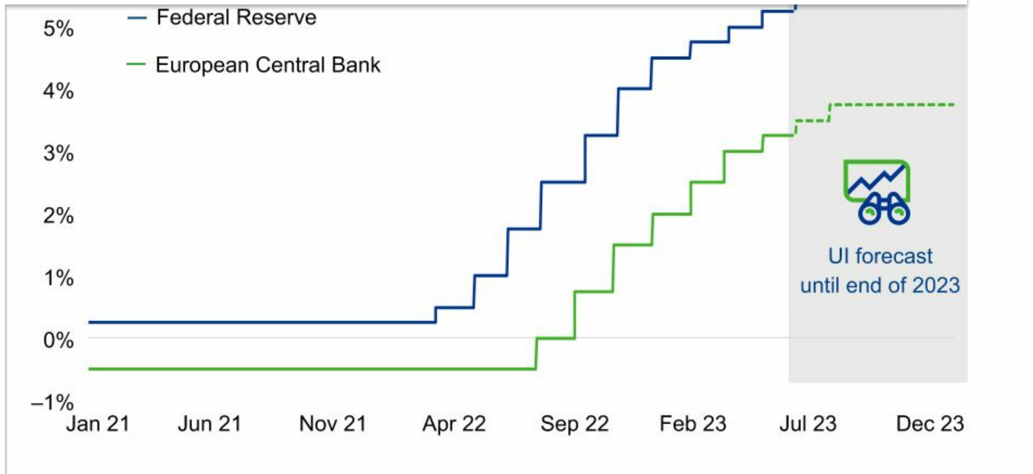
The situation in the euro zone can be assessed differently. Goods prices are hardly rising at all, but price pressure in the services sector remains high. This will only gradually change from late summer. At an annual rate, inflation in the EU is expected to reach 5.5 percent in 2023, falling to 2.8 percent in the following year.

End of key rate hikes is not far off

So there is still no time to sound the all-clear on the key factor of inflation, but the signs are that the situation is easing. This has also reduced the pressure on central banks to act. For the Federal Reserve (Fed) in the USA in particular, there is no longer any reason to continue raising key interest rates. The Fed's job is largely done. One last rate hike of 25 basis points is expected. After that, the Fed will pause until the end of the year and let its tightening work.

Central banks are on the verge of ending key interest rate hikes

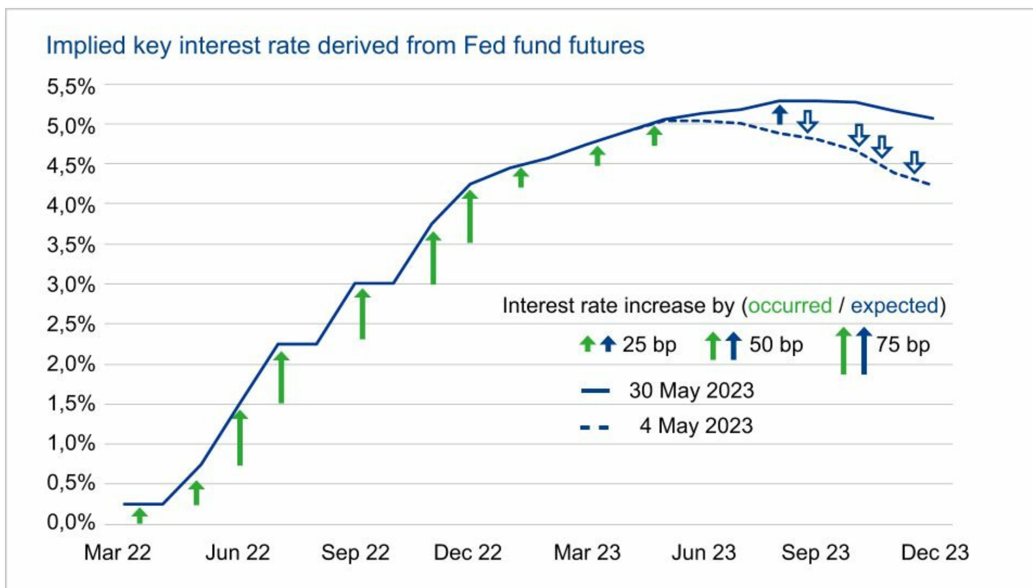
Last interest rate hikes within reach



Source: Bloomberg, Union Investement; as of June 02, 2023.

Central banks are on the verge of ending key interest rate hikes

Fed: Market has recently priced in our interest rate picture



Source: Bloomberg, Union Investement; as of June 02, 2023.

The euro zone has not yet reached that point. The European Central Bank (ECB) has already raised key interest rates significantly. However, inflationary pressure remains high. The ECB is expected to follow up with two further interest rate hikes of 25 basis points each. After that, there is likely to be a pause in the monetary union as well. The end of key rate hikes is not far off on either side of the Atlantic.

> "The clearer it becomes that the peak in key interest rates has been passed, the better the outlook for risk assets."

Dr Frank Engels
on the Board of Managing Directors of Union Investment responsible for portfolio management for securities

Financial market stability not threatened by banking crisis

In the first half of 2023, the collapse of several banks also weighed on the markets. The sharp rise in interest rates combined with the economic slowdown hit financial institutions with fragile business models hard, especially in the USA. Even if the consequences have recently ceased to have

ng and rapid rise in interest rates over the past

all. Moreover, governments, central banks and regulators have demonstrated their ability to deal successfully with such crises. Even in the event of a recurrence, the rapid and decisive action of decision-makers can be expected to prevent the spread of a banking crisis: Financial market stability is thus not currently at risk.

However, a resurgence of the crisis would be a stress factor for the capital markets. At the same time, the economic effect of the banking crisis in the USA is currently still open. After all, ailing banks grant fewer loans and thus slow down growth. It is true that both the supply of and demand for credit in the USA have already been declining for some time as a result of the tighter monetary policy and the weaker economy. However, an additional, significant tightening of lending standards could push the economy further toward recession. How strong this braking effect will be is currently completely open. This means that the issue remains a factor of uncertainty for the markets for the time being.

Economic stagnation in the USA and Europe

This is all the more true as the global economy remains weak for the time being. In the USA and the euro zone, growth will largely stagnate for the rest of the year. Rapid interest rate hikes in particular are having a negative impact. The linchpin in both economic areas remains the labor market. We expect the labor market, which has been running hot at times, to regain its balance and the imbalances between demographically lower supply and robust demand to diminish. However, we do not expect a collapse.

This also makes it unlikely that the US economy will slide into a deep recession. In addition, there are signs of an improvement in the situation toward the end of the year. Economic momentum is likely to pick up toward 2024, not least due to rising investment. The more time passes, the more the structural changes in the Western economies with a view to decarbonization and the partial dismantling of global supply chains will have an impact.

This picture also applies in principle to the euro zone, albeit with a time lag. Here, economic activity is not expected to catch up again toward trend growth until the end of 2024. Concerns about energy bottlenecks and supply chain problems have faded, but at the same time new orders are slow to pick up. In addition, consumers have to absorb significant real wage losses - and the full monetary policy braking effect is yet to come.

As a result, European gross domestic product (GDP) growth of 0.4 percent is realistic for this year, before rising to 0.8 percent next year. The German economy is particularly affected by the slowdown, where we forecast a contraction of 0.4 percent in the annual rate for 2023. Germany has come through the winter half-year in good shape. At the same time, however, real wage losses were high and foreign trade is weak, not least because of fatigue in the Chinese post-Covid recovery. These effects should lose force over the course of the year, so that overall economic growth momentum should pick up in 2024.

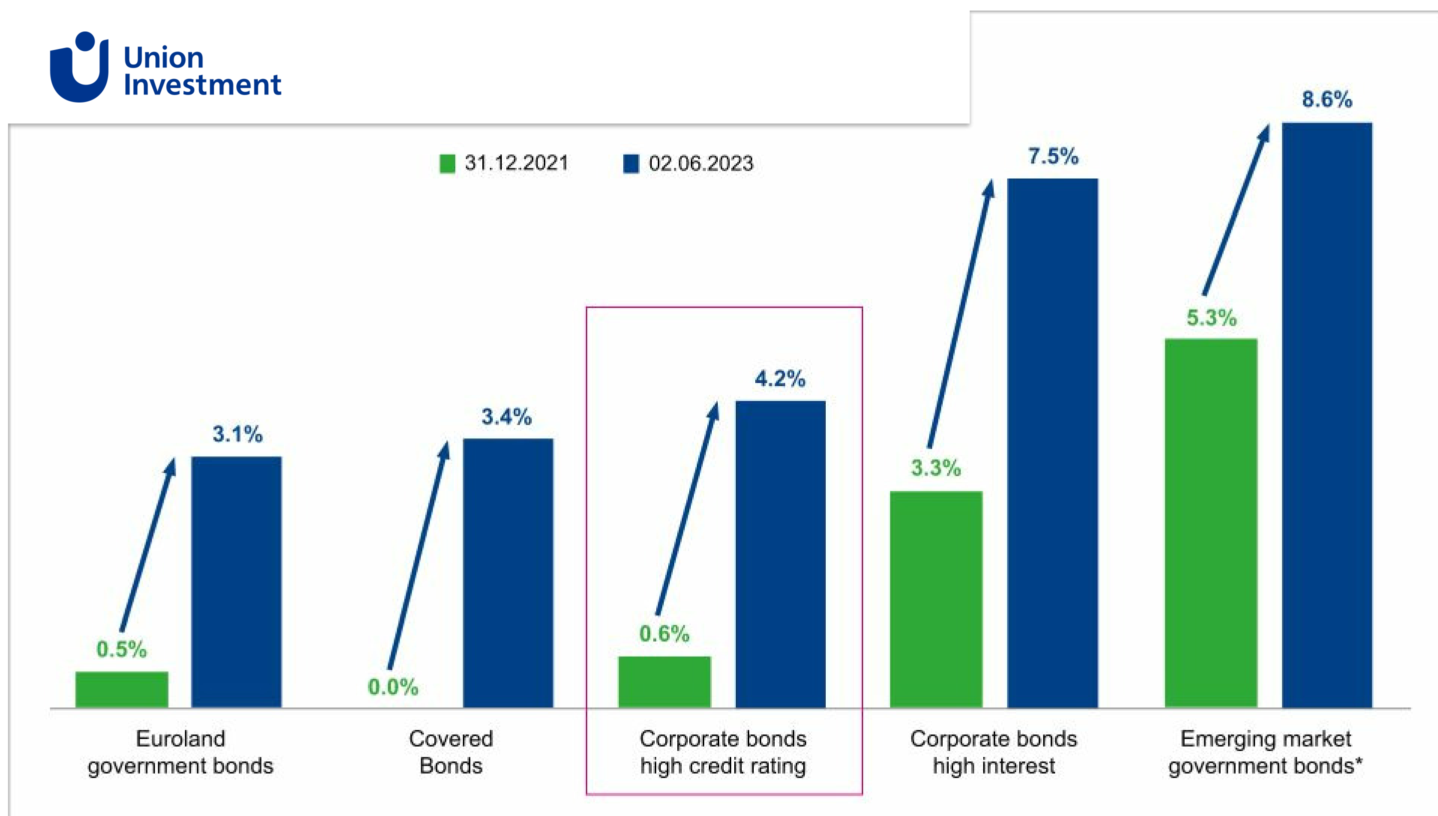
Chances increase the longer the year

All in all, all four key factors - inflation, monetary policy, financial market stability and the economy - are expected to improve or become clearer in the course of the year. However, the market environment remains fragile along the way. The second half of the year remains susceptible to strong fluctuations on the capital markets.

Looking at the individual asset classes, we do not expect the sharp rise in yields on safe government bonds to continue. The issue of rising yields should be largely settled once the key interest rate and inflation summits are reached. At the end of the year, we expect ten-year US government bonds to yield 3.75 percent and German Bunds with the same maturity to yield 2.7 percent. Due to the still inverted yield curve, exposures with shorter maturities are indicated. Corporate bonds remain particularly interesting because the fundamentals are still good and yield levels are attractive. In the current market situation, these investments have the best risk-reward profile. European issuers with good ratings (investment grade) are particularly interesting.

Investment grade corporates with most attractive risk-reward profile

Bond markets have become significantly more attractive



Source: Refinitiv, Union Investment; as of June 02, 2023. *Hard currency

Challenges for equities before the picture brightens up

Shares remain the only alternative for long-term investors. However, challenges for this asset class can also be expected in the coming six months. The stock markets have already recovered noticeably since the fall of 2022. For further, sustainable rises, there needs to be more certainty of expectations on key issues, especially the economy. In particular, the development of margins and profits is likely to play a decisive role. To date, companies have been able to defend their profitability impressively.

However, with wage pressures remaining robust and inflation on the decline, this will become more difficult. Investors are likely to increasingly put a question mark behind the stock market, and a five percent decline in profits on a global level in 2023 is to be expected. But as the economy stabilizes toward the end of the year, a countermovement is conceivable: Double-digit earnings growth is possible in 2024. This should give the stock markets a boost.

Time works for risk assets

A nervous second half of 2023 followed by a more promising 2024 - that's what investors can look forward to. The capital markets will gain more clarity on the key factors, and thus the outlook will brighten. Patience is likely to pay off. In particular, a friendlier growth-inflation mix should make risky assets more attractive.
Until then, opportunities continue to exist on the stock markets through activity and selection. Beneath the surface, there is a lot going on in the markets; we are seeing major structural movements. An active manager can take advantage of these shifts - key words: artificial intelligence, but also green transformation - through skilful stock selection.

An article by Dr Frank Engels.

Status of all information, explanations and illustrations: June 20, 2023, unless otherwise stated.

Your contact person

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