HORIZON

The Berenberg Capital Market Outlook · Wealth and Asset Management

VACCINATION HOPES

If a coronavirus vaccine is approved, a globally synchronised recovery will probably become the dominant theme for capital markets.

POLITICAL UNCERTAINTY

It is not yet possible for investors to adapt their positioning to the outcomes of the US elections and the Brexit negotiations due to their high uncertainty. Volatility spikes are to be expected.

REALLOCATION

Scepticism continues to dominate investor sentiment. The reallocation of cash into real assets has only just begun as negative real interest rates prevail.

Q4 | 2020

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FOREWORD

Prof Dr Bernd Meyer
Chief Investment Strategist

Dear reader,
The recovery of the economy and capital markets continued in the third quarter, albeit at a slower pace in capital markets. The depreciation of the US dollar weighed on markets. For euro investors, global equities did not surpass the level already reached in June until late August, and then declined again. Cyclical stocks and small caps exhibited an above-average performance as the economy recovered. Besides growth stocks and US mega caps, the DAX and emerging-market equities led the pack. We benefited significantly from this trend and from the further compression of yield spreads on corporate and emerging-market bonds.

Although investor sentiment has brightened somewhat, it is still far from euphoric. Investors are sitting on large piles of cash at negative real interest rates. Even systematic investment strategies are not yet fully invested again. As the economic recovery progresses, albeit at a slower pace, the starting position for the fourth quarter is really not so bad. Three developments will probably be decisive for capital markets: the outcome of the US elections, the outcome of Brexit negotiations, and progress made in COVID-19 testing, therapeutics, and vaccines.

Investors are fixated on the US elections and Brexit. However, their outcomes are still too uncertain to allow for clear positioning today. Volatility spikes are therefore to be expected. Adverse scenarios for markets would be a close election victory followed by challenges of the results and an escalation of the trade conflict between China and the United States as an election tactic.

On the other hand, we consider it probable that substantial progress will be made in the development of medicines and vaccines against the coronavirus in the coming three to six months. Numerous potential vaccines are in the final trial phase. The first results can be expected in October. This will probably be the decisive development for capital markets. The approval of medicines or vaccines would clear the way for a synchronised, global economic recovery in 2021. However, it could also usher in the end of the rally in capital markets as this scenario is likely to be largely priced in by then, the majority of investors will be positioned again, and the current healthy scepticism could give way to euphoria. Until then, however, investors should not be too sceptical, despite the continued risks. We have positioned our portfolios even more cyclically.

In the Insights Interview, our fund manager Robert Reichle discusses his fascination with emerging-market bonds and explains why they stand out and what makes them currently attractive. I hope you enjoy reading this issue of Horizon.

CONTENTS

VACCINE HOPES TRUMP POLITICAL UNCERTAINTY

IN A NUTSHELL

- The economic recovery continues, albeit at a slower pace. New shocks resulting from the coronavirus are a risk.
- The probability of a vaccine is rising. Therefore, a globally synchronised recovery in 2021 will probably be the dominant theme in capital markets in the coming months.
- It is not yet possible for investors to adapt their positioning to the outcomes of the US elections and the Brexit negotiations due to their high uncertainty.
- Investor positioning and sentiment are marked by healthy scepticism. The reallocation of cash into real assets has only just begun as negative real interest rates prevail.

Portfolio positioning at a glance

In late June, we had reduced the modest overweight in equities that had been in place since March to neutral and added in exchange more credit risks and more cyclical commodity exposure via silver to our portfolios. Both areas promised more return potential for the lacklustre summer we had expected. Among equities, the focus was placed on emerging markets, the eurozone, European small caps, and the NASDAQ in the underweighted United States. We benefited considerably from this positioning in conjunction with a substantial overweight in gold.

We have now positioned our portfolios even more cyclically in terms of stock selection and by expanding our positions in European small caps and cyclical commodities. In exchange, we took first profits on corporate bonds after the significant compression of spreads and in view of rising yields on safe government bonds. Among bonds, we continue to prefer emerging-market and corporate bonds. Bonds of safe issuers remain underweighted. Among equities, the regional focus is still on emerging markets and the eurozone, especially Germany. A substantial gold position remains an important element of our multi-asset portfolios.

Looking back on the third quarter – continued, slower growth

The recovery in capital markets continued in the third quarter. Positive drivers were better-than-expected economic data and corporate outlooks, as well as the quick agreement reached on the recovery fund in the Eurozone. Negative factors included the renewed rise in coronavirus infections in the United States and Europe, growing tensions between China and the United States, and the upcoming Presidential elections. The pace of recovery in capital markets was slower than in the second quarter, not least due to a significant depreciation of the US dollar. For euro investors global equities surpassed the level reached already in June only in late August. However, there was significant movement beneath the surface. Besides mega caps in the United States and growth stocks, the DAX and emerging-market equities led the pack because cyclical stocks and small caps exhibited an above-average performance as the economic recovery progressed. Lower equity market volatility was accompanied by a further compression of yield spreads on corporate and emerging-market bonds (see the bottom figure on page 5). Supported by the weaker US dollar, rising inflation expectations, and declining real interest rates as central banks are keeping nominal bond yields in check, gold also gained and is therefore the best-performing asset class by far since the beginning of the year.

Economic recovery should continue at a slower pace

The economy has restarted faster than originally expected since May. In the third quarter, the economy is likely to have made up about half the losses from the second quarter, when it suffered the deepest recession in at least 90 years. We expect this recovery to continue. Despite slowing momentum, growth should be above-trend in the next two years. Renewed, far-reaching shutdowns of economic activity in reaction to a new wave of coronavirus infections present a risk, but we do not expect this to materialise. If this expectation proves true, the development of the economy would correspond to the tick-shaped recovery predicted by our economists.

Uncertain outcomes of US elections and Brexit increase volatility

The US Presidential elections on 3 November and Brexit on 31 December will most probably dominate the political headlines in the fourth quarter. The election outcome appears to be completely uncertain. The results of four years ago showed that US elections are always good for surprises. If the election is close, which current polls suggest, the outcome could be deadlocked and it could take longer for the final result to be confirmed, as was the case in 2000. Markets are already preoccupied with this uncertainty and are pricing in fairly high implicit volatilities around the election date. This makes it expensive to hedge the corresponding risks. However, it also means that the markets are not entirely unprepared. What is clear is that there will be different winners and losers depending on the outcome. Biden would probably be negative for the US dollar and US equities, but good for emerging markets and European equities; vice versa if Trump wins. Like Brexit, the outcome of the US election appears too uncertain to allow for clear positioning.

Recovery of equity markets continued at a slower pace in Q3; gold also strengthened; US dollar weakened

Total return	YTD and in 2019 (in %, EUR): YTD (31/12/19-15/09/20)	Q3 20 (30/06/20-15/09/20)	12-month periods of the last 5 years (in %, in EUR): 15/09/19 15/09/20	15/09/18 15/09/19	15/09/17 15/09/18	15/09/16 15/09/17	15/09/15 15/09/16	CAGR* 15/09/15 15/09/20	Std. dev.* 15/09/15 15/09/20
Gold	21.9	4.0	22.7	30.8	-7.0	-5.5	19.2	11.0	12.6
EUR Sovereigns	1.3	0.5	0.3	5.2	-0.3	-0.5	3.7	1.6	2.1
S&P 500	1.1	4.5	7.7	11.0	21.6	11.9	11.4	12.6	20.4
EUR Corporates	0.8	2.1	0.6	5.9	0.0	0.7	6.4	2.7	2.5
US Sovereigns	0.4	-5.0	0.1	12.1	1.1	-6.0	3.6	2.0	7.1
DAX	-0.2	7.4	6.0	2.8	-3.2	20.0	2.4	5.3	20.0
Eonia	-0.3	-0.1	-0.5	-0.4	-0.4	-0.4	-0.3	-0.4	0.0
EM Sovereigns	-2.8	-0.9	-1.8	17.4	-2.1	-0.1	13.8	5.1	8.7
MSCI EM	-3.8	6.7	3.6	7.6	-2.0	19.3	13.3	8.1	16.7
USDEUR	-5.4	-5.2	-6.5	5.0	2.8	-5.9	0.2	-1.0	7.4
Stoxx Europe 50	-9.5	1.2	-3.6	10.3	0.2	13.2	-3.8	3.0	17.2
Brent	-47.1	-7.7	-39.4	-14.4	52.9	1.1	-18.9	-8.2	39.7

Time period: 15/09/2015-15/09/2020.
Source: Bloomberg * CAGR = annualised return (in %, in EUR); Std. dev. = Annualised standard deviation (in %, in EUR).

Rising probability of a COVID-19 vaccine/medication

News and evidence of upcoming vaccines or treatments are likely to proliferate in the fourth quarter and vaccines could possibly be approved before the end of the year. As we see it, this will ultimately be decisive for capital markets as it would clear the way for a synchronised global economic recovery in 2021. Moreover, investments that were hit hard by the coronavirus would then experience a certain recovery. Investors that parked considerable amounts of cash in money market investments (top figure) would probably reallocate the funds to equity investments to a greater degree. This shift has only just begun very tentatively in the third quarter. Investors had ploughed more money into bonds and commodities in Q2 and Q3. To date, investor positioning and sentiment show no signs of the kind of euphoria that typically ends a bull market: Healthy scepticism prevails.

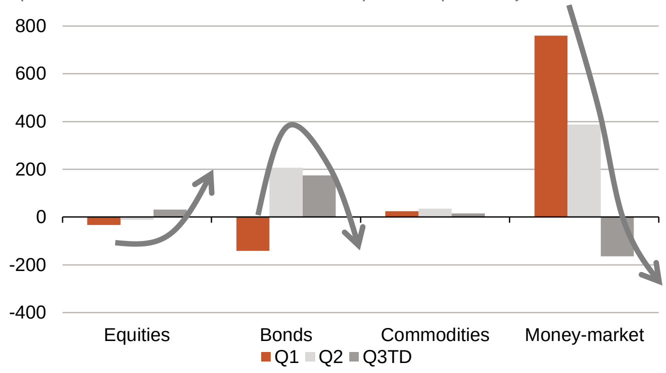
Financial repression persists supporting equities and commodities

All this suggests that a further cyclical recovery will ultimately dominate the markets in the next three to six months, despite the political uncertainty. The longer-term inflation expectations priced in bond markets will probably increase slightly further (centre figure), especially considering the more flexible handling of the inflation target announced by the US central bank. A modest rise in yields for bonds with longer duration can be expected, but will certainly not exceed the rise of inflation expectations. Negative real interest rates will prevail. Central banks will probably try to keep interest rates very low for years to come keep financing conditions loose for the high levels of government debt incurred as a result of the fiscal policy measures taken to combat the coronavirus crisis, and effectively finance the debt by way of bond purchases. Yield curves can be expected to steepen and the US dollar is likely to remain weak in the medium term, especially if Joe Biden wins the election. In this scenario, equities that are more on the cyclical side, as well as small caps, emerging-market equities, and cyclical commodities, offer above-average return potential over three to six months. Corporate and emerging-market bonds also remain supported (bottom figure.). However, investors should keep in mind that the broad availability of a vaccine will probably mark the end of the recovery in capital markets, rather than the beginning since most investor groups will be positioned adequately by then and euphoria will take over.

Prof. Dr. Bernd Meyer, Chief Investment Strategist

Reallocation of cash only just began in the third quarter

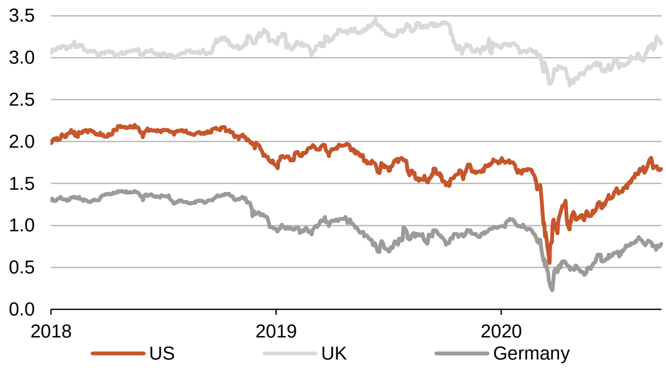
Global fund flows by asset class in billions of US dollars. Investors are still sitting on piles of cash. Arrows indicate the development expected by us.



Time period: 01/01/2020-16/09/2020.
Source: Bank of America, own calculations.

US inflation expectations priced-in by the market at pre-crisis levels

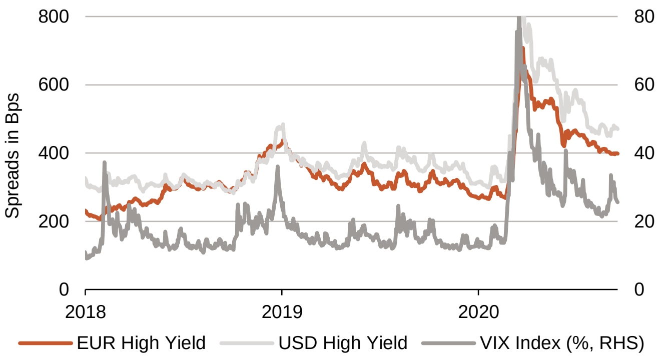
Inflation expectations, priced-in to inflation-linked 10-year bonds (breakeven inflation, in %), are rising



Time period: 01/01/2018–15/09/2020.
Source: Bloomberg, own calculations.

Equity volatility and credit spreads are still above pre-crisis levels

The spreads on corporate bonds have tightened in conjunction with lower equity volatility, but still have some potential



Time period: 01/01/2018–15/09/2020.
Source: Bloomberg, FactSet, own calculations.

SOLID RECOVERY WITHOUT INFLATION

IN A NUTSHELL

- Economy: the global economy is recovering appreciably after the unprecedented collapse in March and April.
- The slope of recovery is slowly flattening.
- Aggressive monetary and fiscal policy is supporting the economy.
- Inflation risks remain low for now.

The shock is subsiding

The COVID-19 pandemic and the drastic interventions in everyday life to contain the spread of the virus have hit the economy hard. Large parts of the world slid into a deep recession in March and April. Already in May, however, nearly all industrialised nations turned the corner and began to recover.

So far, the economic recovery in the Western roughly resembles the shape of a “tick”. The sharp drop was followed by an upswing, but one that was initially not strong enough to resemble a V-shape and has flattened over time. The gradual easing of lockdowns and contact restrictions quickly reactivated parts of the economy such as retail sales after the dramatic collapse. Therefore, activity has recovered appreciably, although the slope of recovery has been substantially flatter than the presumed V-shape. Now that the initial catch-up effect has faded, the pace of economic recovery in the western world has slowed.

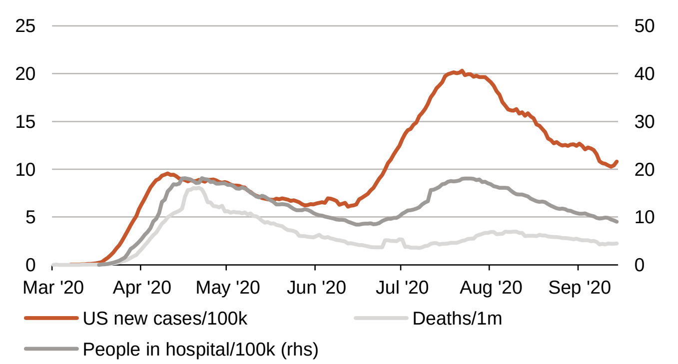
Four phases of recovery

The forces driving the recovery have been changing since July. Whereas consumer spending can now be expected to increase only moderately, manufacturing and foreign trade have just started recovering. The stronger economy in China, which rebounded from the pandemic relatively quickly and is, as usual, also providing considerable support to its domestic market, is contributing to industrial recovery. Nevertheless, it will probably take up to two years before conditions have normalised in the manufacturing sector; that being said, the outlook for the consumer goods industry is much better now than for mechanical engineering, given that consumer demand has returned to normal.

Companies tend to hold back on investments in uncertain times. Capital expenditures in Germany and in the country’s trading partners can be expected to recover from the shock of the pandemic after something of a delay, and then only gradually. Whereas equipment investments will presumably remain relatively weak in the autumn of this year, they will probably increase appreciably in the course of next year. If that happens, it would be a third phase of the recovery. Also in 2021, additional government spending should lend considerable support to the economy in the western world. Fiscal policy will pivot increasingly from the original goal of softening the blow of the economic downturn to the goal of supporting the new upswing. Substantial business investment in supply chain transformation could then support a fourth phase of recovery from 2023 onwards, with growth above the current trend.

COVID-19 in the US: Many infections, fewer complications

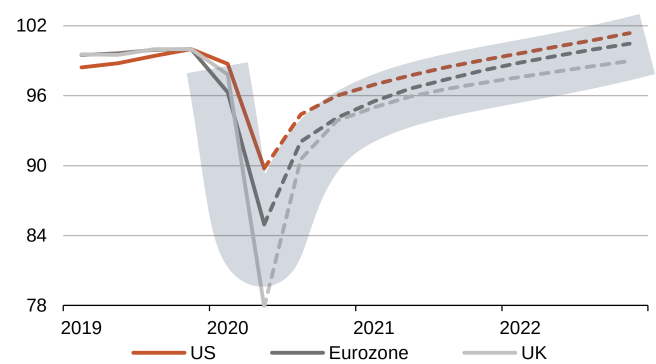
Daily new infections, hospitalised patients, and deaths



Moving seven-day averages. Time period: 01/03/2020-14/09/2020.
Source: Johns Hopkins University, Covid-19 Tracking Project.

“Tick”-shaped collapse and recovery

Real gross domestic product, Q4 2019 = 100



Time period: 01/01/2019-31/12/2022.
Sources: BLS, ONS, Eurostat; Berenberg projections as of Q3 2020.

Major differences between countries

Although the pattern of economic growth is generally similar in all countries of the western world, there are some significant differences. At -9.5%, the drop in economic output in the United States in the second quarter was somewhat less severe than in Germany (-9.7%) and much milder than in the Eurozone overall (-12.4%) and in the United Kingdom (-20.4%). The lockdowns in the United States were mostly less strict than in Europe. Due to the fact that the United Kingdom initially hesitated in March to impose tough restrictions, allowing the virus to spread exponentially across the island for a longer time, the country then had to keep lockdowns in place for a much longer period. For this reason, the recovery in the United Kingdom began only in June, instead of May. This is reflected in the weak Q2 numbers.

We have learned a lot about the virus: a renewed lockdown can hopefully be avoided.

Thanks to an especially large fiscal stimulus, which will probably be increased again after the US elections on 3 November, the United States will presumably maintain a small lead over the eurozone. By contrast, the Brexit-damaged United Kingdom will probably continue to lag behind.

Living with the virus

Our forecasts are based on the assumption that governments will not need to drastically restrict economic activity again even if infection numbers continue to rise. This assumption is supported by the experience in the United States over the last three months. We have learned a lot about dealing with the virus since March. Today, we know better how to protect ourselves and especially those who are most vulnerable. Treatments have made substantial progress. Despite a rapid rise in infections in the United States in June and July, hospitalisations and COVID-19 fatalities have increased at a much slower rate than in March and April. In the meantime, the United States has apparently succeeded in containing the pandemic with relatively mild and regionally limited interventions and wider use of face masks. We therefore expect the same approach also to succeed in Europe, where case numbers have risen again since August, although to a much smaller extent than previously in the United States, with the exception of Spain and France.

New cycle with initially low inflation pressure

Although we are apparently slowly learning to live with the virus, monetary and fiscal policy will remain very expansive for a few years. Cost and price pressures will remain low due to considerably higher unemployment than before and the still cautious behaviour of consumers and businesses. Economically, the western world is at the beginning of a new cycle with initially low inflation risks. Barring a massive resurgence of the pandemic, the economic outlook is therefore positive at this time.

Dr. Holger Schmieding, Chief Economist

Growth and inflation forecasts

	GDP Growth (in %)						Inflation (in %)					
	2019		2020		2021		2019		2020		2021	
		∅**		∅**		∅**		∅**		∅**		∅**
USA	2.3	2.3	-4.5	-5.0	3.5	3.8	1.8	1.8	1.2	1.0	1.8	1.7
Eurozone	1.2	1.2	-7.9	-8.1	5.5	5.7	1.2	1.2	0.4	0.4	0.7	1.0
Germany	0.6	0.6	-6.0	-6.0	4.6	5.0	1.4	1.4	0.6	0.6	1.6	1.5
France	1.2	1.2	-10.2	-10.0	8.4	7.0	1.3	1.3	0.8	0.6	1.0	1.0
Italy	0.2	0.2	-10.4	-10.1	6.7	5.8	0.6	0.6	-0.1	-0.1	0.7	0.6
Spain	2.0	2.0	-13.5	-12.0	9.2	6.9	0.8	0.8	-0.3	-0.2	0.6	0.7
UK	1.4	1.3	-9.8	-9.9	6.8	6.4	1.8	1.8	0.7	0.8	1.6	1.4
Japan	0.8	1.0	-5.8	-5.5	3.0	2.5	0.5	0.5	0.1	0.0	0.2	0.2
China	6.2	6.1	2.5	2.1	5.0	8.0	2.9	2.9	3.2	2.7	2.1	2.2
World*	2.3	-	2.3	-	2.4	-	-	3.0	-	3.0	-	3.0

* * Berenberg data at actual exchange rates, not purchasing power parities (PPPs). PPPs lend more weight to the fast-growing emerging-market countries.
** Average, Bloomberg consensus as of 15/09/2020.

TEMPORARY ROTATION UPON POSITIVE VACCINE NEWS

IN A NUTSHELL

- Earnings in the Eurozone are likely to grow sharply next year, provided that the euro does not appreciate too much.
- Valuations have risen broadly, especially for US technology stocks. Compared with bonds, however, equities are still not expensive.
- A vaccine approval in Q4 is increasingly probable; this would favour a rotation to coronavirus-ravaged segments.

Cyclicals took the lead in the third quarter

The recovery of equity markets is continuing for the most part. Besides US mega caps, cyclical segments such as the DAX and European small caps in particular have made gains. This recovery has mainly been driven by the liquidity support of central banks, positive economic data, the reversal of short positions, and growing hopes for a coronavirus vaccine. In addition, US technology stocks have benefitted from strong corporate earnings, their popularity with retail investors, continuing share buyback programmes, and a weaker US dollar. By contrast, defensive sectors have struggled after their substantial outperformance in the first half of the year. In euro terms, Asian emerging-market countries have performed the best since the beginning of the year, followed by the S&P 500 and the DAX. Eastern European and UK stocks have been the relative losers and are still well below their levels at the start of the year.

Substantial profit growth is to be expected next year

In line with improving economic data, analysts have recently upgraded their earnings estimates, in particular for the United States and Asian emerging-market countries. On a global scale, however, corporate earnings will probably be significantly lower this year. The consensus expectation is a 20% profit decline for the industrialised nations, although the regional differences are huge. Analysts expect a profit decline of less than 10% for Switzerland but more than 40% for the United Kingdom. They anticipate a synchronised economic recovery next year, which will presumably fuel double-digit earnings growth rates. The consensus expectation for the Eurozone and Germany is optimistic, also thanks to fiscal policy support. However, strong earnings growth next year is contingent on the euro not rising as quickly and sharply as recently. ECB decision makers have already warned that a further appreciation of the euro would weigh on exports, push prices lower, and increase pressure for additional monetary policy stimulus.

Valuations are very ambitious in some cases

The enormous liquidity and the low interest rate environment have caused equity prices to run well ahead of earnings estimates. For example, the price/earnings ratio for the NASDAQ-100 based on earnings estimates for the next 12 months has nearly doubled from 18 in mid-March to 32 in early September. Even though equities are still not expensive compared with bonds, they are indeed expensive compared with their own history. This is especially true for US equities.

Recovery of equity markets has generally continued, especially for US mega caps and cyclical equity segments

Total return	YTD and in Q3 20 (in %, EUR)		12-month periods of the last 5 years (in %, EUR)					P/B*	Div.*	P/E*
	YTD (31/12/19-15/09/20)	Q3 20 (30/06/20-15/09/20)	15/09/19 15/09/20	15/09/18 15/09/19	15/09/17 15/09/18	15/09/16 15/09/17	15/09/15 15/09/16	15/09/20	15/09/20	15/09/20
MSCI EM Asia	4.4	8.3	13.2	4.4	1.0	20.5	14.4	1.7	2.0	18.1
S&P 500	2.8	6.2	9.6	11.0	21.6	11.9	11.4	3.6	1.7	26.0
DAX	-1.4	6.1	4.7	2.8	-3.2	20.0	2.4	1.6	2.6	21.6
Topix	-6.6	1.1	-0.9	3.8	9.4	11.8	7.4	1.2	2.2	21.1
Stoxx Europe Small 200	-7.6	6.4	0.0	2.4	6.2	18.6	0.1	1.5	2.3	38.1
Stoxx Europe Defensives	-9.4	-2.4	-3.1	9.0	4.7	7.0	-2.2			
Euro Stoxx 50	-10.2	2.5	-4.9	9.1	-2.3	21.3	-4.5	1.6	2.9	21.1
Stoxx Europe 50	-10.8	-0.2	-5.0	10.3	0.2	13.2	-3.8	2.0	3.3	20.3
MSCI USA Small Caps	-11.3	2.0	-7.2	0.5	24.3	10.6	7.4	2.0	1.4	46.5
Stoxx Europe Cyclicals	-11.9	4.2	-5.2	1.9	0.3	24.1	-5.1			
MSCI UK	-25.5	-2.9	-19.6	5.6	3.6	7.9	-1.8	1.5	4.0	19.2
MSCI EM Eastern Europe	-27.6	-3.8	-20.0	26.2	3.3	21.0	8.2	0.9	4.7	12.3

Time period: 15/09/2015-15/09/2020.
Source: Bloomberg * PBV = Price/book value ratio; Div. = Dividend yield (%); PER = Price/earnings ratio. Values based on estimates for the next 12 months.

High probability of rotation

In our opinion, the probability that a coronavirus vaccine will be approved in the fourth quarter is very high. Many vaccine manufacturers have made optimistic statements and Donald Trump will do everything he can to have a vaccine approved before the US elections in November so as to increase his odds of victory in the election. This scenario favours the probability of an at least temporary catch-up effect for coronavirus-ravaged sectors and regions. We therefore like emerging-market stocks and European small caps. Valuations in both regions are more favourable than in the United States and these regions are also likely to benefit more than others from a globally synchronised economic recovery. However, the United States should not be written off. After all, the world's most powerful and innovative companies with high rates of earnings growth are still located there. Moreover, US mega caps in particular are still supported by continuing share buyback programmes. Many systematic equity strategies invest primarily in the US equity market due to its size and liquidity. And these strategies will increase their equity exposure if equity market volatility declines further. Finally, the probability of Donald Trump winning the US elections has recently increased.

Ulrich Urbahn, Head of Multi-Asset Strategy & Research

WHAT IS ON COMPANIES' MINDS?

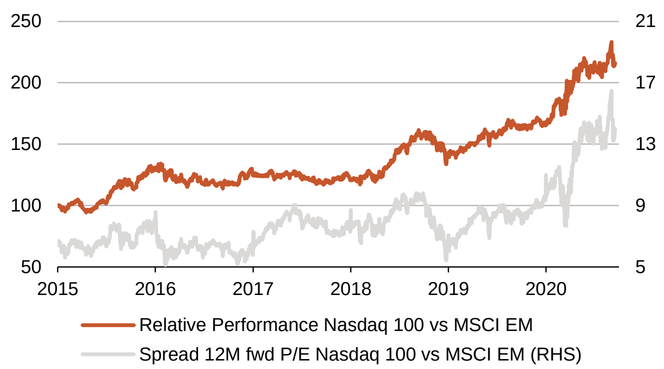
The recovery continues

The trends from the preceding quarter continued to prevail in the third quarter. Tech companies are still the clear winners of this crisis. As management teams in nearly all sectors have confirmed to us, the highest priority is being placed on digitalisation and the entire value chain is benefitting from this trend. A good example is the beleaguered travel and aviation industry. Even there, companies continue to invest in digitalisation while preferring to save in the segment of business travel. That is because no one expects these revenues to return quickly. For some industries under pressure, however, a significant recovery began in the last quarter. While the luxury goods industry was previously kept afloat by strong spending in China, appreciable improvements can now also be observed in Europe and the United States. Within the healthcare sector, elective surgery, which was particularly hard hit, can report similar developments. Hospitals, which are naturally also benefitting from this trend, are reporting that they are much better prepared for a second wave of coronavirus infections.

Matthias Born, CIO Equities

NASDAQ outperformance also driven by P/E ratio expansion

P/E ratio valuation on the basis of earnings estimates for the next 12 months for NASDAQ-100 and MSCI EM, and relative performance (01/01/2015 = 100)

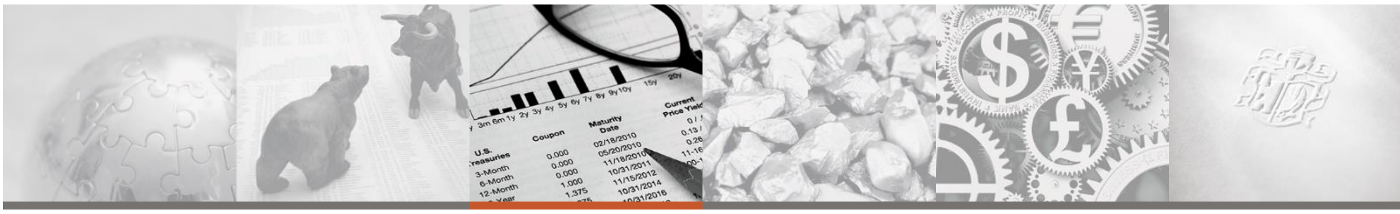


Time period: 01/01/2015-15/09/2020.
Source: Bloomberg, Berenberg.

Forecast summary: Further upside potential for equities

	Currently	Berenberg		Ø*
Index forecasts	15/09/2020	30/06/2021	31/12/2021	in 12 months
S&P500	3,401	3,600	3,700	3,704
Dax	13,218	13,800	14,200	14,531
EuroStoxx 50	3,332	3,500	3,650	3,705
MSCI UK	1,716	1,800	1,850	1,950
Index potential (in %)				
S&P500	-	5.8	8.8	8.9
Dax	-	4.4	7.4	9.9
EuroStoxx 50	-	5.0	9.5	11.2
MSCI UK	-	4.9	7.8	13.6

* Average, consensus as of 15/09/2020.
Source: Bloomberg, FactSet, Berenberg.



RISK PREMIUMS ARE A "MUST-HAVE"

IN A NUTSHELL

- Safe government bonds are still unattractive as an investment, although US Treasuries could serve as a hedge.
- Despite the lower yield spreads, we remain overweight in European corporate bonds.
- Among emerging-market bonds, we prefer hard currencies; rising yields favour the high-yield segment.

On the way back to normalcy

Although uncertainty about the further progression of the coronavirus persists, our base assumption is a gradual normalisation of economic life towards the end of the year. We do not expect renewed, far-reaching restrictions, but they are indeed a risk scenario. This means that primarily fundamental factors should determine the course of the bond markets and risk aversion should subside further.

Government bonds are largely unattractive

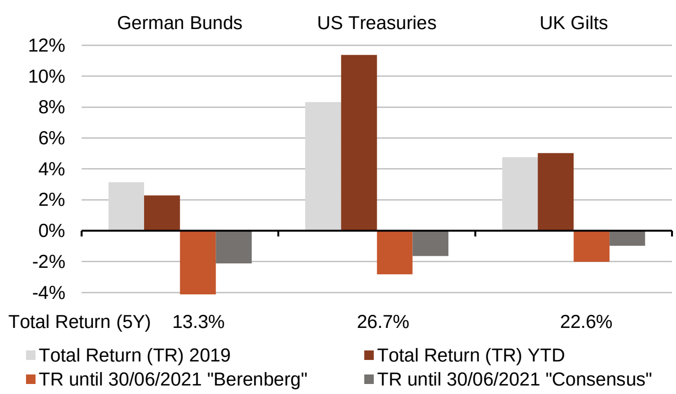
Improving economic data and rising inflation expectations on the one hand and continued, massively expansionary central bank policy on the other created an environment in which German Bunds and US Treasuries traded sideways in the third quarter. Negative real interest rates and the low level of (nominal) yields remain in effect. Coupled with the expected trend of modestly rising yields, these factors make an investment in safe European bonds unattractive. Issuers from the so-called periphery countries are somewhat more attractive, although their yield advantage over core Eurozone countries has shrunk recently. Inflation-hedged bonds are worth a look in the medium term. In the multi-asset context, US government bonds could serve as a hedge. Moreover, their yield advantage over German Bunds is still around 115 basis points in the 10-year tenor. Nevertheless, US Treasuries are exposed to the risk of continued US dollar weakness.

Corporate bonds: more expensive towards year-end

Corporate bonds of all colour earned respectable current income over the summer. Growing central bank purchases and fund inflows kept demand for corporate bonds high in an environment of negative interest rates. Moreover, the still relatively large cash positions of many market participants offer potential for a further rise in prices. Meanwhile, the volume of new issues fell sharply, especially during the vacation months of July and August (see the left-hand graph on page 11), and banks' trading books were relatively empty. The result could and can still be seen on trading screens: markets are one-sided and large buy orders wait for execution, sometimes without success. We expect new issuance activity to be a key driver of performance in this asset class through the end of the year. If the volume of new issues is rather small, the pressure on risk spreads would intensify further. But even if primary market activity is very strong, as it was in the first half of the year, the market should have no trouble absorbing new issues. It would take a record issuance volume to cause permanent spread widening. However, this is improbable consider-

Safe government bonds are only attractive for hedging purposes

Past and expected performance of 10-year government bonds, overall effect from yield/price change, coupon income, and roll-down effect



Time period: Time period: 15/09/2015-15/09/2020.
Source: Bloomberg, own calculations, iBoxx Government Bond Indices (7-10 years, TR)

Forecasts: base interest rates and government bond yields (in %)

Comparison of Berenberg and consensus forecasts, values at mid-year and end of 2021

	15/09/2020	31/12/2020		30/06/2020	
	Currently		∅*		∅*
USA					
Base interest rate	0.00-0.25	0.00-0.25	0.25	0.00-0.25	0.30
10Y US yield	0.68	1.25	0.97	1.40	1.16
Eurozone					
Base interest rate	0.00	0.00	0.00	0.00	0.00
10Y Bund yield	-0.48	-0.10	-0.25	0.10	-0.17
UK					
Base interest rate	0.10	0.10	0.10	0.10	0.10
10Y Gilt yield	0.22	0.50	0.39	0.60	0.57

* Average, consensus as of 15/09/2020.
Source: Bloomberg.

ing the extensive liquidity-raising measures taken by companies in the early months of the year. Other positive drivers include consistently better macro indicators, stabilising corporate earnings, and the first rating upgrades. Although many segments are no longer inexpensive in the historical context, we are sticking with our overweight. However, we are no longer further increasing portfolio sensitivity to credit risks at this stage, but would use yield increases as an opportunity to reduce the duration underweight to the benchmark by successively adding longer-duration bonds with higher credit ratings.

Emerging-market bonds: Attractive spreads in hard currencies

Both hard-currency and local-currency bonds continued the positive trend of the preceding months in the course of the third quarter. Despite rising COVID-19 infection rates across the world, both assets classes were in strong demand. Demand was consistently supported by stable commodity prices and a weaker US dollar. Taking a closer look at the positive performance, it can be seen that it is largely attributable to the tightening of spreads. Moreover, capital inflows to this asset class have increased continuously over the past months. We continue to regard the current spreads for both government bonds and corporate bonds denominated in hard currencies as attractive. Focusing for example on countries and companies with resilient crisis and economic management and good access to international capital markets, bonds in the BBB-A rating range still offers more than two percentage-point higher yields than German government bonds, if the currency risk is hedged. However, we do expect an outperformance of the high-yield segment if the trends of moderately rising interest rates in the US government bond market and better than expected economic data continue. Despite the already sharply lower yields of local-currency bonds, we consider them to be worthwhile in the medium term due to the currency catch-up potential associated with continued US dollar weakness.

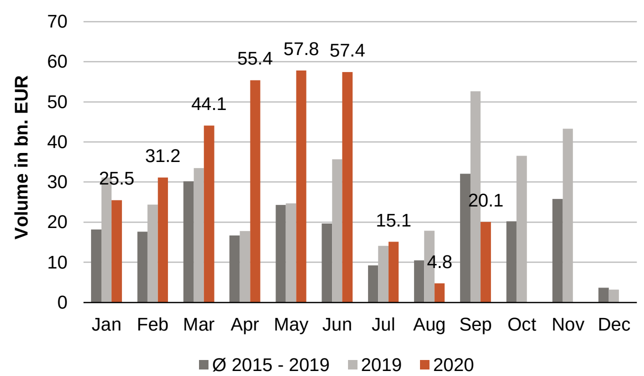
Conclusion: risk premiums are a "must-have"

If the fourth quarter is not dominated by negative coronavirus news, as we expect, safe government bonds are likely to incur losses in the coming months. In our main scenario, therefore, (modestly) rising interest rates pose a fundamental risk that investors should counter by holding positions in instruments that offer risk premiums. Both corporate and emerging-market bonds, the latter especially in hard currencies, should be considered in this case as we expect the trend of tightening spreads to continue, supported by a global economic recovery. In case of (modestly) rising US yields, high-yield emerging-market bonds should fare better than investment-grade emerging-market bonds.

Martin Mayer, Senior Portfolio Manager Multi Asset
Christian Bettinger, Head of Fixed Income
Robert Reichle, Head of Emerging Markets Selection

Corporate bonds: strong demand and shrinking supply

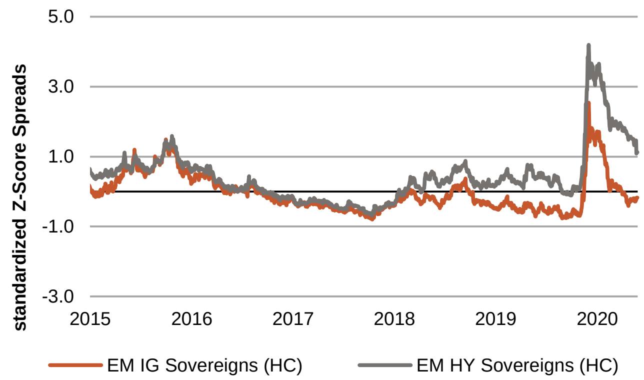
After above-average primary market activity in previous months, new issuance volume declined well below the levels of prior years in August.



Time period: 01/01/2015-15/09/2020.
Source: Bloomberg.

EM countries: higher-yielding government bonds have potential

Spreads for high-yield government bonds (HY) are well above average, in contrast to the investment-grade segment (IG).



Time period: 14/09/2015-14/09/2020, Source: J.P. Morgan.
Presentation: Z-Score, moving 15-year average, HC = hard currency.

NOT ONLY GOLD GLITTERS

Coronavirus vaccine would lift demand for crude oil

The recovery in the oil market initially continued in the third quarter, albeit at a slower pace. In addition to the weak US dollar and positive seasonality, the unusually strict production discipline of OPEC+ was particularly supportive. However, the latest demand concerns show that broad availability of a corona vaccine is necessary for a further, sustained price increase. Only then can a significant recovery in demand in the transport sector, the most important consumer of crude oil, be expected. The US shale oil industry, on the other hand, is unlikely to regain its former strength as drilling activity looks set to remain weak due to the necessary capital discipline. Given that the probability of an effective vaccine is steadily rising, crude oil should be supported by OPEC+ cuts, despite typically weak autumn months.

The golden age continues

Although the economic recovery began in the past few months, gold continued to gain ground in this environment – and even broke through the USD2,000 per ounce mark for the first time in history and thus reached a new all-time high. Thanks to key interest rates at close to 0% and massive bond purchasing programmes, the opportunity costs of holding gold as a real investment compared with other nominal safe havens are currently non-existent. Certainly, gold will repeatedly come under pressure in the short term as nominal interest rates rise, but even in this case it will still be supported in the medium term. In order not to jeopardise the sustainability of the mountains of debt of many governments, which have risen sharply in the fight against coronavirus, interest rates should remain below inflation expectations and real interest rates should therefore remain negative.

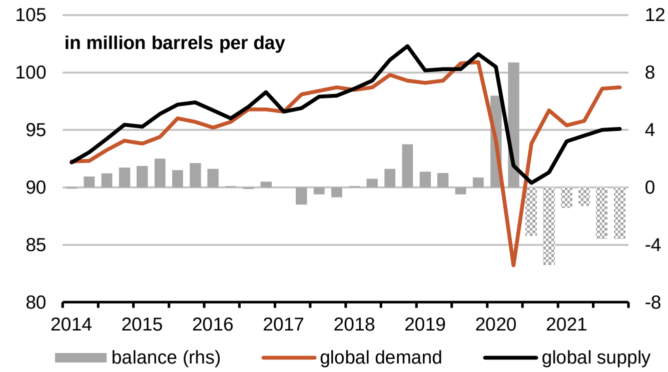
Industrial metals are likely to shift downward

Thanks to the economic recovery and the massive fiscal support programmes, industrial metals were the big winners in the past quarter. The LME Index rose by roughly 13% and is therefore also in positive territory year-to-date. Purchasing manager indices for manufacturing are signalling further demand growth, while key mines in South America are still suffering from quarantine measures. Industrial metals have potential to rise further, albeit at a slower pace, in reaction to a globally synchronised economic recovery. Some metals will additionally benefit from the trend towards green energy in the medium term.

Ludwig Kemper, Analyst Multi-Asset Strategy & Research

Oil market in deficit, oil prices on the rise

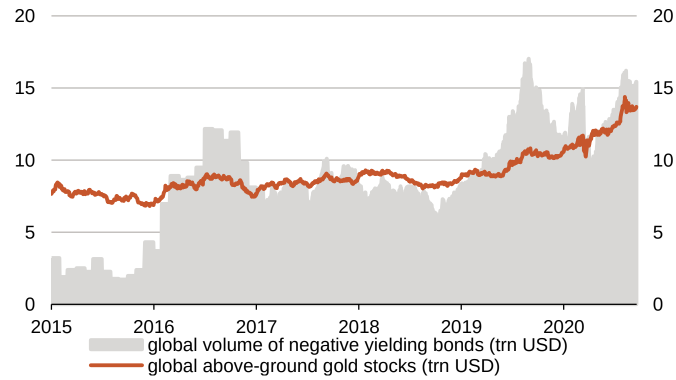
If OPEC+ members stick to the agreed cuts, the deficit predicted by the IEA should support oil prices.



Time period: 01/01/2014–31/12/2021.
Source: Commerzbank Research, IEA.

There is not enough gold for everyone

If all investors wanted to reallocate their negative-yielding bonds into gold, not even all globally available gold stocks would suffice.



Time period: 01/01/2015–15/09/2020.
Source: Bloomberg, World Gold Council, own calculations.

Industrial metals are benefitting from the economic recovery

Industrial metals gained as manufacturing recovered. A globally synchronised recovery would likely offer additional potential.

Time period: 01/01/2014–15/09/2020.
Source: Bloomberg.

CURRENCY MARKET: US DOLLAR UNDER PRESSURE

Movement in the currency market

After a relatively calm second quarter, the currency market took off in July. The upward movement of the euro against the US dollar is remarkable: starting from a little more than USD1.12 per euro, the European currency soared to reach a year-to-date high of almost USD1.20 in mid-August.

Europe more convincing than the US during the pandemic

At a special summit in the middle of July, the EU agreed on a "Recovery Fund" – an important signal for markets. Although the details of the new fund were not as ambitious as had been intended by the EU Commission, the impression of European solidarity was the dominant takeaway for market participants. EU countries will join forces to revive the economy after the coronavirus pandemic. Consequently, euro disintegration fears are being priced out in the currency market.

However, the euro's rise cannot be attributed solely to the currency's own strength. Instead, the higher exchange rate is a reflection of the current weakness of the US currency. The dollar is currently not very popular with investors for a variety of reasons, including the mismanagement of the coronavirus pandemic, the generally weak political leadership, and domestic unrest. Moreover, the dollar is less in demand as a safe-haven currency as financial markets have recovered and the real economic shock is gradually being digested. It is only logical that the dollar is correcting from its high mark in March 2020, when anxious investors shifted capital to the United States. Nevertheless, we do not think it is appropriate to interpret the latest losses as the demise of the dollar, as some are suggesting, because it is by no means weak at its currently lower level. In the coming weeks, the presidential election may cause volatility.

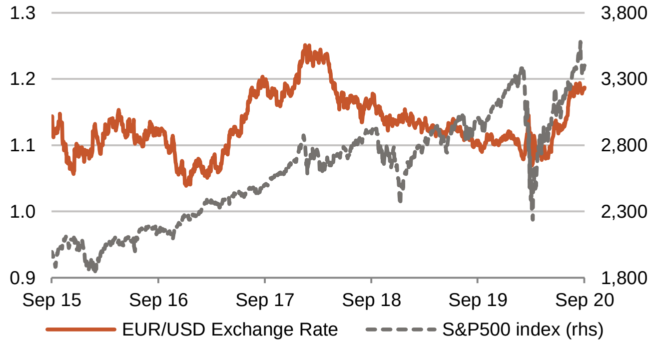
New monetary policy strategy of the US Fed

Fed Chairman Powell announced a new strategy at the central bank conference in Jackson Hole, Wyoming. To date, the US central bank has striven to raise the inflation rate to 2%. In the future, it will allow more leeway and also accept inflation rates of more than 2% if inflation had previously been lower than this target for a longer period. Hence, an average inflation rate of 2% is now being targeted. Within the framework of its dual mandate, the Fed will also increase its focus on the labour market. The overall effect of this new strategy will probably weaken the dollar.

Dr. Jörn Quitzau, Senior Economist

EUR/USD: euro benefits from own strength and weak dollar

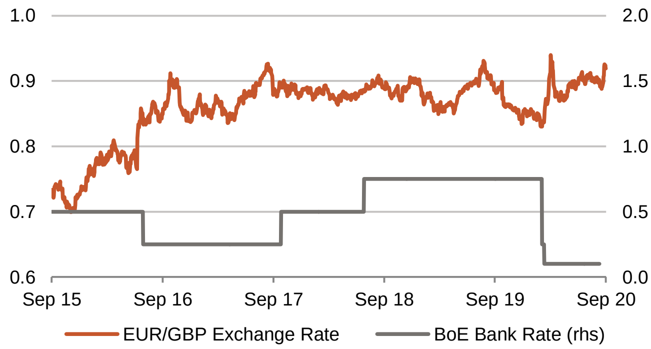
The US dollar is currently not in demand because risk appetite has risen in markets.



Time period: 15/09/2020-15/09/2020.
Exchange rate in US dollars; SPX Index in points. Source: Bloomberg.

EUR/GBP: renewed focus on Brexit

Renewed worries of a hard Brexit are putting pressure on the pound



Time period: 15/09/2015-15/09/2020.
Exchange rate in GBP, base interest rate in %. Source: Bloomberg.

Exchange rate forecasts

US dollar weakness is likely to persist

	15/09/2020	30/06/2021		31/12/2021	
Exchange rate forecast	**Currently**		**∅***		**∅***
EUR/USD	1.18	1.22	1.20	1.23	1.23
EUR/GBP	0.92	0.90	0.90	0.88	0.90
EUR/CHF	1.08	1.10	1.09	1.11	1.12
EUR/JPY	125	127	127	128	131
Change against the euro in %					
USD	-	-2.9	-1.3	-3.7	-3.7
GBP	-	2.1	2.1	4.4	2.1
CHF	-	-2.2	-1.3	-3.1	-3.9
JPY	-	-1.6	-1.6	-2.4	-4.3

* Average, consensus as of 15/09/2020.
Source: Bloomberg.

INTERVIEW WITH ROBERT REICHLE

Mr Reichle, your work as a portfolio manager at Berenberg is focused on emerging-market bonds. What is your day-to-day routine?

Managing emerging-market bonds is a global business. In the morning, we look at Asia and analyse the overnight news. Then all risk systems have to be reviewed: Has there been a significant change in the risk spreads of government or corporate bonds? Do currency positions need to be adjusted? After Asia, we turn our attention to Africa and Eastern Europe, and finally Latin America in the afternoon. This region is closely tied to US stock markets and can often completely reverse the day's action in emerging markets. Plus, we consult with colleagues on a daily basis, constantly improve our investment processes, and conduct a whole lot of research.

Do you have a personal tie to emerging-market countries, or how does one end up in this job?

I worked as a trainee in the Emerging Markets Structured Credit Trading Desk of WestLB in London in 2004. That is where I gained my first insights into trading emerging-market bonds, credit default swaps, and currency and bond options in these markets. I developed a strong interest in this segment already then. Interestingly, many of my direct colleagues while I was working abroad came from emerging-market countries such as Armenia and Mexico. And in my private life, I often visit emerging-market countries. I have taken longer trips to Brazil, Costa Rica, and Myanmar, for example.

Are emerging-market bonds not a highly risky Investment?

Yes and no. Taking a close look is extremely important. Countries and often also companies develop very heterogeneously. The task of us active managers is to find the pearls and avoid default candidates such as recently Argentina, Lebanon, and Ecuador. In general, emerging market bonds are, of course, more risky than bonds of developed countries. Besides the still high dependence on commodity prices, issues such as lack of transparency or corruption, especially in the government sector, play a major role. But this is precisely where the integration of sustainability criteria (ESG) can lower risks. In the best case, it may even identify opportunities by selecting countries or companies that actively tackle such risks.

What distinguishes emerging-market bonds from bonds in developed countries? And what is the difference between local-currency and hard-currency bonds?

Emerging-market bonds are primarily characterised by comparatively high yields, but also by fundamentally higher volatility. They usually also have a relatively low correlation with other bond segments. The currency selection often depends on the strategy of investors. Investments in local-currency bonds tend to be rather long-term in nature. Currency volatility can be extremely high in the short term and can even offset the high yields in the local currency. Local-currency bonds can be attractive in countries with strong economic catch-up potential because investors could potentially benefit from currency appreciation. The performance of hard-currency bonds denominated in US dollars or euros is dominated by change in yield spreads of the bonds. Hard-currency bonds tend to hold up well in most market phases. The biggest influencing factor here is the yields of US government bonds, to which most hard-currency bonds are tied.

What is your investment philosophy?

In my opinion, there are inefficiencies in the market for emerging-market bonds. As an active, disciplined fund manager, you can therefore generate disproportionately high income in relation to the risk assumed with a systematic investment process. Given the size of the investment universe, a systematic approach is very important; on the other hand, market liquidity, primary market activity, or so-called black swans could sometimes necessitate discretionary and quick action on the part of the portfolio manager outside of the rule-based investment process.

ESG and emerging-market countries: Is that not a contradiction?

ESG and emerging-market countries are not mutually exclusive. On the contrary, sustainability actually makes a lot of sense for emerging-market countries because you can really see sustainable effects and sustainable influence in these countries or companies that are often still at an early stage of their economic development. In addition to the commonly applied hard exclusion criteria, our investment philosophy entails a three-part "best-in-class" approach that only selects the best countries and companies based on their sustainability rating, financial rating, and fundamental strength. We rely on the specialised expertise of independent resources for each sustainability category. In total, we obtain sustainability data from 15 research providers and non-governmental organisations. In addition, we utilise dedicated ESG research from the data provider MSCI, with which we also actively exchange views about current ESG trends.

What effect is (has) the coronavirus crisis having (had) on emerging-market countries and their bond markets?

Panic also prevailed in the emerging market bond market, with risk premiums widening dramatically, especially in mid-March, across all sovereign and corporate bonds. There was no place to hide as even currencies underwent extreme depreciation. Capital market participants withdrew billions in capital in only a few weeks. But the situation calmed down much faster than the pandemic itself. Due to the homogeneous nature of the sell-off, some opportunities arose in less-affected countries. As the global recovery continued, investors came back in the second and third quarter. Due to the still high level of yields, also relative to all other bond segments, emerging-market bonds appear to be more attractive than ever.

How satisfied are you with the performance of your funds?

We can be satisfied with the performance of both mutual funds since the beginning of the year. Both funds are currently outperforming their benchmarks in both absolute and risk-adjusted terms. One key factor contributing to the positive performance of the EM Bonds Fund was the good timing in reducing risks in advance of the most volatile days in March; an important factor for the Sustainable EM Bonds Fund was the increase in the allocation of EM corporate bonds to 30%, also in advance of the coronavirus pandemic. As part of the reallocation in May, both funds were positioned more aggressively again, which helped significantly in the recent upward trend. Both funds are performing very well compared to their peers, not only since the beginning of the year, but also since inception ten years ago and almost three years ago, respectively.

How would you describe your collaboration with your colleagues in fixed income and multi-asset portfolio management?

As part of the Fixed-Income Department in the Multi-Asset Division, I am in constant communication with my colleagues. We keep each other up-to-date in order to discuss projects and innovations with the goal of moving the entire team forward. In that sense, I am one of many and also contribute my expertise to a wide variety of publications, investment ideas or in our monthly Investment Committee meetings. In return, the funds I manage also benefit from the assessments and convictions of my colleagues.

BRIEF BIOGRAPHY

Robert Reichle is in charge of Fixed Income Emerging Markets at Berenberg. He is responsible for the investment processes for emerging-market and global government bonds. The economics graduate has worked in finance since 2004 and has been with Berenberg since January 2010. He is a Chartered Financial Analyst (CFA) and holds the Certificate in Quantitative Finance (CQF), the Certificate in Computational Finance, and a master's degree in international economics from Panthe-on-Sorbonne University.

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IMPORTANT NOTICES

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