SLOWER GROWTH
Political risks are increasingly crimping economic growth and dragging markets down, but a recession in 2019 is still improbable.

LIQUIDITY WITHDRAWAL
The quantitative tightening of central banks is accelerating. The medium-term profit outlook is limited and volatility is rising.

RECOVERY POTENTIAL
Equities are valued attractively and have already priced in a substantial growth slowdown; investment alternatives are still lacking.
Dear reader,

2018 was a harrowing year for capital markets, perhaps the most difficult since 2008. Economic growth and the performance of capital markets were in line with expectations at first. After that, however, (trade) policy risks gained the upper hand and did not recede by the end of the year as we had expected. Growth began to slow, stoking fears of a coming recession. The sharp sell-off of cyclical stocks in particular and declining inflation expectations reflect the scepticism of market participants. On top of that, western central banks have begun to change their policies. Liquidity is now being withdrawn from the markets as part of a policy of quantitative tightening. The end of general asset price inflation is becoming more and more evident: interest rates, risk premiums and volatility are all rising, and equity valuations are shrinking. Hardly any region or asset class has posted gains in local currency terms in 2018.

Are the fears of recession justified? Will the global economy slide into recession in 2019? Or do the weak leading indicators signal only a temporary slowdown within an intact upswing, as in 2012 and 2016? We think an imminent recession is unlikely. Inflation remains moderate and hardly any excesses can be observed in consumer spending, business investment and credit growth. Furthermore, interest rate policies are not even close to being restrictive globally. Our renowned economist Holger Schmieding expects growth to stabilise at a low level in the first half of 2019. That means that equity markets have recovery potential.

Generally speaking, however, the market environment will probably remain challenging in 2019. Economic growth will be slower, profit-margin pressure will increase, corporate profits will likely rise only at a rate in the mid-single digits and there will be no shortage of political uncertainties. The Brexit question is still unanswered and there is no end in sight to the trade dispute between the US and China. Furthermore, quantitative tightening will put an even stronger drag on all asset classes. Therefore, our return expectations are limited. However, there is also potential for positive surprises – whether from the dissipation of political uncertainties or monetary policy changes, such as an early pause in the rate-raising cycle of the US central bank, or expansive fiscal policy in other countries besides the US.

Equities are still preferable after the strong correction. The strength of the US dollar should fade, which would create tailwinds for emerging markets and commodities, as soon as the fears of recession subside. Corporate bonds will probably suffer the most from quantitative tightening.

We wish you all the best in 2019.

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We wish you all the best in 2019.
2019: CHALLENGES PRESENT OPPORTUNITIES

IN A NUTSHELL

• A recession in 2019 remains improbable; we expect economic growth to stabilise at close to the trend level.
• The market environment remains difficult, with many challenges aside from the economic cycle.
• The quantitative tightening pursued by central banks is putting a drag on all asset classes; corporate bonds will probably suffer the most; volatility will increase further.
• The strength of the US dollar will probably fade and this will be a boon for emerging-market currencies and commodities.
• Equities have the potential to recover and should be preferred to bonds going into the new year.

Portfolio positioning at a glance
Equity markets already priced in a substantial growth slowdown in the fourth quarter and could recover if political risks subside and signs increasingly point to a stabilisation of economic growth. This applies particularly to equities in emerging markets and Europe; Japanese equities are strategically attractive. We are overweight in equities. However, the market environment will remain difficult, not least of all due to the continuous withdrawal of liquidity by central banks. Recession fears will, we expect, come and go regularly over the next few years. We are especially sceptical about corporate bonds. The debt levels of US companies are at record highs. Corporate bonds could, in our view, also suffer the most from the withdrawal of liquidity. We do not expect positive returns from the euro-denominated government bonds of safe issuers. US dollar-denominated government bonds offer more-attractive yields, but Eurozone investors will probably not benefit due to the weakening dollar. We prefer frontier market bonds, emerging-market bonds and convertible bonds. Gold makes sense as a portfolio diversification instrument and should benefit, particularly from low investor positioning and a weaker US dollar.
Review of 2018: Trump steps on the gas, the end of asset price inflation and rising fears of recession

US President Donald Trump stepped on the gas in 2018. His tax reform created strong tailwinds for the US economy and its equity market, even as the trade disputes he instigated dampened the sentiment, growth and equity markets of export-oriented countries. Consequently, the US dollar appreciated substantially, contrary to consensus expectations at the start of the year. Emerging markets were hard hit by the trade dispute, slowing Chinese growth, the appreciation of the dollar and home-made problems, such as issues in Turkey, as well as the substantial rise in the oil price in the first three quarters of the year. Rising base interest rates in the US and the departure from quantitative easing policies also created headwinds for all asset classes. The fourth quarter was dominated by political risks, growth disappointments and fears of recession. The oil price collapsed in the face of considerable oversupply, inflation expectations fell and cyclical stocks in particular sustained sharp losses (see the figure at the top of page 5). After the correction, equity markets have priced in a substantial growth slowdown (see the figure at the centre of page 5).

Crucial challenges aside from the economic cycle

We consider an imminent recession to be improbable and markets have already priced in a substantial growth slowdown. However, markets will have a difficult start to 2019. Growth is slowing even as wages and core inflation are gradually accelerating. Global growth seems to be falling back to the limited levels from 2012 to 2016; the support provided by Trump’s election and the huge fiscal package in the US is fading. Despite the recent reductions, consensus expectations for corporate profits in 2019 are too optimistic. It seems realistic to expect mid-single-digit profit growth. Finally, central banks will withdraw liquidity at a faster pace, given that even the ECB will discontinue its bond purchases. The strong rise in stock buybacks and dividend payments in the US in 2018 was caused by the tax reform and will probably not recur to the same extent. The Brexit situation is still unresolved, as is the lack of budget discipline of the populist government in Italy. And the truce between the US and China certainly does not mean an end to the trade disputes. Markets could also be depressed by other risks, such as a sharper rise of inflation or the record-high debt of non-financial companies in the US.

Mostly negative returns in 2018; only European investors reaped gains from US investments due to US dollar appreciation

<table>
<thead>
<tr>
<th>Total return</th>
<th>Year-to-date and in Q4 (in %, in EUR)</th>
<th>12-month periods of the last 5 years (in %, in EUR)</th>
<th>CAGR*</th>
<th>Std. dev.*</th>
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<td>Q4 (30/09/18 - 17/12/2018)</td>
<td>17/12/17 - 17/12/18 17/12/16 - 17/12/15 17/12/14 - 17/12/13</td>
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</table>

* CAGR = Annualised return (in %, in EUR); Std. dev. = Annualised standard deviation (in %, in EUR)
stantially. German government bonds are still unattractive due to their expected negative overall performance. US government bonds are more attractive, but will probably be less appealing to Eurozone investors due to the weaker US dollar.

**Caution with corporate bonds**

We expect that the widening of risk spreads for corporate bonds will continue in 2019, interrupted only by the temporary narrowing in risk-on phases. Corporate bonds will probably suffer the most from the withdrawal of liquidity by central banks. In the US, corporate debt has reached a record level, credit quality continues to deteriorate and government bonds already offer handsome returns again. Government bonds are clearly preferable to corporate bonds in the US.

**Equities offer the greatest potential, at least for now**

The pessimistic sentiment, coupled with attractive valuations, offers the potential for a recovery during the typically strong season for equities from November to April. By that time, signs that growth is stabilising should be evident. Indications that the Chinese central bank and government are succeeding in stabilising growth, as they did in 2016, would be especially positive. There is also hope that Chinese house prices may rise at a faster pace again. Besides the dissipation of political uncertainties, monetary and fiscal policy could hold the promise of positive surprises for equities.

**Emerging-markets and commodities should improve**

Given the strong US economic growth, the performance of emerging countries did not improve in comparison to industrialised markets in 2018, as had been expected. The growth difference remained at around 2.3%. However, the IMF expects the growth lead of emerging markets to widen in 2019. We expect the strain caused by the strong US dollar to ease, and less restrictive monetary and fiscal policies in China should also help. After the weak performance of emerging-market currencies and equities in 2018, we believe there is recovery potential in 2019. Industrial and precious metals should, we expect, benefit from a weaker US dollar and a pause by the Fed. Rising real interest rates continue to pose a risk for precious metals. Signs that Chinese growth is stabilising would probably create tailwinds for industrial metals, given the short positioning of speculative investors.

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*Dr. Bernd Meyer, Chief Strategist Wealth and Asset Management*
ECONOMICS: FIRST WINTER, THEN SPRING

IN A NUTSHELL

- Economic slowdown: Europe must be prepared for a grey winter
- Fresh momentum in the spring if the trade war eases and a hard Brexit is avoided
- The US Fed will soon hold off on raising rates further

A harsh winter for Europe’s economy
A series of political crises and external shocks has thrown a spanner into the economy in parts of the western world. Above all, the trade tensions stoked by the US have dampened business sentiment. In addition, exports to some emerging-market countries, such as Turkey, which had taken on too much foreign currency debt and are now mired in an adjustment crisis, have collapsed. At the same time, the high prices of heating oil and fuels leading into November have cut into the purchasing power of many consumers to the extent that they have had to limit their spending on other goods and services. The business climate in Europe has been further clouded since October by the worsening Brexit turmoil and the roll-back of reforms by the radical government in Rome.

In the US, there have been only a few signs of an impending slowdown so far. The costs of the shocks outlined above have been obscured in that country by the tax gifts from early 2018 and the higher revenues of oil producers. By contrast, economic growth in the Eurozone and Japan has slowed considerably.

There will be no end to the current growth weakness in Europe in the coming months. Instead, we must be prepared for more bad news. Nevertheless, we believe that the dark winter could be followed by a brighter spring. Economically speaking, there is no reason to fear economic stagnation, much less a recession, either in Europe or elsewhere in the western world. The outlook is mainly influenced by political risks. If these risks subside a little in 2019, the economy could pick up again. The small increase in researcher ZEW’s expectations in December indicates that this scenario is a real possibility.

Trade war: how far will Trump go?
Despite sporadic truces with the EU and China, the US is making the rest of the world very uneasy with its aggressive trade threats. There are, however, growing signs that the US economic boom will end and the country will return to more-normal growth rates of slightly below 2% as the fiscal stimulus runs out. When that happens, the costs of the damage caused by the trade wars, which are currently obscured by the economic boom, will become increasingly evident to companies and voters in the US. This could well create a growing incentive for Trump to “make deals” with China and the EU instead of further escalating the trade war, which would endanger his chances for re-election in 2020.

Trans-Atlantic divergence
Purchasing Managers Index: Eurozone versus USA

Declining exports cause pain
Eurozone goods exports to key partners, annual change in %

Source: ISM, Markit.

Time period: 01/01/2013-30/09/2018.
Source: Eurostat.
Our economic and market forecasts are based in part on the expectation that at least some of the main disputes will be resolved by the spring. Otherwise, the world will be threatened with lasting and pronounced economic weakness.

**Turbulent times, some glimmers of hope**

Brexit: In the midst of all the political turmoil, the Brexit outcome remains uncertain. However, it is becoming evident that a cross-party majority in the UK parliament will want to prevent a hard Brexit without an agreement with the EU. A hard Brexit without a follow-on agreement on trade relations could push the UK and the EU into a recession lasting a few quarters. In our view, the risk of such a disaster is about 20%. Any other solution would ease the crisis. On the other hand, the odds that the UK calls off Brexit altogether are probably 25%.

Italy: Given the risk of a credit crunch in Italy triggered by higher risk premiums, chances are good that the radical government in Rome will yield a little in the budget dispute and accept a lower deficit target. This would at least lessen the risk of Italy falling into a debt crisis already in 2019.

Turkey: After the recent downturn, Turkey and some other emerging markets will probably reach the bottom of their adjustment crises. After that, exports to these countries will probably not shrink further, and that would remove another factor that is weakening the European economy today. Without the Turkish crisis, Eurozone growth would have been almost 0.2ppt higher in autumn 2018.

Oil: The recent decline in crude oil prices to a normal level has lessened the burden on consumers. It could lift consumer spending during the course of 2019.

**Inflation remains subdued**

The inflation worries that arose in early 2018 proved to be overblown. Wage pressures are rising only slowly in the US and Europe, so the core rates of inflation are either very low, at around 1% in the Eurozone, or in line with the targeted rate of around 2% in the US.

Central banks: After the interest rate hike in December, the US Fed has reached a nearly neutral level of interest rates again. In view of the somewhat less vibrant US economy, we expect the Fed to hold off raising interest rates for longer than it had planned. This could also support the markets. The ECB will begin raising interest rates in late 2019, almost one year after planned. The inflation worries that arose in early 2018 proved to be overblown. Wage pressures are rising only slowly in the US and Europe, so the core rates of inflation are either very low, at around 1% in the Eurozone, or in line with the targeted rate of around 2% in the US.

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Dr Holger Schmieding, Chief Economist

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**Growth and inflation forecasts**

<table>
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<tr>
<th>Country</th>
<th>US</th>
<th>Eurozone</th>
<th>Germany</th>
<th>France</th>
<th>Italy</th>
<th>Spain</th>
<th>UK</th>
<th>Japan</th>
<th>China</th>
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<td>-</td>
<td>3.3</td>
<td>-</td>
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* Berenberg data on actual exchange rates, not purchasing power parity because PPP would give more weight to the fast-growing emerging-market countries
** Average, Bloomberg consensus as of 17/12/2018.
2019: EQUITIES SHOULD RISE IN A DIFFICULT ENVIRONMENT

IN A NUTSHELL

- We expect equity prices to rise in 2019, supported by rising corporate profits, lower valuations and the lack of investment alternatives. However, we anticipate further volatility spikes as central banks withdraw their support, the trade (policy) risks do not fully subside and global growth slows.
- Consequently, equity market valuations should increase only modestly and profit margin pressure will intensify due to rising interest rates, wages and tariffs.

2018 was an extremely tough year for equities

Equity markets mostly lost ground in 2018 due to more restrictive US monetary policy, the escalation of the trade conflict, disappointing economic data outside the US and political uncertainties (Italy, Brexit, North Korea). As a result, businesses came under pressure – this particularly affected cyclical companies in Europe, especially DAX-listed stocks (-17% since the beginning of the year) – as did Asian emerging markets. US stocks benefited from tax reforms and were the relative winners of the global trade conflict thanks to their large domestic market. They therefore performed among the best and benefited from the appreciation of the US dollar from a euro perspective. In Europe, defensive stocks fared the best. Japanese stocks also held up relatively well. On a worldwide basis, equities became less expensive because global corporate profits rose year-over-year by more than 16% in 2018. In the US alone, profits rose by around 24% thanks to the tax reform and the higher average oil prices during the year. The profits of oil and financial companies grew at an especially fast rate.

Rising corporate profits despite tighter profit margins

We anticipate a modest slowing of global economic growth, accompanied by moderate inflation and a small interest rate rise in 2019. However, the profitability of companies will probably diminish under the weight of higher wages, commodity prices, interest rates and tariffs; we think that profit margins have already peaked. Given the shrinking profit margins and mixed revenue growth, we believe it will be necessary to lower 2019 profit estimates further, especially for Europe. However, fiscal policy measures and higher inflation could, we believe, favour nominal growth. We therefore expect that global corporate profits will rise year-over-year by around 5-7% in 2019. Consensus currently forecasts around 8%.

Valuations should increase modestly

Trade (policy) risks and growth worries have led to a considerable reduction of valuation ratios in the last few months. The equity markets have already priced in a substantial growth slowdown. However, because we do not expect an imminent recession and we think that political risks will subside at least in part in the coming months (the trade dispute will probably last longer), we...

Mainly cyclical stocks have fared the worst since the beginning of the year and in Q4

<table>
<thead>
<tr>
<th>Total return</th>
<th>Year-to-date and in Q4 (in %, EUR)</th>
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<th>P/B*</th>
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</table>

anticipate a modest increase in valuations in 2019. This development will, however, probably be limited by rising interest rates and diminishing central bank support worldwide, which will also fuel further volatility spikes.

**Rising equity markets in 2019**

Equity markets should make gains next year although the market environment will probably remain difficult. The return potential is likely to be higher in the first half than in the second half of the year, given the seasonal tendency for equities to perform better in the spring and the pause in the Fed’s rate-raising cycle that our economists are predicting. In the second half of the year, however, the positive effects of the US tax reform should run out completely. For this reason, we are somewhat more cautious with respect to US equities, which are higher-priced and have performed much better than the rest of the world in the last few years. For the same reason, we believe that Europe has the potential to catch up to the US in 2019 as both growth rates and central bank policy converge. Outside Europe, we like emerging markets due to their relative attractiveness, the fading of dollar strength and the widening growth gap. We also consider Japanese stocks to be attractive. Bucking the general trend, Japan should grow faster in 2019, despite the increase in the value-added tax. The Japanese equity market is supported by stable politics, laxer monetary policy, rising wages and domestic consumption.

Ulrich Urbahn, Head of Multi-Asset Strategy & Research

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**WHAT IS ON COMPANIES’ MINDS?**

**Revenue worries supplant cost worries**

Revenue worries were virtually negligible in the first half of the year, when companies were more troubled by the cost side. They are, however, now increasingly concerned about the course of business in the fourth quarter and in 2019. Companies are increasingly worried about the downturn as growth begins to slow, especially in cyclical sectors.

The outlooks presented by many companies in their third-quarter reports are increasingly being walked back and profit expectations are coming down. The slowdown anticipated by the market will affect the real economy, as reflected in numerous profit warnings, especially in cyclical sectors, such as industrial goods, chemicals and automotive.

When companies report their results for the fourth quarter and the full year 2018, this trend will probably continue and many businesses will find it very hard to offer a reliable outlook for the coming year. Top executives will certainly begin the year with caution, given the situation in the stock markets and the political uncertainties.

Matthias Born, CIO Equities

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**Rest of world has catch-up potential compared to the US**

Relative performance of the net return index MSCI All Country World Index ex USA vs MSCI USA and performance of the trade-weighted US dollar

Time period: 01/01/1999-17/12/2018.
Source: Bloomberg, Berenberg.

**Forecast summary: catch-up potential for Europe**

<table>
<thead>
<tr>
<th>Index forecasts</th>
<th>Currently</th>
<th>30/06/2019</th>
<th>31/12/2019</th>
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<tr>
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<th>Index potential (in %)</th>
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<td>MSCI UK</td>
<td>7.0</td>
<td>12.1</td>
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* Average, consensus, as of 17/12/2018.
Source: Bloomberg, Factset, Berenberg.
NEW YEAR, NO NEW LUCK FOR BONDS?

IN A NUTSHELL

• Safe government bonds cannot be expected to yield positive income.
• Still no recovery in corporate and high-yield bonds, tough start to the year expected.
• We are more optimistic about emerging-market bonds, especially local currency bonds

Looking back on a mixed year
German Bunds and British Gilts in particular have benefited in their respective currencies from the gradually increasing need of market participants to seek safety, causing those bonds to rise in value. In addition, the growing risk awareness meant that investors in all types of corporate bonds were unable to generate positive income in absolute terms until the middle of December, even though they fared better than those who invested in emerging-market bonds. From the standpoint of a euro investor, however, US high-yield and government bonds topped the list of winners, ahead of Bunds, due to the strong appreciation of the US dollar. From this currency perspective, both Gilts and US investment-grade corporate bonds were top performers as well. By contrast, both emerging-market bonds and European high-yield bonds were the losers from the standpoint of euro investors.

Tough year ahead for government bonds
The future direction of government bonds will depend very much on whether and how quickly the storm clouds still hanging over the financial markets dissipate. Based on our main scenarios, however, Eurozone “safe haven” bonds will probably have a hard time. Due to the discontinuation of the asset purchasing programme of the ECB and moderately rising inflation, among other factors, investors are likely to lose money on 10-year German Bunds, assuming that yields rise by around 50bp by the end of 2019 as we expect. The outlook for British Gilts is similarly modest, assuming that the Brexit negotiations lead to an acceptable outcome and the current safety premium is priced out of UK government bonds. Even the modest appreciation of the pound that we expect will do little to change this outlook from the standpoint of a euro investor. By contrast, US Treasuries, to which we ascribe much less potential for rising returns than to Gilts and top Eurozone issuers, would seem at first glance to at least offer a contribution to stabilising a bond portfolio, although this effect could fade quickly as a result of the anticipated weakening of the US dollar.

Corporate bonds: no land in sight (yet)
There are no signs of an appreciable recovery at the start of the new year. Although risk spreads have returned to their levels of early 2016, the fund outflows from European investment-grade and high-yield funds during the year suggest no recovery. Despite
In our view, emerging-market bonds and local currency corporate bonds are out of favor. This we do not expect to change before the middle of 2019. We are avoiding Italian financials, especially those of banks and insurance companies, which appear to be attractive given their high price levels, we are also cautious about real estate companies. Whereas especially highly rated banks and insurance companies appear to be attractive, we are avoiding Italian financial bonds as long as the country is fraught with so much political uncertainty.

Confidence in emerging-market bonds

We expect that confidence in the asset class of emerging market bonds will generally increase again in 2019. When this happens, investors who tend to be overweight in the local currency segment should benefit not only from the generally positive market performance in this area, but also from relatively cheap entry levels. Capital flows into local currency bonds, which have now outpaced capital flows into hard currency bonds for the first time since 2013, already suggest the beginning of such a (re-) positioning. Furthermore, many emerging-market currencies depreciated sharply as the US economy boomed and the dollar strengthened (especially in 2018). This makes their current levels seem relatively inexpensive, particularly given the expectation of a slowly consolidating US economy coupled with the weakening of the US dollar. Hard-currency emerging-market bonds may seem just as attractive due to their current risk premiums. However, the return-risk ratio of local-currency bonds seems more promising to us on the whole, in view of the factors mentioned above.

Conclusion: emerging markets present the biggest opportunities

Many of the traditional “safe havens” among government bonds will enter rough waters, the risk premiums of corporate bonds are historically unattractive, and the ECB will end its bond purchasing programme. So, where can bond investors turn to make money? In our view, emerging-market bonds and especially the sub-segment of local-currency bonds offer the best prospects. Those who want defensive protection can best obtain this with US Treasuries, which would benefit the most from a sustained crisis scenario (which we do not expect) from the euro standpoint, both in terms of capital flows and the currency component.

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

Oil prices to stabilise when the markets are no longer oversupplied

After peaking in early October, the price of oil plummeted due to Venezuela’s and Iran’s unexpectedly high oil exports and the substantial production increases by major oil-producing countries. The oil price was dragged down further by the sharp reduction of positions by speculative investors, who are now sustaining roll losses on the futures curve. First Canada and then the OPEC+ countries reacted to the latest oversupply and the associated drop in oil prices. The OPEC+ countries will reduce their daily production by 1.2m barrels for six months, beginning in January 2019. However, doubts could arise concerning the implementation of this agreement, especially considering the pressure exerted by US President Trump. If the production quotas are met, the oil market could return to equilibrium in the first half of 2019. We expect that oil prices will fluctuate sideways with volatility. Fast-rising US oil production, which would cause prices to fall again, remains a risk to watch.

Recovery potential for gold

Gold did not glisten in 2018. It was a tough year for gold investors, who sustained losses (in USD terms) due to the strong US dollar, rising US bond yields leading to higher real interest rates due to stable inflation expectations, sales by ETF investors and weak physical demand. Although rising US real interest rates could create headwinds in 2019, gold will probably benefit from the expected end of US dollar strength, leading to higher physical demand in key purchasing countries. Now that gold ETFs have received fresh inflows of late, investor sentiment could turn. The current net short positioning presents the potential for a price recovery when the shorts are covered, although in euro terms any rise in the price of gold could well be blunted by the currency effect.

Turnaround for industrial metal prices during 2019

Industrial metal prices declined in 2018 as a result of trade disputes, growth worries, the strong US dollar and negative investor positioning. The coming year will probably be more favourable for industrial metals because these effects could reverse. An end to US dollar strength would be especially supportive. Moreover, inventories have declined to low levels. China has already reacted to the growth slowdown by loosening its monetary policy. In the past, commodity prices have typically bottomed out with some delay after such a move. After a subdued start, we believe there is recovery potential in the course of 2019 as Chinese leading indicators improve and the dollar weakens.

Guido Urban, Senior Analyst Multi Asset Strategy & Research
CURRENCIES: EURO HELD BACK BY A COCKTAIL OF RISKS

The Eurozone economy was hit comparatively hard by a cocktail of risks in 2018, causing repeated setbacks for the euro in the currency market. The single currency was also under pressure in the fourth quarter, when the exchange rate declined from 1.16 US dollars per euro to almost 1.12 at times. In particular, the single currency was held back by the conflict surrounding the Italian government budget. The euro comeback will be further delayed until the problems with Italy, Turkey, Brexit and trade policy are finally defused. We expect that the economy will pick up in the spring, after which the euro will slowly rise again.

US monetary policy could help the euro
We expect no major surprises from the ECB in 2019. Market rates of interest will probably increase moderately after the end of the ECB’s bond purchasing programme. However, the benchmark interest rate will probably remain at 0% through the autumn and only rise to 0.25% at the start of 2020. The markets have already anticipated this monetary policy restraint. By contrast, the US Fed could surprise the markets with less-restrictive monetary policy than expected to date. Furthermore, there is no longer much room for US market interest rates to rise. Against the US dollar, therefore, the euro could benefit from some headwinds caused by interest rates. All in all, however, we do not expect the euro to appreciate very much in the first quarter. Instead, it will make only smaller steps in the direction of 1.16 US dollars per euro, with volatility.

Swiss franc benefits from risks
The Swiss franc is living up to its reputation as a safe haven for investors. When the Eurozone economy was still humming in the spring of 2018, the euro rose to 1.20 francs per euro for the first time since January 2015. However, the Swiss franc reasserted itself as the economy slowed and equity prices slumped. At times, the euro exchange rate fell to as low as 1.12 francs per euro. We expect that the Swiss currency will continue to benefit from the fragile economic and political situation at the start of 2019. According to our base scenario, the various hot spots will gradually cool and the pace of global economic growth will pick up again. As the risk propensity of investors increases, capital should flow out of the franc. However, we also expect that the euro will slow to rise. We believe the rate will return to 1.20 francs per euro only at the end of 2019.

Dr. Jörn Quitzau, Senior-Economist

EUR/USD: euro to benefit from the narrowing interest rate gap
The interest rate gap (in percentage points) between 10-year US Treasuries and 10-year German Bunds will probably narrow, lending support to the euro.

EUR/CHF: weak stock markets, strong franc
The franc has gained again in reaction to worsening sentiment in business and stock markets (declining euro exchange rate in the graph).

Exchange rate forecasts
The diverse (political) risks would have to be defused before the euro can rise again.

<table>
<thead>
<tr>
<th>Exchange rate forecast</th>
<th>17/12/2018</th>
<th>30/06/2019</th>
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<td>EUR/CHF</td>
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<td>EUR/JPY</td>
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<th>30/06/2019</th>
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<tbody>
<tr>
<td>USD</td>
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<tr>
<td>GBP</td>
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<tr>
<td>CHF</td>
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<tr>
<td>JPY</td>
<td>-7.2</td>
<td>-1.5</td>
<td>-9.8</td>
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</table>

*Average, consensus as of 17/12/2018.
Source: Bloomberg.
Mr Brunner, you are Co-Head of Multi-Asset Portfolio Management at Berenberg. Which client groups and mandate types do you manage primarily?

My focus is on managing defensive investment strategies, both for conservative, wealthy individuals and institutional investors such as foundations, church organisations, pension insurance carriers and pension funds. My responsibilities include developing custom solutions for these investors in the form of special funds and mandates, and managing the mutual funds Berenberg 1590 Stiftung and Berenberg 1590 Total Return Strategy. Depending on the strategy in each case, I pursue a benchmark-oriented approach, a total-return approach or investment concepts tailored to the needs of foundations.

What experience does Berenberg have in serving foundations?

We at Berenberg have served foundations and similar institutions for many years and therefore have gained substantial experience in meeting the specific investment needs that differentiate this class of investors from private individuals or other institutional investors. Thanks to this expertise, we can serve foundations with tailored investment concepts, especially those that also incorporate sustainability criteria. In our “Foundations” centre of competence, we support them in all matters related to the professionalisation of their investments and offer them a network of experts. We offer our clients additional contacts and expertise in many other matters of importance for foundations in our lecture series “Berenberg Foundation Talk”.

Foundations are different from other clients. What are their special investment needs?

Foundations essentially pursue two goals: first, to generate distributable (regular) income to finance their foundation purpose, and, second, to conserve their capital stock. Increasingly, however, they are also seeking to make a positive social contribution by observing sustainability criteria in their investments. In accordance with their financial goals, foundations are typically conservative investors with a small share of risky investments and a focus on fixed-income securities. With respect to income generation, they often focus on regular income, meaning interest income and dividends. Often, only these kinds of income can be used to finance projects, as opposed to realised capital gains, which often cannot be used for this purpose, or only in part. Charitable foundations have the advantage of being exempt from income tax, so they collect the full amount of regular income. For this reason, we issued a tax-exempt tranche of our foundation fund that is reserved for charities after the passage of the Investment Tax Reform Act.

That sounds like a very defensive asset allocation for foundations. How do you generate enough income to finance the foundation purpose and preserve the capital stock?

In the past, foundations were able to generate sufficient income at manageable risk through a traditionally conservative asset allocation with up to 25% high-dividend stocks, for example. Those days are over, unfortunately. The low interest rate environment has made conventional bond investments, like German Bunds, for example, unattractive. Besides investing in equities within the given limits, we invest in special bond segments, like emerging-market bonds and subordinated securities. But even in these segments, income prospects are still very limited. An active management approach is called for today: the days of buy-and-hold strategies are gone, and investments must be actively and tactically managed. A useful option is a moderate increase in the strategic equities allocation because average dividend yields are far higher than returns in the bond market.

How did you react to the persistent low interest rate environment to benefit your clients? Did you change your product offering?

Investors have now largely recognised and accepted that the returns they could generate in earlier years are no longer achievable without increasing risk in the portfolio. Therefore, a clear trend towards structurally higher equity allocations is discernible, even though they are still far below the levels of US university endowments like Harvard or Yale, for example. At the same time,
we have been less restrictive in our foundation strategies with respect to the minimum credit ratings of bonds and the proportion of foreign currencies. We reacted to the changed interest rate environment by offering foundations management solutions with higher equity allocations tailored to their investment objectives, which also conform to our comprehensive sustainability concept.

Do foundations have the necessary risk tolerance for such management solutions? How do you manage investment risks?
In the low interest rate environment, foundations either accept risks or generate no income – and the latter is not really an option, especially considering that these investors would like to preserve their capital after inflation. Those who are willing to take on higher risks should understand from the outset what risk means and whether it is acceptable, at least temporarily. After all, one thing is certain: the acid test will come sooner or later. Generally speaking, foundations are ideally suited for higher risks because an essential characteristic of all foundations is their long-term orientation and investment horizon. However, risk management is especially important for foundations because they need to preserve their capital over the long term. Even though we try to avoid losses as much as possible by means of active management, temporary book losses must be manageable. Portfolios are diversified across different asset classes, regions and issuers. In addition, we monitor the performance and risk of every portfolio on a daily basis and make appropriate adjustments when necessary.

What other expertise does Berenberg offer foundations?
All of our foundation strategies and foundation funds observe distinct sustainability criteria with the goal of generating attractive returns over the long term with sustainable and adaptable companies. We rule out companies that do not conduct sustainable business or operate in controversial fields, such as the arms industry, for example. Sovereign bond issuers are also selected on the basis of sustainability criteria. Besides excluding certain investments, we also attempt to make a positive overall impact through our in-house Sustainability Department. For example, we raise sustainability issues directly with the management of companies in which we are invested. In addition, specific sustainability objectives can be agreed in relation to special funds or special mandates. We offer tailored floor value or total return concepts to foundations that are especially focused on loss limitation.

Are there other investment opportunities for foundations beyond investing in liquid asset classes?
As I mentioned before, we consider a broadly diversified portfolio to be the optimal long-term investment structure for foundations. Besides conventional liquid investments, illiquid investments can also be an appropriate element of a portfolio’s total assets. Berenberg also has extensive expertise in this segment, including in real estate investments by way of our in-house Real Estate Office and equity investments in infrastructure, such as new forms of energy or fibre-optics networks. Such investments usually offer the characteristics prized by foundations in the form of attractive regular income coupled with a high level of calculability.

BIOGRAPHY

Oliver Brunner is Co-Head of Multi-Asset Portfolio Management. He has worked at Berenberg since 2007. He holds a master’s degree in business engineering. Besides bearing responsibility for defensive and total return asset management strategies, he also manages strategies and funds for foundations. He has many years of experience and expertise in the management of large special mandates and funds with specific requirements. He became a Certified International Investment Analyst (CIIA) in 2006.
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Date: 18 December 2018