IV Outlook

1 Economic conditions

1.1 Global economic trends

At present, the war in Ukraine is casting a shadow over the outlook for the global economy. Western countries imposed sanctions on Russia at an early stage and have gradually tightened them. The effects are being felt not only by Russia. The entire global economy is suffering from steep increases in the cost of commodities and high energy prices. Germany and other European Union (EU) countries are particularly badly affected because of their dependence on Russian energy supplies. Overall, the war and its consequences represent the biggest threat to economic growth in 2022. The forecasts provided below are based on the assumption that gas supplies from Russia will be repeatedly interrupted or reduced, resulting in high energy prices and hampering macroeconomic growth.

Besides high energy prices, factors that are likely to hold back the economy as a whole include the ongoing COVID-19 pandemic and related supply chain problems, elevated inflation rates, and rising interest rates. For example, different Omicron variants of coronavirus will trigger repeated regional waves of infection, with the risk of a seasonal spike in case numbers in the autumn. Although the risk to health from Omicron is regarded as lower than from the Delta variant, the pandemic will continue to weigh on the economy. Moreover, consumer spending is expected to be muted and supply chains will face fresh disruptions. China's zero-COVID policy, which involves the imposition of tight restrictions, is a particularly significant source of potential disruption to the international movement of goods. This will be compounded by war-related supply bottlenecks and price rises in the agricultural, industrial, grocery, and construction sectors.

Even before the outbreak of war, inflation rates had soared in the major industrialized nations owing to high energy prices and increased costs resulting from global supply chain problems. The war in Ukraine and the sanctions imposed by the West then drove prices even higher. Although DZ BANK expects inflation rates in most countries to have peaked over the summer, the overall increase in prices will probably weaken only slowly between now and the end of the year and will continue to depress the economy. Another factor is the sharp rise in interest rates, which is likely to be prolonged and marks the end of the phase of negative interest rates. Not only are higher interest rates making it more difficult for companies to invest but they also mean that buying a home is becoming prohibitively expensive for a growing number of households. Assuming that the conflict in Ukraine continues into 2023 and interest rates do not go back down, the growth of the global economy is expected to have weakened further by the end of this year.

1.2 Trends in the USA

US economic output shrank in the first half of 2022, primarily due to the exceptionally large trade deficit, the huge wave of Omicron cases at the start of the year, and the strong depletion of inventories across the economy in the second quarter. DZ BANK does not anticipate that the Federal Reserve's restrictive monetary policy will result in a continued period of recession for the US economy; in other words, the central bank is achieving its targeted 'soft landing'. This is indicated, in particular, by the healthy labor market and households' high levels of savings, which are still propping up consumer spending at present. At the same time, there are positive signals from the industry because the availability of components has recently improved.

However, the very high rates of inflation continue to be one of the biggest risks to the economy. Despite substantial wage increases, inflation is eating into households' real incomes. This is likely to be reflected in slower growth of consumer spending. The Federal Reserve is also taking a hard line against inflation. Interest-rate rises are resulting in worse funding terms for consumers and companies. DZ BANK continues to anticipate growth of 2.5 percent for 2022.

1.3 Trends in the eurozone

Contrary to the initial calculations, the eurozone's gross domestic product (GDP) increased markedly, by 0.5 percent, in the first quarter compared with the previous quarter. However, the growth figure was distorted by excessively large jumps within Ireland's statistics for investment in intellectual property and for imports and therefore does not reflect the actual underlying growth trend. The difficult conditions created by persistent supply problems, the uncertainty resulting from the war in Ukraine – including the aforementioned difficulties with gas supplies – and substantial inflationary pressure do not suggest that the situation will ease over the remainder of the year, even though the second quarter was also positive. Although a technical recession – two consecutive quarters of negative growth – can probably be avoided in the second half of 2022, the economic outlook remains bleak in other respects.

Overall, the forecast of weak economic growth and continued high levels of inflation can be described as a stagflationary trend. Another contributory factor is the protracted war in Ukraine. Moreover, the shift in monetary policy at the European Central Bank (ECB) is acting as a brake on economic growth. DZ BANK anticipates that the eurozone's economy will expand by 1.3 percent in 2022, despite an average inflation rate of 7.0 percent. This is partly due to the situation in the first half of 2022 described above.

1.4 Trends in Germany

Like other countries, Germany cannot escape high inflation, the global supply chain problems, the uncertainty resulting from the war in Ukraine – including the aforementioned difficulties with gas supplies – and the rise in interest rates after a policy of zero interest rates that has been in place for many years. This suggests that the economy is unlikely to stage a robust recovery any time soon.

Against this backdrop and in view of Germany's comparatively high dependency on gas supplies from Russia, DZ BANK anticipates a small increase in GDP of 1.0 percent for 2022. As measured by the Harmonized Index of Consumer Prices (HICP), Germany's inflation rate of 7.0 percent will be significantly higher than the ECB's target of 2.0 percent.

1.5 Trends in the financial sector

The conditions that have prevailed in the financial sector for some years, including structural change driven by competition, the agenda of regulatory reforms, and active support for companies' green transformation, have not changed compared with 2021. Detailed statements on these matters can be found in the outlook in the 2021 group management report.

Turning to interest-rate markets, monetary policy changed direction this year. The main central banks decided to depart from the expansionary monetary policy pursued in response to the financial crisis, although there are big differences between them in terms of the extent and timing of the monetary policy measures themselves. The Bank of England, for example, has been steadily raising its key interest rate since December 2021 – reaching 1.25 percent – in view of rising inflation rates. In addition to the discontinuation of its asset purchase programs, the US Federal Reserve increased interest rates four times to reach a range of 2.25 percent to 2.5 percent (as at July 31, 2022) and is planning further interest-rate hikes.

After reassessing the situation following the recent increases in inflation, the ECB implemented its first interest-rate hike on July 21, 2022, taking the key rate to 0.5 percent, and raised the prospect of further rises. It had already announced that it would gradually wind down the asset purchase programs established to soften the impact of the financial crisis and the fallout from the COVID-19 pandemic.

This monetary policy environment caused the nominal interest-rate level – starting from a very low level at the beginning of this year – to rise sharply in the first half of 2022; the previously relatively flat yield curve also became steeper. Although the interest-rate level is likely to continue to normalize, a significant increase in nominal interest rates combined with positive real interest rates is not currently expected.

In the last few years, central banks' expansionary monetary policy, and particularly the ECB's bond-buying programs, meant that structural problems in some European Monetary Union (EMU) member countries went unnoticed in the capital markets. Owing to the COVID-19 pandemic, the economies of these countries are particularly struggling and their need to obtain funding in the capital markets has risen sharply in view of the fiscal support measures that have been required. The widening of credit spreads on the bonds of individual countries as a result of the announced ending of the asset purchase programs is being monitored closely by the ECB. The central bank is concerned that if eurozone countries see an excessive rise in yields that is not justified by the fundamentals, the monetary policy transmission mechanism could be disrupted. This potential fragmentation risk is to be mitigated by the option of flexibly reinvesting liquidity from securities in the PEPP portfolio when they mature. In addition, the ECB approved the Transmission Protection Instrument (TPI) on July 21, 2022, with which it aims to control undesirable yield differentials between the government bonds of various EU member states. It remains to be seen what effect this tool will have, including in terms of the stability of the eurozone.

As described above, the predicted combination of weak economic growth, persistently high inflation rates, and a difficult geopolitical environment is leading to a stagflationary trend (see sections 1.1 to 1.4 of the outlook). Additional information on overarching macroeconomic risk factors can be found in the risk report (chapter VI.3).

It is not possible to rule out continued negative effects because of these conditions over the remainder of 2022, not only for businesses, consumers, and the real estate sector but also for the capital and financial markets, which in turn could have an adverse impact on the financial sector. In the medium term, at least, the moderate rise in interest rates should serve to somewhat stabilize the financial position and financial performance of the entities in the financial sector.

2 Financial performance

The forecasts below are based on the outcome of the DZ BANK Group's projection process. Changes in the underlying assumptions, particularly as a result of the macroeconomic conditions described above, may lead to deviations from the forecasts.

Profit before taxes is expected to fall sharply in 2022 compared with the exceptionally high figure that was achieved in 2021, which had been partly due to favorable conditions. The 2022 figure is therefore likely to be almost at the bottom end of the target range of €1.5 billion to €2.0 billion. The predicted financial performance will be heavily influenced by the challenging economic and geopolitical environment. At present, the resulting correction in the capital and financial markets is weighing particularly heavily on the earnings of the R+V and UMH operating segments. The evolving risk situation may also have negative implications, especially for the operating segments in the DZ BANK Group that are sensitive to interest rates.

In 2022, **net interest income** including income from long-term equity investments is predicted to remain at the high level recorded in 2021. This prediction is partly based on the encouraging level of customer business, especially in the BSH, DZ BANK – CICB, DZ HYP, and TeamBank operating segments.

Despite a higher, slightly steeper yield curve, the still difficult economic conditions in the eurozone may lead to falls in income for the interest-rate-sensitive business models within the DZ BANK Group.

Although **net fee and commission income** is projected to be noticeably lower in 2022 than in 2021, which had benefited from favorable conditions, it will still make a very strong contribution to the earnings of the DZ BANK Group thanks to the net fee and commission income generated by the UMH, DZ BANK – CICB, and DZ PRIVATBANK operating segments.

The volatility currently observable in the capital and financial markets could continue to have a negative impact on confidence and sentiment among retail and institutional investors, thereby depressing net fee and commission income.

Gains and losses on trading activities are anticipated to improve markedly in 2022 owing to positive IFRS-related valuation effects.

The customer-driven capital markets business in the DZ BANK – CICB operating segment may continue to suffer as the capital and financial markets environment is expected to remain volatile.

Gains and losses on investments will probably decline sharply this year, partly due to the inclusion in the prior-year figure of positive non-recurring items (such as the sale of direct equity investments at VR Equitypartner).

Other gains and losses on valuation of financial instruments are expected to deteriorate markedly year on year to a net loss in 2022, primarily due to the negative effects of valuing securities from government issuers in European periphery countries in the DZ HYP operating segment and valuing guarantee commitments for investment products in the UMH operating segment.

The forecast for this key figure may be adversely affected by volatility in the capital markets, for example as a result of the widening of credit spreads on securities from the aforementioned issuers.

According to the latest projections, **net income from insurance business** in 2022 is expected to be well below the 2021 figure. This is because gains and losses on investments held by insurance companies are expected to deteriorate sharply in the R+V operating segment owing to the volatile conditions in the capital and financial markets. However, this will be partly offset by premiums earned, which are likely to be slightly higher than the very encouraging level achieved in 2021.

The net income from insurance business generated in the remainder of 2022 may be negatively impacted not only by exceptional developments in the capital and financial markets but also by loss events and changes in underwriting practices.

The difficult environment faced by businesses and consumers – especially the supply chain problems, the impact of the war in Ukraine, and high inflation, combined with more expensive commodities and the jump in energy prices – means that expenses for **loss allowances** are forecast to rise and to reach their expected level in 2022, in contrast with 2021, which had been characterized by an unremarkable risk situation and the net reversal of loss allowances.

In 2022, **administrative expenses** are expected to rise moderately year on year. This will predominantly be due to growth-related increases in general and administrative expenses in selected operating segments and higher contributions to protection schemes.

In 2022, **other net operating income** is anticipated to climb sharply year on year, partly because the 2021 figure had been adversely impacted by non-recurring items (such as the recognition of restructuring expenses in the DVB operating segment).

The **cost/income ratio** for the DZ BANK Group is likely to rise sharply in 2022 compared with 2021 owing to the expected decrease in income.

One of the main strategic aims continues to be to reduce the cost/income ratio over the long term by rigorously managing costs on the one hand and by accelerating growth in the operating business of all segments on the other.

Regulatory RORAC, the risk-adjusted performance measure based on regulatory risk capital, will probably fall significantly year on year in 2022 in view of the expected considerable drop in profit before taxes.

3 Liquidity and capital adequacy

The DZ BANK Group is assuming that it can continue to maintain an appropriate level of **liquidity adequacy** in the second half of 2022. Further information on liquidity adequacy can be found in the risk report (chapter VI.5).

As matters currently stand, the DZ BANK Group's **capital adequacy** will continue to be assured for the second half of 2022 from both economic and regulatory perspectives; that is to say, it will continue to have at its disposal the available internal capital and own funds necessary to cover the risks associated with the finance business and other risks arising from the group's business operations. Further information on capital adequacy can be found in the risk report (chapter VI.6).