Market Commentary on the Q2'2021 Results Season:

From Reflation Trade to First Signs of Stagflation?

While the investment sentiment in the global stock markets has changed rapidly from the so-called "reflation trade" to an **increasing fear of inflationary pressures**, this is a vital moment to not only analyse first market reaction to the Q2'2021 reporting season, but also to scrutinise the **outlook provided by various management teams** against the hard economic data published on 30 July. The latter had something for everybody's conviction, with growth in the eurozone economy at 2 per cent in Q2'2021 exceeding economists' expectations of 1.5 per cent (as polled by Reuters), essentially outpacing growth in the US (1.6 per cent) and China (1.3 per cent) for the first time since the pandemic started in March 2020.[i] In turn, for those who see the glass "half empty", the eurozone GDP is still 3 per cent below its pre-crisis level, and is expected to catch up only by end-2021 - something which China and the US have already achieved. Even worse, the eurozone inflation increased faster than expected to 2.2 per cent in July – compared with 1.9 per cent in June – exceeding the inflation target of 2 per cent recently raised by the European Central Bank.[ii]

This development goes to the very heart of the current investor debate, with growing institutional anxiety about the implications of a potential departure from ultra-loose monetary policy and the **repricing of assets under greater inflationary expectations**, with some market observers seeing even first signs of "stagflation", referring to a combination of low growth and high inflation.[iii] While the official line of the US Federal Reserve and other central banks has so far been to point to a more "transitory" narrative during the pandemic (supply-chain disruptions, oil price recovery), which should go back to equilibrium by end-2021, professional fund managers have taken the **growing business and consumer confidence surveys more with a grain of salt**, largely reverting the previous rotation into small cap, value stocks and focusing more strongly on potential winners of the post-pandemic recovery in an environment of higher inflation and slower growth.

The European banking industry is a good place to start, having returned from bumper trading profits in Q1'2021 to a more "normalised income stream" in Q2'2021, on the back of strong fee performance, further cost cutting and new digital initiatives.[iv] Banks have also increasingly looked into **cryptocurrency and blockchain technology**, which we focus on in our first section, as this alternative asset class has undoubtedly made a further step into the mainstream investment. We then have a closer look at the driving forces of **unwinding the global reflation trade, before discussing some new ESG developments**, with a special focus on the European energy industry. Finally, we reflect on the ongoing debate about **structural change in the wake of the Corona pandemic**, ranging from shortages in semiconductors, raw materials and container shipping to the newly evolving work and business practices.

CRYPTOCURRENCY AND TRADING

For the purpose of our analysis, the growing interest in digital assets and blockchain technology has two main facets: a) the decline in equity trading starting in early April pretty much coincided with a massive surge in cryptocurrency trading, spurred by speculation of retail traders following daily rumours;[v] and b) mainstream financial institutions getting increasingly involved as they were pressed by clients to offer services in cryptocurrency trading, custody and financing, together with regulators and central banks getting more concerned about the impact on the global financial system.[vi] While there remains scepticism whether conventional banks will ever be able to compete against bitcoin specialists that have been active in this space for years, there is no doubt that some of the crypto firms have meanwhile become large financial institutions, whether they include crypto exchanges like Coinbase and Binance, or issuers of digital tokens such as Tether and USD Coin, with the latter two backed, among others, by reserves that include short-term debt issued by traditional companies. This implies that they have become "systemically significant", raising concern of the US Federal Reserve and rating agencies.[vii]

From our perspective, the discussion on digital assets has gained the new momentum from the growing acceptance among institutional investors and regulatory authorities that blockchain technology has become more disruptive to an often inefficient financial industry, together with cryptocurrencies forming a larger part of investor portfolios and also getting "more prevalent in the payments ecosystem".[viii] While this is not the place either to discuss the geopolitical implications, with most of the crypto mining still done in China but the Chinese authorities also opting for a strict top-down control, or to reflect on the broader debate on energy intensity,[ix] what was striking during the Q2'2021 reporting period was the growing interest among analysts to raise specific questions on digital assets during Q&A. While bank management teams insisted on remaining cautious and still perceiving the crypto trading as "very speculative", they confirmed, at the same time, that they invest in the underlying blockchain technology and view the "tokenisation of assets" as further supporting market efficiency in future.[x]

UNWINDING THE GLOBAL REFLATION TRADE

One key observation of the Q2'2021 reporting season was the predominantly muted outlook for the current quarter between July and September while, at the same time, reporting record results for April to June 2021, partly on the back of difficult like-for-like comparisons with the major lockdown period last year, but also due to a combination of renewed inventory build-ups, growing consumer demand after lockdowns were relaxed in Europe and the US in April-May and ongoing government support for SMEs as well as large corporates.[xi] From an investor's perspective, inflationary fears were aggravated by labour shortages, the massive price increase of raw materials, ranging from copper, iron ore and rare earth metals to timber, plastics and cement, and even oil and gas, as well as semiconductor bottlenecks and logistical constraints, largely due to the limited availability and exorbitantly high costs of shipping containers.[xii]

Unexpectedly high inflation data led the US Federal Reserve in mid-June to move forward its guidance of when it might start raising interest rates, unwinding the "reflation trade" which had dominated global stock markets since the emergence of coronavirus vaccines in late October 2020, and leading to a steep decline in commodity prices. This marked a major setback for those investors betting on stocks that might benefit from higher inflation and, at the same time, loose monetary policy to continue for some time and growth to be supported through fiscal stimulus.[xiii] Within a short period of time, one of the key assumptions – that the current rise in inflation will be "transitory" – got challenged on the basis of structural changes in supply, notably in the labour market, supply chains, inventory management and transportation, despite aggregate demand remaining robust.[xiv] Going forward, this might lead to further doubts about the other two elements of the current market consensus – high growth and supporting central banks.

SIGNS OF A NEW GREEN RUSH

Against the backdrop of recent government efforts to further implement the EU New Green Deal and the US administration's job plan, the bar was set higher in May through new investor activist campaigns, notably in the oil and gas industry, where shareholders of Exxon succeeded in appointing a new Board to drive down emissions more aggressively, followed by Chevron's management being defied on a major climate vote and Shell ordered by a Dutch court to accelerate and deepen its emissions cuts. While some portfolio managers perceived these votes as a "tipping point for companies that are unprepared for the global energy transition",[xv] at company level there were clear signs of a "green rush" to commit to reaching a net zero goal in greenhouse gas emissions and to join the Science Based Targets initiative, with the number of companies joining in March 2021 being three times higher than the average monthly rate in 2020.[xvi]

On the back of these recent developments, it was not surprising that management teams in the European energy sector were pressed hard at the Q2'2021 results' calls to share their insight into lessons learned from the energy transition[xvii] and how to accelerate the decarbonisation effort against a) a shifting demand globally away from Europe; and b) without any disposals.[xviii] In turn, others specifically focused on the "Fit for 55" EU Climate Package, with options for carbon capture and Scope III quarterly volatility being mostly discussed.[xix] In this context, the IEA report published in May 2021 was widely quoted, coming to the conclusion that essentially all new oil and gas exploration projects must stop to reach the Paris agreement of net zero by 2050.[xx] In the broader investor debate, it remains to be seen whether we have entered a new commodities supercycle driven by a shift to cleaner energy, which some market observers align with copper as the new strategically important raw material for electrification and decarbonisation.[xxi]

FOCUS ON LABOUR

In all the debates on the pandemic-induced structural changes, ranging from supply-chain disruptions to semiconductor shortages, inflationary pressure through raw materials increases and a new commodities supercycle, the one factor gaining growing prominence is that of labour, not only through more reports on shortages and supply-demand mismatches,[xxii] but also companies outlining more clearly their position on the future of work and how best to look after their workforce. In this context, it was perhaps not surprising that companies, which have gone through a recent crisis, became more articulate on that subject, outlining office flexibility, retention packages and opportunities for further qualification.[xxiii]

Interestingly, the global shipping industry was directly faced with the human factor, as about 15% of the global sea crew comes from India, which was heavily affected by Covid-19 infections, leading to fears about a renewed global crew change crisis as was the case in 2020, when about one quarter of the estimated 1.6 million seafarers globally were stranded at sea beyond their contract length because of the pandemic.[xxiv] Back in Europe, a number of companies raised the issue of organic growth and the need to invest in R&D, where some CEOs currently see a higher return on investment compared with M&A activity.[xxv] This remains a space to be watched for Q3'2021, for which various companies have already provided a more muted outlook.

Peter Kirkow
2 August 2021

ENDNOTES

[i] Martin Arnold, "*Growth returns to eurozone with healthy rebound in second quarter*", Financial Times, 30 July 2021

[ii] A similar development was the case in the US, with GDP growth in Q2'2021 increasing slightly to 6.3 per cent on an annualised basis – compared with 6.3 per cent in Q1'2021 – against an 8.5% forecast, while the PCE price index rose to 6.4 per cent in Q2'2021 from 3.8 per cent in Q1'2021. While this is not the place to discuss all the adjustments for measuring volatile food and energy costs in Europe and the US, it is clear that investor sentiment has been impacted, with some fund managers now expecting real GDP growth to slow down in the second half of 2021. See, James Politi and Mamta Badkar, *"US economic growth weaker than expected in second quarter"*, Financial Times, 30 July 2021

[iii] Tommy Stubbington, *"US real yields hit record low on growth concerns"*, Financial Times, 27 July 2021

[iv] This was the key focus of the first strategic outline of Andrea Orcel, the new CEO of UniCredit, at the Q2'2021 analyst call on 30 July (see relevant slide in the Appendix). For an example of considering the glass "half full", see the CEO of Austria's Erste Group, Bernd Spalt, at the Q2'2021 call on 30 July, when describing the rebound in Central & Eastern Europe as being in "full swing", something his main competitor in Milan has not necessarily subscribed to (UniCredit reporting Q2'2021 results on the same day). Incidentally, it was also Bernd Spalt talking about a fast "V-shaped recovery" a year ago, something we might have seen in stock markets but not in the European economy at large. It also indicates the danger of solely relying on in-house economic forecasts.

[v] Philip Stafford and Joe Rennison, "*Crypto trading volumes boom as activity cools on stock markets*", Financial Times, 6 May 2021

[vi] For the former, as an example for Citigroup among major investment banks, see: Eva Szalay, "*Citi weighs launching crypto services after surge in client interest"*, Financial Times, 7 May 2021; and for the latter, on the example of the Bank for International Settlements (BIS) in Basel, see: Gillian Tett: *"A contest to control crypto is under way"*, Financial Times, 25 June 2021. The BIS was quoted in encouraging central banks to create crypto currencies to "offer in digital form the unique advantages of central bank money: settlement finality, liquidity and integrity".

[vii] Adam Samson, *"Crypto world faces a fateful choice"*, Financial Times, 16 July 2021

[viii] Mohamed El-Erian, *"China lays down challenge to the west on crypto"*, Financial Times, 29 July 2021

[ix] On global bitcoin electricity usage, see: Siddharth Venkataramakrishnan, *"China's share of global bitcoin electricity usage drops under half"*, Financial Times, 15 July 2021, with global bitcoin mining consuming at constant levels 70 terawatt hours of electricity, or slightly more than the annual consumption of Austria. In turn, on the growing energy problem, with climate activists becoming increasingly vocal as crypto mining often implies a reversal to coal-fired power plants, and not least Elon Musk conceding the environmental impact in May leading to a massive decline in the value of cryptocurrency, see: Katie Martin and Billy Nauman, "*Bitcoin's growing energy problem: 'It's a dirty currency'*", Financial Times, 20 May 2021. In this respect, for lobbying efforts by the Bitcoin network, see: Bitcoin Clean Energy Initiative Memorandum, *"Bitcoin is Key to an Abundant, Clean Energy Future"*, April 2021

[x] See, UBS Q2'2021 results call, 20 July 2021. On the next day, the Julius Baer management team was asked a similar question, equally confirming that they have provided access for clients into the crypto space and completed "smart contracts" through blockchain, Julius Baer H1'2021 results call, 21 July 2021. Through new crypto exchanges, investors are reportedly able to deposit their own assets into "smart contracts" and let automated computer code handle buying and selling with interested parties. These "smart contracts" hold funds and take in data, as well as performing settlement and clearing, see: Philip Stafford and Eva Szalay, *"Billionaires Peter Thiel and Alan Howard back new $10bn crypto exchange"*, Financial Times, 12 May 2021

[xi] ABB talked extensively about the inventory build-up by many clients foreseeing renewed problems arising from supply-chain constraints and higher-priced raw materials, ABB Q2'2021 results call on 22 July 2021. In turn, KPN mentioned to what extent government support was still of help when asked about any visibility of bad debt from

SMEs, KPN Q2'2021 results call on 27 July 2021.

[xii] Volkswagen was among the first to have adjusted their guidance for Q3'2021 in May and reiterated their outlook for a more difficult third quarter at the Q2'2021 results call on 29 July 2021. The company remains hopeful to be able to catch up by year-end, with the assumption that problems with semiconductor shortages would ease in Q4'2021.

[xiii] For more detail on this sudden setback, see: Robin Wigglesworth, Tommy Stubbington and Colby Smith, *"Reflation trades pummelled as Fed's shift resets markets"*, Financial Times, 18 June 2021 and for some hedge funds struggling with the new situation, see: Colby Smith and Laurence Fletcher, "*Reflation trade unwind wrongfoots several big-name hedge funds"*, Financial Times, 29 June 2021.

[xiv] For an eloquent explanation of the different forces involved, see: Mohamed El-Erian, "*The inherent instability of the Goldilocks market consensus"*, Financial Times, 30 June 2021.

[xv] Justin Jacobs and Anjli Raval, *"Defeats for Big Oil mark 'sea change' in climate battle"*, Financial Times, 27 May 2021

[xvi] Pilita Clark, *"Beware the looming net zero car crash"*, Financial Times, 18 May 2021

[xvii] This question was addressed by the JPMorgan analyst to the outgoing CEO of Austrian OMV, Rainer Seele, who pointed to the most challenging issue being time, as investors and other stakeholders would like things to happen immediately, and also the need to engage in M&A in order to reduce the share of the traditional fossil fuels business, OMV Q2'2021 results call on 28 July 2021.

[xviii] These questions were raised by the analysts of Goldman Sachs and Merrill Lynch at the Shell Q2'2021 results call on 29 July 2021, with the CEO, Ben van Beurden, confirming that it implies not only changes in the product but also in business model and that Shell can't be faster than its customers in implementing the Scope III emissions target.

[xix] See relevant questions by Morgan Stanley and Mediobanca analysts at the TotalEnergies Q2'2021 results call on 29 July 2021.

[xx] See, https://www.iea.org/reports/net-zero-by-2050. The BP Statistical Review of World Energy 2021 published on 8 July 2021 made not only a special reference to the IEA report but also conceded that the CO2 reduction achieved through the corona-induced lockdowns and grounding of flights in 2020 has been quickly reversed:
https://www.bp.com/en/global/corporate/energy-economics/statistical-review-of-world-energy.html

[xxi] See, among others: Neil Hume and Henry Sanderson, "*Copper boom: how clean energy is driving a commodities supercycle"*, Financial Times, 8 June 2021 and Michael Mackenzie, *"A commodity boom with a difference"*, Financial Times, 7 May 2021

[xxii] For an example in Germany, see: Martin Arnold and Erika Solomon, "*'We need people': Berlin's grand reopening hit by labour shortages"*, Financial Times, 28 May 2021

[xxiii] This was a major topic at the Credit Suisse Q2'2021 results call on 29 July 2021, presenting not only statistics on the return to office and employee turnover (see relevant slide in the Appendix) but also outlining in the concluding remarks that "we value our deep pool of talented and dedicated employees" (slide 37). In the wake of the Archegos and Greenhill Capital scandals earlier this year, which led to a write-off of more than CHF 5 billion so far, the company faced, among others, the departure of 23 senior managers from Capital Markets & Advisory, who had opted for a more generous bonus pool elsewhere.

[xxiv] Harry Dempsey and Benjamin Parkin, *"India's covid surge rocks global shipping industry"*, Financial Times, 6 May 2021

[xxv] See for clear statements in this regard: ABB, Q2'2021 results call on 22 July 2021 and, on the same day, Trelleborg, Q2'2021 results call on 22 July 2021.

Guiding principles to underpin strategy: simplification, clients and digital

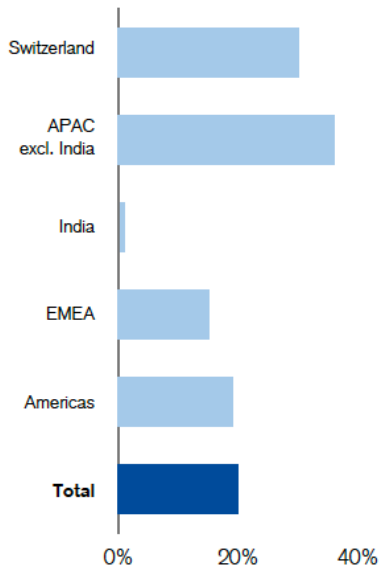
Simplification
- Reducing complexity
- Simplifying working interactions
- Empowering colleagues

Clients
- Client centricity
- Clients and communities are the reason we exist
- Proximity to clients

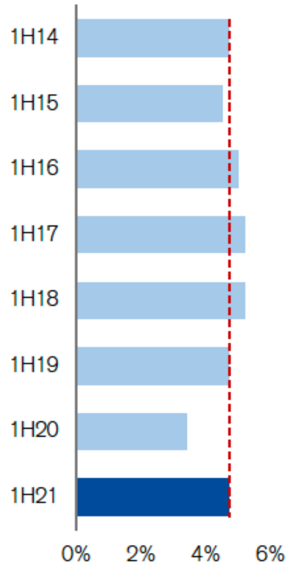
Digital
- Make innovative technologies central
- Digitalisation as part of UniCredit's DNA
- Incorporate technology in decision making
- Enhance service to clients

Return to office and turnover in employees

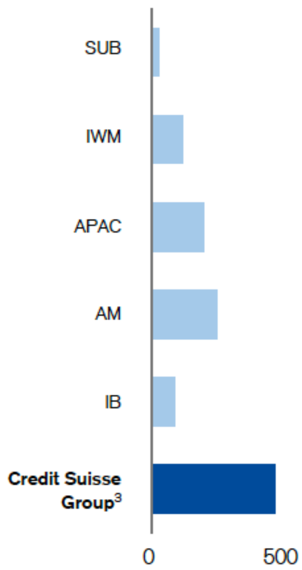
Return to office[1]
Average daily office access rate in %



Turnover in employees[2]
Employees leaving CS voluntarily divided by the total number of employees for the respective year in %



Net movement in staff
Change in number of employees (FTE) in 1H21



1 For the period of July 12-16, 2021 2 As at June 30, 2021 3 Includes Corporate Center