STABILISATION
If key political risks subside further, we would expect economic data to stabilise in the course of the second quarter.

OVERREACTION
Markets are already betting the Fed will lower interest rates in 2020. But only one of two things can happen: either an economic recovery or an interest rate cut.

SUPPORT
The fact that investors are not positioned aggressively creates tailwinds for riskier assets at first (assuming that economic data stabilise) – but summer weakness looms on the horizon.
Dear reader,
The markets staged a grand turnaround in Q1. In the first two months, global equities had the best start to a year since 1991. The collapse of equity markets in the fourth quarter of 2018, a reflection of recession fears, has since proved to have been overblown. Those who did not lose their nerve at the end of last year have benefitted handsomely from the broad recovery since the beginning of this year.

The recovery of market sentiment was not caused by economic data, which have continued to disappoint and will most probably not stabilise in a sustainable way until the second quarter at the earliest. Instead, statements by the US central bank doused interest rate fears, just as diminishing fears of a hard Brexit and a hard landing for the Chinese economy considerably eased recession worries.

There would be further upside potential for equities if economic growth increasingly shows signs of stabilising in the coming months. Most analysis of positioning and capital flows shows that market participants and investors are not positioned aggressively. They are likely to increase their exposure to equity markets if our expectations for the economy are confirmed.

Nevertheless, somewhat more caution is advisable after the strong start to the year unless and until economic data show improvement. Furthermore, the conflict between the United States and the EU is likely to escalate at the latest after the trade conflict between the US and China is resolved. And the risk of a hard Brexit is still hanging in the air. Moreover, only one of two things will happen in the medium term: either economic growth recovers, or the US Federal Reserve will not raise interest rates further – not both. Markets are already betting that interest rates will be lowered in 2020. More stable economic data would probably revive fears that the Fed will resume its interest rate raising cycle in the medium term. This coupled with rising bond yields could then create headwinds for all investments, especially considering that valuations now appear to be fair, but no longer cheap. Barring an eruption of political risks and assuming that economic data stabilise, we can expect market sentiment to be mainly positive for now. 2019 could then follow the classic seasonal pattern of a strong start to the year followed by a weak summer beginning in May or June (“Sell in May …”).

Besides the economic environment and central bank policies, investors should pay close attention to the changed market structure and the associated change of market behaviour. I discuss what has changed and which investment strategies should benefit from these changes in the Insights Interview on page 16.

We hope you enjoy reading this issue.

Dr Bernd Meyer
Chief strategist multi-asset

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THOUGH CONFIDENT, WE DO ADVISE SOME CAUTION

IN A NUTSHELL

• After the strong start to the year, equity markets are no longer preoccupied with interest rate or recession fears; but now we need to see a stabilisation of economic data.
• If key political risks subside, economic data stabilises in Q2.
• If that happens, cautious investors and the fair level of valuations suggest further recovery potential.
• Temporary flash points include an escalation of the trade dispute between the United States and the EU, a hard Brexit, or the possibility of resurging interest rate fears in the medium term.
• Despite our confident outlook, our equity allocation is only slightly overweighted and close to neutral.

Portfolio positioning at a glance
We have gradually lowered our equities overweight to almost neutral in the course of the first quarter. The higher cash holdings will enable us to respond to opportunities and increase our equity weighting at short notice, if appropriate. If equity markets avoid major downturns or corrections in the coming months, the traditional “summer weak phase” for equities and risk assets could begin in May/June. In that case, we would reduce our equity weighting further in the medium term. Within equities, we prefer emerging markets and Germany, which can be expected to benefit the most from a stabilisation of global growth and an easing of the trade conflict. We remain underweighted in bonds, especially those of safe issuers. We continue to prefer frontier and emerging-market bonds over corporate bonds.

We are maintaining our gold position as a hedge in the portfolio. Gold could benefit from a weaker US dollar. On the other hand, investor positioning is no longer low after the strong rise in the price of gold since December, and the price of gold could be adversely impacted by a resurgence of interest rate fears.

Current weight deviations from the benchmark allocation for multi-asset strategies measured in EUR (Absolute representation)

• Underweight □ Neutral □ Overweight
Looking back at Q1: Easing tensions on a broad front

Markets staged a grand recovery rally in Q1. Market volatility fell to the lowest level since early October 2018, equity markets regained their levels from mid-October, and with only few exceptions (such as the DAX, for example), the gains since the start of 2019 have (more than) made up the losses of 2018. At first glance, the trends of falling bond yields, the rising gold price and the stronger US dollar do not seem to fit with the risk-hungry sentiment. However, the quick recovery of market sentiment was not driven by economic data, which have continued to disappoint. Instead, interest rate and recession fears appear to have been taken off the table. For example, the US central bank signalled a remarkable policy reversal in January, correcting the statements it made in December about continuing the balance sheet run-off on “autopilot” and raising interest rates further. In fact, a growing number of commentators are saying that the balance sheet reduction could end already this year. Moreover, the ECB was surprisingly restrained in March. In China, the economic policy measures have begun to bear fruit, and the probable postponement of the Brexit deadline has lowered the risk of a no-deal exit. Markets anticipate weaker growth, but not an imminent recession.

Economic data should stabilise in the second quarter

Economic data to date have been disappointing. They would first need to stabilise to justify the market recovery since the start of this year and open up further potential for equities. We expect data to stabilise in a more sustainable way during the course of the second quarter. For one thing, the Chinese government and central bank have adopted additional stimulus measures. The reduction of minimum reserve rates has already led to a substantial decline in the interest rate on interbank dealings and supported credit growth. The credit impulse in China, i.e. the change in velocity of credit growth, has increased considerably since the start of the year, and Chinese home prices are also rising at a faster pace again (see the upper figure on p5). China’s economic data should therefore stabilise in the coming months, especially if an agreement is reached in the trade conflict between the United States and China. Moreover, growth in Europe can also be expected to stabilise, especially without a hard Brexit. As the exceptional boom in the United States fades, the growth differential between the United States and Europe should slowly narrow.

After the good start to the year for equities, summer weakness looms on the horizon

Assuming that economic data stabilise and barring a major eruption of political risks, we see further upside potential for equities in the short term in view of the fact that investor positioning is not particularly aggressive, despite the good start to the year, and valuation ratios are still not high. Equity funds across the world have seen strong outflows since the beginning of the year, cash holdings are extremely high and speculative investors have not built net long positions in many equity futures. For this reason, it is more likely that investors will gradually increase their exposures than react to rising markets by “selling on the news”.

Furthermore, the historical market trend in years that start off on

<table>
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<th>Total return</th>
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<th>12-month periods of the last 5 years (in %, in EUR)</th>
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<th>Std. dev.*</th>
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*Time period: 19/03/2014-19/03/2019.
Source: Bloomberg. * CAGR = annualized return (in %, in EUR); Std. dev. = Annualised standard deviation (in %, in EUR).
a strong note suggests that the positive momentum will continue for now. The S&P500 Index gained 11% in the first two months of this year. Since 1950, there have been nine years in which the index has increased by at least 7%; the average gain since then has been 11% (see middle graph). Historically, the positive trend has tended to continue in March and in the second quarter.

“Investors are not positioned aggressively. That creates tailwinds if economic data were to stabilise.”

On the other hand, equity markets tend to weaken in the summer in years when they got off to a very strong start, and then firm up again in the fourth quarter, according to the historical pattern. And indeed, this scenario could well come to pass this year. Equity markets have already priced in the expectation that economic data will stabilise towards the summer at the latest. When that happens, interest rate fears could flare up again, especially with a view to 2020. Given that markets have since completely priced out further interest rate hikes by the Fed and have instead priced in a certain probability for an interest rate cut in 2020, there is a potential for negative surprises (see lower graph).

Rising bond yields, weaker US dollar and support for emerging-market equities, bonds and industrial metals

Although realised inflation should not have a significant effect on bond yields this year due to weaker growth and lower oil prices, the stabilisation of growth can be expected to cause bond yields to rise at least modestly as a result of increasing inflation expectations and higher real interest rates. For this reason, safe bonds will probably not generate positive overall returns by the end of the year and are advisable only for diversification reasons in the portfolio context. US Treasuries should be preferred due to the higher yield as long as the currency position fits with the portfolio and does not need to be hedged; after all, the US dollar can be expected to weaken further. On a trade-weighted basis, the US dollar appears to have peaked in November of last year. Investments in emerging markets, including both equities and bonds, should benefit from US dollar weakening. They would likewise benefit from a stabilisation of growth in China and a resolution of the trade conflict between the United States and China. In this environment, industrial metals could be expected to continue the positive trend in place since the start of this year.

Economic policy measures in China have begun to bear fruit

As interest rates have fallen, credit growth in China has accelerated already since November and Chinese home prices are rising at a faster pace again. Despite lower interest rates, inflation should not have a significant effect on economic policy measures in China.

Weak summer often follows a strong start to the year for equities

Average quarterly return of the S&P500 Index depending on the performance in the first two calendar months, since 1950 (%)

Market over-reacts, bets on falling US central bank rates

Economic stabilisation will probably lead to a resurgence of Fed interest rate fears. Rising inflation expectations will put upward pressure on bond yields.
PICK-UP IN THE SPRING

IN A NUTSHELL

- Economy: The gruelling winter in Europe and East Asia is not yet over, world trade is faltering.
- Fresh momentum in the late spring if the trade dispute eases and a hard Brexit is avoided.
- China is adding stimulus, central banks are supporting the economy.

The gruelling winter is not yet over

A series of political crises and external shocks has knocked the economies of Europe and East Asia off stride. Business sentiment is being adversely affected primarily by the trade tensions being stoked by the United States and the growth weakness in China. The situation in Europe is still clouded by worries of a hard Brexit, meaning the possibility that the UK would leave the EU without a follow-up agreement on March 29, 2019. The still declining business expectations of European industry and the current drop in trade with China suggest that the downturn in Europe and East Asia will last a few more months. We should be prepared for more bad news in the short term.

After the extensive tax gifts generated 2.9% growth in the United States in 2018, the economy there has lost some momentum since December. Manufacturing growth is slowing, due at least in part to the trade dispute with China. However, the solid growth of consumers’ real incomes suggests that the US economy could expand by almost 2.5% in 2019.

Progress in sight

Three conditions would need to be met in order for the economy in Europe and East Asia to pick up more steam:

1. Trade tensions would need to ease appreciably. This appears to be happening. The fact that the costs of the trade dispute will become apparent in the United States after the fading of last year’s fiscal stimulus should give President Donald Trump more incentive to strike deals this year instead of endangering the US upswing with a further escalation of tensions, which would reduce his chances for re-election in 2020. The United States and China have evidently made progress in their negotiations, which they may possibly want to seal in a summit soon. The trade dispute between the United States and the EU will take longer to resolve, but if Trump can reach an agreement with China, markets and businesses will presumably bet that the same will ultimately happen with the EU as well.

2. China would need to overcome its pronounced economic weakness. This is likely to happen in the near future. The monetary and credit policy steps taken in late 2018 are slowly showing results in the form of somewhat faster credit growth. In addition, China announced in early March that it will lower taxes by around 2% of economic output, further...
loosen lending restrictions and increase infrastructure spending again. As a result, China’s economy will probably turn around quickly.

3. The United Kingdom would need to avoid a hard Brexit. Although the risks are substantial and British politics appear to be chaotic, the risk of an abrupt and disorderly departure from the EU has recently diminished appreciably. Although the British Parliament is finding it very difficult to agree on any specific variant of Brexit, several votes have shown that a bipartisan majority of Parliament would like to avoid a hard Brexit. Any other solution would ease tensions considerably.

“China’s economy will probably turn around quickly.”

Because we see progress being made on these three conditions, we continue to expect that the gruelling winter for the economies of Europe and East Asia will be followed by a friendlier spring, although the beginning of this spring may be delayed somewhat.

Political risks in the Eurozone

Now that Italy has slid into recession mainly as a result of the politically induced widening of risk spreads, it will miss its budget targets for 2019 by a wide margin. But given that the especially free-spending Five Star party is losing political support in Italy, the chances are good that Italy will adjust its policies if necessary to limit the risk of a debt crisis. In France, President Emmanuel Macron is apparently succeeding in containing the yellow vest protests without abandoning his growth-promoting reforms.

Central banks pivot

Wage pressures are rising only slowly in the United States and Europe. For this reason, core inflation rates are either very low, at around 1% in the Eurozone, or in line with the targeted rate of around 2% in the United States. Central banks can afford to adapt their policies to the outlook for the economy. After the US Fed rattled markets in December with its statement that part of its monetary policy was on “autopilot”, it corrected that mistake in January. It is pausing any further interest rate hikes and will end the gradual reduction of its balance sheet already at the end of this year.

In March, the ECB lowered its growth forecast for 2019 considerably (to the 1.1% rate we expected) and adjusted its monetary policy. It will offer banks fresh, generous liquidity injections and leave its base interest rates unchanged until at least the end of 2019, instead of only until the end of summer. These pivots on the part of central banks limit the downside risks for the economy.

Dr Holger Schmieding, Chief Economist

Growth and inflation forecasts

<table>
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<th>2018</th>
<th>2019</th>
<th>2020</th>
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<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 19/03/2019.
This table was updated on 22/03/2019 and deviates from the print document.
ECONOMIC DATA NEED TO STABILISE

IN A NUTSHELL

- Negative profit estimate revisions have continued across all regions, but will probably bottom out soon.
- Valuation ratios are close to their historical averages again. In order for equities to rise further, economic data must first signal a trend reversal.
- We especially like emerging-market equities, as they can be expected to benefit from an end to USD strength and an easing of tensions in the trade dispute.

Global equities had their strongest start to a year since 1998

Whereas most investors were preoccupied with recession and interest rate fears in the fourth quarter, these fears seem to have disappeared in the first quarter. New risk budgets coupled with a wait-and-see Fed, Chinese stimulus measures and signs of an easing of the trade conflict between the United States and China have fuelled a broad-based recovery rally. US small caps have performed the best since the beginning of the year, followed by European cyclical and small caps. Stocks that lost the most value in the fourth quarter tended to recover the most in the first quarter. By contrast, defensive stocks have performed below average, as have German stocks, which are suffering from homemade problems such as those in the automotive industry. Equity segments like US small caps and defensive European equities have made up their earlier losses from 2018 in contrast to the DAX.

Momentum of negative profit revisions is likely to slow

Analysts have recently downgraded their profit estimates further across all regions, in line with the weaker economic data. Corporate profits have been adversely impacted by the global growth slowdown and by higher wages and tariffs; we think that the peak for profit margins has passed. In view of shrinking profit margins and mixed revenue growth, we consider the negative profit estimate revisions to be justified and expect that European profit estimates for 2019 will need to be downgraded further. The consensus expectation for 2019 profit growth is around 9% for European companies. We find this to be overly optimistic.

On the positive side, however, it should be noted that the momentum of downward revisions has recently slowed. For example, profit estimate revisions for Asia-Pacific ex-Japan have been revised downward by 7.4% in the last three months, but “only” by 1.2% in the last month. However, nominal growth is likely to be boosted by fiscal policy measures such as those taken in China. We therefore expect that global corporate profits will increase year-over-year by around 3-5% in 2019. The consensus expectation is currently around 4%.

Valuations are fairer again

Due to the pricing-out of trade (political) risks and growth worries, valuation ratios have climbed further in the direction of their historical averages. The equity market is no longer pricing in an imminent recession. As a result of this upward movement, however, leading economic indicators would need to signal a trend
reversal before equity markets can rise further. Our economists expect that the global economy will pick up steam again in the second half at the latest, assuming that political risks have subsided by then.

Preference for emerging-market equities
We especially like emerging-market equities due to their relative attractiveness, the expected end to US dollar strength and the widening growth differential. Moreover, emerging-market equities in particular can be expected to benefit from the apparent rapprochement in the trade dispute between China and the United States, as well as the Chinese stimulus measures. In addition, we see catch-up potential for Europe compared to the United States because the growth rates of these two regions should converge in the coming quarters, not least of all due to the fact that the positive effects of the US tax reform will probably fade completely in the coming months. Besides that, US equities are higher-priced. In the short term, however, the upside potential of European equities is probably limited due to the high likelihood that Donald Trump will turn his attention to punitive tariffs on European products after reaching a deal with China. This will probably fuel heightened volatility. Nevertheless, we do not expect the trade conflict between the United States and Europe to escalate because both sides can make formidable threats. Moreover, the US side has an interest in reaching a deal that can be touted in next year’s US presidential election.

Ulrich Urbahn, Head of Multi-Asset Strategy & Research

WHAT IS ON COMPANIES’ MINDS?

Subdued outlooks with hopes for improvement in H2
European corporate results in the fourth quarter were somewhat more constructive than generally expected. Two points are especially noteworthy. First, the divergence between strong consumer spending and weakening industrial demand in China. Thus, luxury good manufacturers, such as LVMH and Moncler, and spirits producers posted double-digit revenue gains, while industrial enterprises (for example) reported declines in China, including substantial declines in some cases. We expect this divergence to continue in the future. Second, the outlooks for 2019 are very conservative. There is great restraint especially with regard to the first half. The reasons for this include the trade war, the ongoing uncertainty surrounding Brexit and the high prior-year comparison values. Interestingly, a large number of our interlocutors expect economic conditions to improve in the second half of the year. When asked about the impetus for this recovery, however, most respondents essentially shrugged their shoulders. At the moment, this expectation is almost certainly based on calculated optimism, but it could prove to be true if economic indicators find a bottom.

Matthias Born, CIO Equities

Equities are now fairly valued again
P/E ratio valuation based on profit estimates for European and US equities for the next 12 months and the corresponding P/E ratio average since 1988

In 2018, European and US equities are now fairly valued again. The improvement in the European P/E ratio will be reinforced by the fact that Donald Trump will turn his attention to punitive tariffs on European products after reaching a deal with China. This will probably fuel heightened volatility. Nevertheless, we do not expect the trade conflict between the United States and Europe to escalate because both sides can make formidable threats. Moreover, the US side has an interest in reaching a deal that can be touted in next year’s US presidential election.

Ulrich Urbahn, Head of Multi-Asset Strategy & Research

Forecast summary: Catch-up potential for Europe

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<tr>
<td>MSCI UK</td>
<td>-</td>
<td>4.1</td>
<td>8.8</td>
</tr>
</tbody>
</table>

* Average, consensus, as of 19/03/2019.
Source: Bloomberg, Factset, Berenberg.
RISKS HERE, OPPORTUNITIES THERE

IN A NUTSHELL

- Yield forecasts for safe government bonds have been lowered since the beginning of the year, but income prospects are predominantly negative.
- Despite the good start to the year, we remain cautious towards corporate and high-yield bonds. We prefer subordinated financial bonds.
- Even after recovering, emerging-market bonds remain attractive; we prefer the hard currency segment.

Central banks are not enough
“Still no luck for bonds?” we asked on these pages a few months ago. “Well, maybe a little” could be the answer to this question after the first months of 2019, especially considering that all bonds have benefited from the more dovish stance of central banks. Aside from that factor, however, additional opportunities for specific segments of the bond market vary widely.

Safe government bonds will probably run out of steam soon
After a surprisingly good performance with positive returns in 2018, German Bunds, US Treasuries and British Gilts have defied the broadly negative income forecasts also in the current year. Although the risk appetite of many market participants has increased again, as evidenced not only by the equity markets, but also the appreciably tighter yield spreads of Spanish, Portuguese, and Greek government bonds, a sufficiently large number of bond investors remain in standby mode. Their demand for top-rated bonds has pushed down the yields of US Treasuries, German Bunds and British Gilts. We do not consider this trend to be sustainable. Although we recently lowered our yield forecasts, safe government bonds from the Eurozone core and the United Kingdom will gradually run out of steam in the second quarter, in all likelihood. We also expect yields to rise in the United States, where the expected price losses will at least be offset by comparatively higher basic yields.

Corporate bonds took a different direction (for now)!
The year was only a few days old when corporate bond markets took an opposite direction to consensus expectations, causing spreads to narrow significantly across many segments. Despite the doubtlessly more attractive valuations, the explanations offered by market participants to date have been less than convincing. One reason cited among others is that high cash positions of institutional investors at the start of the year and growing pressure on short sellers supposedly fuelled the rally. And yet, most political risks have not yet dissipated. For this reason, we are surprised at the extent and speed of the market’s movement. We plan to use the ongoing recovery by taking profits into the rising market so as to have reserves for buying opportunities in the event of a possibly imminent correction. Within the segment

Safe government bonds: Red light in Europe, yellow in the US
Past and expected performance of 10-year government bonds, overall effect of yield/price changes, coupon income and roll-down effect

<table>
<thead>
<tr>
<th></th>
<th>2017 Total Return (5Y)</th>
<th>2017 Total Return (TR)</th>
<th>2018 Total Return (5Y)</th>
<th>2018 Total Return (TR)</th>
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<tr>
<td>German Bunds</td>
<td>20.3%</td>
<td>2.0%</td>
<td>15.5%</td>
<td>2.6%</td>
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<tr>
<td>US Treasuries</td>
<td>20.3%</td>
<td>2.0%</td>
<td>15.5%</td>
<td>2.6%</td>
</tr>
<tr>
<td>UK Gilts</td>
<td>25.6%</td>
<td>2.5%</td>
<td>15.5%</td>
<td>2.6%</td>
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</tbody>
</table>

Time period: 22/03/2014-22/03/2019; updated and deviating from the print document.
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 the end of 2019 and the middle of 2020

<table>
<thead>
<tr>
<th></th>
<th>22/03/2019</th>
<th>31/12/2019</th>
<th>30/06/2020</th>
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<tr>
<td></td>
<td>Currently</td>
<td>Consensus</td>
<td>Consensus</td>
</tr>
<tr>
<td></td>
<td>USA</td>
<td>Eurozone</td>
<td>UK</td>
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<tr>
<td>Base interest rate</td>
<td>2.25-2.50</td>
<td>2.25-2.50</td>
<td>0.75</td>
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<tr>
<td>10Y US yield</td>
<td>2.44</td>
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<td>1.00</td>
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<tr>
<td>Base interest rate</td>
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<td>0.75</td>
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<td>10Y Bund yield</td>
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<td>0.60</td>
<td>1.00</td>
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<tr>
<td>Base interest rate</td>
<td>0.75</td>
<td>1.00</td>
<td>1.25</td>
</tr>
<tr>
<td>10Y Gilt yield</td>
<td>1.01</td>
<td>1.90</td>
<td>2.19</td>
</tr>
</tbody>
</table>

This table was updated on 22/03/2019 and deviates from the print document.
of corporate bonds, we prefer subordinated financial bonds, which had performed well below average in 2018 – despite relatively better credit profiles – and therefore offer catch-up potential. Moreover, this asset class stands to benefit from lower new issue volumes coupled with narrowing risk spreads.

We are more cautiously positioned in the segment of European high-yield bonds, specifically those with ratings in the BB range. In this segment, risk spreads have already compressed by around 110 basis points from the start of the year until mid March, thereby making up about 88% of the negative development in the preceding quarter.

Emerging-market bonds are still attractive
Since the start of the year, emerging-market bonds denominated in both local and hard currencies have recovered strongly from their earlier losses. This recovery can be attributed to a variety of factors. It began with attractive entry levels, especially on the hard currency side, which then led to sharply higher capital inflows. Moreover, the signs of an easing of the trade conflict between the United States and China, which is important for many emerging-market countries, added further positive momentum to this asset class. The only fly in the ointment of this generally positive story, which has mainly influenced the local currency segment to date, is the continued strength of the US dollar. However, the recovery of this segment had begun already in the fourth quarter of 2018, much earlier than the recovery of hard-currency bonds. These movements caused the relative yields of the two segments to converge to the benefit of hard currency bonds. With an eye to historical patterns, however, the yields of hard currency bonds can be expected to fall well below those of local currency bonds in the future, which is why it makes sense to give preference to hard currency bonds in the second quarter. Although consolidation tendencies have been observed in both segments in the last few weeks of the current quarter, this is hardly surprising given the strong movement earlier. Overall, both segments remain attractive, especially compared to other alternatives in the bond market.

Conclusion: Income from bonds? Difficult, but not impossible
Given the expectation of rising yields, bonds are still not an easy asset class. But where do we see opportunities? In the last issue of *Horizon*, we ascribed the best income chances to emerging-market bonds; and nothing has changed in that assessment, it is still our favourite segment. In addition, we see potential in the segment of subordinated financial bonds. By contrast, top-rated European government bonds will probably not be able to withstand rising yield levels and will therefore lose a lot of value, whereas US Treasuries offer the prospect (subject to the currency component) of stable to only slightly negative income in the further course of this year.

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

European high-yield bonds: Recovery potential is used up
The rise in risk premiums from 125 and 240 basis points (bp) in the BB and B rating ranges respectively in Q4 2018 was followed by a broad-based recovery.

Positive capital inflows to emerging-market bonds
After disappointing inflows in 2018, inflows have been very promising in the current year to date, especially for hard currency bonds.
FRESH OPPORTUNITIES IN THE COURSE OF THE YEAR

“OPEC+” countries are successfully managing the oil market

The oil production cut by the “OPEC+” countries has been successfully executed. In fact, the quota reductions have recently been overfulfilled, particularly because Saudi Arabia has reduced its oil production substantially. In addition, oil production in the countries of Venezuela and Iran, which are not covered by the OPEC+ reduction agreement, has fallen as a result of US sanctions. These reductions have offset the substantial increase in oil production by non-OPEC countries, especially the US. Based on the development of inventory levels, the oil market appears to be in equilibrium. However, the positioning of market participants is only moderately long. The price of oil should rise modestly in the direction of USD70 per barrel in the coming months, especially if economic growth stabilises. In the second half, markets will likely focus on a possible extension of the OPEC production cuts and US production numbers.

Gold continues to glitter

Until February, precious metals benefitted from ETF inflows, despite the stable trade-weighted US dollar. Gold in particular was in high demand as a result of the equity market losses in Q4 and the lingering political risks. The price of gold was additionally supported by the pause in US monetary policy and declining real interest rates. Gold has been less in demand in the last few weeks due to the higher risk appetite of investors, and consequently the price of gold has fallen back to below USD1,300 per ounce. In view of the predicted US dollar weakening and solid demand, we expect higher gold prices in the further course of the year. In addition, gold is still attractive as a portfolio hedge, even though the potential is limited by interest rate worries.

Industrial metals are likely to become more attractive in 2019

The rise in prices since the start of the year means that industrial metals have mainly priced in the positive factors. Recession fears have dissipated and an agreement in the trade dispute between the US and China is considered to be a done deal. The weakening of the Chinese purchasing managers index for manufacturing did not have a lasting negative impact on prices, although China is responsible for around 50% of worldwide demand for industrial metals. Instead, market participants are hoping that the monetary and fiscal policy measures of the Chinese government will be effective. In the short term, the potential for disappointments has risen and the risk of a downturn in prices has increased. Yet, an economic recovery and an end to US dollar strength would create potential in the further course of the year.

Guido Urban, Senior Analyst Multi-Asset Strategy & Research
CURRENCY MARKETS FOCUSED ON RISKS

Limited volatility in currency markets since the start of the year

There are still a good many potential risks to the economy and financial markets. Considering the precarious state of affairs in the world, currency markets were remarkably quiet in the first quarter of 2019. Only the strong Swiss franc signalled a heightened awareness of risks. Market volatility has been relatively low; apparently, market participants are in “wait-and-see” mode. “Wait-and-see” is also a good way to describe the current monetary policy stance of central banks in the United States, United Kingdom and Europe. For now, central banks are compelled to exercise restraint by the weakened economic data. Thus, the latest ECB meeting on 7 March made it clear that monetary policy will remain very expansive for a longer period of time.

Slowing US economy will probably weaken the dollar

Mixed economic data have been coming out of the United States. Although GDP data for the fourth quarter of 2018 surprised to the upside, the fiscal economic stimulus can be expected to fade in 2019. We also expect weak economic data for the Eurozone until later in the spring, when a gradual improvement can be expected. Considering the overall situation, strong arguments cannot be made for either the US dollar or the euro in the short term. Now that the euro has fallen to 1.12 against the dollar, we see only limited upside potential for the dollar. It will probably continue trading sideways with volatility for now – as long as there are no real surprises in the trade conflict or with respect to the Brexit outcome. In the presence of indications that external disruptive factors will subside and the economy will pick up again, the euro exchange rate could rise by a few cents to, say, USD1.16 per euro in the second quarter.

Currency markets discount the possibility of a hard Brexit

In the meantime, currency markets have discounted the possibility of a hard Brexit. Sterling has recently gained and the euro has weakened accordingly. The euro has lost nearly five cents since the start of the year. The exchange rate is currently trading at 0.86 pounds per euro. If the optimism prevailing in the market proves to be well founded and a no-deal Brexit is averted, the pound would probably have some more room to rise. If, on the other hand, it surprisingly comes to a hard Brexit after all, the downside potential for the pound would be substantial, possibly to the level of parity between the euro and the pound. Is the day of the decision imminent or will the decision be postponed?

Dr Jörn Quitzau, Senior Economist

EUR/USD: Euro remains weak

The economic slowdown and political risks are weighing on the euro’s exchange rate. Will the trend reverse in the spring?

*Average consensus as of 19/03/2019. Source: Bloomberg.

Exchange rate forecasts

The euro’s exchange rate would rise again if the weight of political risks is lifted.
INTERVIEW WITH DR BERND MEYER

Dr. Meyer, last year was especially challenging for multi-asset investors. Why is that, in your opinion?

Only few asset classes managed to generate a positive overall return in 2018. The proportion of asset segments with positive returns was actually lower than in 2008, the year of the financial crisis. Depending on how you measure it, you would have to go back to the 1980s or even the 1960s to find a comparably difficult year. In other words, multi-asset investors hardly had a chance to generate positive returns last year. In addition, there were surprisingly many sudden and sharp market swings, which are both a curse and a blessing. Although they offer chances for opportunistic investors, it is very hard to correctly time your investments.

What were the reasons for this market situation? Should investors be prepared for the possibility that the market environment will remain just as challenging?

I think the challenging market environment is the combined result of three structural trends occurring at the same time. The cessation of bond purchases by central banks ended the general trend of asset price inflation of the last 10 years. In addition, investors changed their behaviour and their positioning in reaction to low or even negative interest rates. This led to continuously growing demand for riskier and higher-yielding investments. On top of that, the stricter regulation of banks in this environment changed the liquidity situation in the markets. These trends will certainly not reverse quickly in the next few years. We can expect more sudden, sharp market swings, whether triggered by political risks (e.g. Brexit, trade war, etc.), sentiment-related factors, or technical or fundamental factors. We expect increased volatility spikes in the coming months as well, triggered for example by purchasing manager indices approaching the 50-point mark, which could either fuel hopes for growth or fears of recession, depending on the sentiment of financial players.

We need to ask the question again: To what extent have the behaviour and positioning of investors changed?

When bond yields declined, investors were increasingly compelled to take on other risks in order to design a portfolio with an acceptable expected return. For example, they increased their exposure to equities or replaced safe government bonds with corporate or emerging-market bonds. Multi-asset portfolios thus became riskier on average and portfolio diversification measures became less effective. In addition, the hedging effect of German Bunds, for example, has steadily declined in the last years. Because 10-year yields were already close to 0%, these bonds no longer offered the same level of protection as before the financial crisis. That is because bond yields will not fall by as much in reaction to a crisis and therefore bond prices will not rise as much either. All multi-asset products in the market suffered from this effect last year. One consequence has been that even multi-asset investors now tend to reduce risks in falling markets, and vice versa. This effect reinforces market swings in both directions.

Would it not be advisable in this environment to attach more importance to risk limitation in the portfolio?

That would seem to make sense at first glance and indeed, strategies based on target volatility or risk parity have become considerably more prominent in the last 10 years. The problem is, these strategies all do the same thing, ultimately. If volatility rises in one asset class, investments in that asset class are reduced. If volatility rises across the board, everything is reduced. In effect, this is a trend-reinforcing, pro-cyclical approach that essentially perpetuates the current market environment of recurring sharp corrections. Other trend-reinforcing strategies, including short volatility strategies and pure momentum strategies such as CTAs, for example, have also become more influential. And given the growing importance of robo-advisers, this situation is not likely to improve because robo-advisors usually also fall under these categories due to their systematic asset allocation strategies. In this
environment, it makes more sense, in my opinion, to be more opportunistic and sometimes go against the market trend on the basis of conviction and reasoned opinion, or at least not jump on every trend. For example, we used the sharp correction in February 2018 to increase the equity allocation in our multi-asset strategies, and that paid off for us. However, it’s not always easy to get the timing right, even if the conviction behind the decision is ultimately correct. After the October correction, for example, we increased the equity positioning of our multi-asset strategies too early in November because we considered the recession fears of many market participants to be overblown. However, the recovery rally did not come until January.

“We have diversified our multi-asset strategies even more along these lines in the last few months.”

In this environment, it is especially important to emphasise diversification, even though this has not worked so well in the last years due to the increasing synchronism of most asset classes. Actually, diversification still only works well with safe government bonds, gold and cash. We have diversified our multi-asset strategies even more along these lines in the last few months.

You have been the Chief Investment Strategist for Berenberg and responsible for multi-asset strategies in Wealth and Asset Management since October 2017. How have you reacted to the changed market environment in your area of responsibility?

In this environment, a well-reasoned market opinion is extremely important for being able to distinguish market movements driven by systematic investment strategies from fundamentally justified movements. That is because it only makes sense to go against market trends when you are truly convinced of your opinion. It is also important to constantly observe risks, market sentiment and measures of investor positioning. Such information provides a solid foundation for our decision-making process, including both necessary ad-hoc decisions and the decisions made in our regular investment and asset allocation committees. We have strengthened our capabilities in this area considerably. We communicate our opinion of capital markets clearly and regularly in our Horizon series of publications, including the monthly Horizon Handout and Berenberg Markets. The biweekly Berenberg Markets Monitor gives investors detailed insights into current market developments. All publications can be viewed on the Berenberg website or also subscribed as regular newsletters.

Have you also adjusted your strategies or launched new strategies to benefit from the current market environment?

In our benchmark-based multi-asset strategies, we implement our opinion of capital markets clearly and decisively as active managers, also anti-cyclically and outside of the benchmark. We are convinced that this is the only way to generate better results than the benchmark over the long term. Last year we also launched two new investment funds operating with a high degree of discretionary latitude, which invest independently of a benchmark and have a medium-term total return character, which is appropriate for the current market environment. The first of these is the Berenberg Global Bond Opportunities Fund, which invests flexibly in the bond segment. The second is the Berenberg Variato Fund, an opportunistic multi-asset fund guided by the best ideas of the Berenberg platform. In this fund, strategic positions in promising segments of the capital markets are supplemented with speciality investments and opportunistic-tactical positions. I myself am the lead fund manager of the Berenberg Variato Fund, with the support of Ulrich Urbahn, Head of Multi-Asset Strategy & Research, and Henning Gebhardt, Head of Berenberg Wealth and Asset Management.

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Dr Bernd Meyer is the Chief Strategist of Wealth and Asset Management and is responsible for Berenberg’s discretionary multi-asset strategies, which also include asset management mandates. He was Head of European Equity Strategy at Deutsche Bank, before he joined Commerzbank in 2010. At Commerzbank he established the global cross-asset strategy research. Dr Meyer has received multiple awards. For example, he and his team ranked among the best three multi-asset research teams worldwide in the renowned Extel Survey in the years 2013 to 2017. He is also a chartered financial analyst (CFA) and guest lecturer for “Empirical Capital Markets Research” at Trier University.
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