FEWER RISKS
Political uncertainties can be expected to dissipate somewhat in Q4. The focus should turn to robust economic growth, also in 2019.

LOWER PROFITS
The central bank support of the last few years is being withdrawn. Profits and valuations are declining. Investors need to be more selective and tactical with their investments.

END-OF-YEAR RALLY
Preference should be given to equities over bonds. Despite the ongoing trade dispute, factors such as seasonality, the upcoming US congressional elections, profit growth, and moderate valuations point to an end-of-year rally for equities.
Dear reader,

It has been a hot summer, both in terms of politics and weather. Although economic sentiment stabilised and the feared trade war did not break out, interest rates, currencies, and equity markets in the industrialised nations were largely weak or lacking in direction. Only the US S&P 500 index managed to climb above its high of January. However, the weak performance by all asset classes, especially in the emerging markets, reflected not just the political uncertainty, but also the diminishing support of central banks. The lack of broad liquidity support of the kind provided in recent years is becoming increasingly apparent. Investors face an environment of tendentially declining valuations and lower returns in capital markets. They must be increasingly selective and tactical with their investments.

The coming autumn could well be stormy. Political uncertainty remains high. And equity market volatility has historically always been highest in October. After that, however, some of the uncertainties should dissipate. The budget debate in Italy should be over by the end of October, the US congressional elections will be held on 6 November, and the Brexit terms may be finalised during the course of November. Even if the trade dispute between the US and China is not quickly settled and harsh US sanctions against Iran take effect in November, investors will turn their attention to 2019.

As investors look forward, they will increasingly focus on the end of bond purchases, the reversal of interest rate policy in the eurozone, and the generally diminishing support provided by central banks. However, it should also become obvious that central banks have no reason to pursue restrictive monetary policies. On the contrary, they can be expected to continue on a path of moderate monetary policy normalisation. The yields of safe-haven bonds will probably rise only slowly. Pronounced economic weakening, or even a recession in 2019, remains improbable. Following the stabilisation of economic growth in the eurozone and Japan and the dissipation of political uncertainties, the world’s regions should return to a course of more synchronous growth.

This environment is favourable for a positive performance by equity markets around the end of the year and into the new year. Moreover, equity markets have historically exhibited the strongest performance in the period from November to April. What is more, US equity markets have risen in the six months following every one of the 17 mid-term congressional election since 1950. Finally, solid corporate profit growth and moderate valuations support our expectation for an end-of-year equity rally, with relatively more catch-up potential for European than US equities, and recovery potential for emerging-market equities.

We hope you enjoy reading this issue of Horizon.
END-OF-YEAR RALLY DESPITE LOWER RETURNS

IN A NUTSHELL

- A recession is also unlikely in 2019. Considering that economic surprises across the world’s regions are already converging, more synchronous growth should follow.
- Globally diminishing central bank support is leading to lower valuations and returns. Investors must be more selective and tactical with their investments.
- Equities should be preferred to bonds. Factors such as seasonality, the US congressional elections, profit growth, and moderate valuations create favourable conditions for an end-of-year rally for equities.
- A higher cash allocation is helpful in the current environment, so that opportunities can be seized when they arise.

If equities do rally towards the end of the year, safe sovereign bonds cannot be expected to exhibit a positive performance. As investors look forward to 2019, they are likely to focus on moderately rising inflation and diminishing central bank support. Bond yields will probably rise slowly. The outlook is no better for corporate bonds, especially considering the fact that risk premiums are currently very low. Strategically speaking, we prefer emerging-market and convertible bonds.

Portfolio positioning at a glance: Keep some powder dry
A preference for equities over bonds is still an essential element of our positioning. Although markets are currently still under pressure from numerous uncertainties, many of these should dissipate in the fourth quarter. There is already a strong dose of scepticism in the markets and seasonality tends to start favouring equities in November, especially after the US congressional elections. Adding solid corporate profit growth and moderate valuations, this seems to justify hopes for an end-of-year rally. In that case, European and emerging-market equities in particular offer the most catch-up potential. It makes sense to us to keep some powder dry in the form of a higher cash allocation in order to increase exposure if necessary. Until then, we are maintaining only a medium overweight in equities.

Schematic representation of weighting deviations from the strategic benchmark allocation for euro-denominated multi-asset strategies. Within each asset class the average deviation is equal to the total deviation of the asset class.
Looking back: end of asset price inflation more apparent

Most markets were directionless or weak in the third quarter. Only US equities continued to rise, supported by another near-record quarterly reporting season and record-high stock buyback programmes and M&A activities. In the first half of 2018, the volume of US stock buybacks was 50% higher, dividend payments were 8% higher, and M&A activity was 30% higher than in the first half of 2017. In absolute terms, stock buybacks and dividend payments were USD119bn higher than in the second half of 2017 and USD142bn higher than in the first half of 2017. This increase alone offset the USD143bn reduction in the Fed’s balance sheet since the beginning of the year (see the figure at the top of page 5). US assets were also supported by international capital flows, as reflected in the almost 3% appreciation of the trade-weighted US dollar since the beginning of 2018. Therefore, the Fed’s balance sheet reduction has not had a negative impact on the US market. Nevertheless, the effects of globally diminishing central bank support – including (for example) the low or negative returns on nearly all asset classes since the beginning of the year – are becoming increasingly apparent. Even the valuations of US equities have declined. The broad liquidity support of the last few years is already being missed and that means the trend of general asset price inflation is coming to an end.

In view of stable core inflation rates, mixed economic data, political uncertainties, and stable oil prices, the market shrugged off the wave of rising realised inflation, which was due to baseline effects. In fact, inflation expectations have trended modestly lower. The yields of safe-haven bonds have fluctuated widely, but have risen only moderately. The prices of government bonds, European bonds, emerging-market bonds, and gold have fallen. The price of gold has suffered from the growing split between rising production and declining demand. However, the positioning of speculative investors is already very negative now, suggesting that the price of gold should stabilise.

The cycle will continue but capital markets face greater challenges

Economic surprises across the world’s regions are increasingly converging. Economic surprises have turned positive for the eurozone and Japan. This trend, combined with further solid growth in the US and the reduced strain on emerging markets that can be expected to result from the waning strength of the US dollar, means that the world’s economic regions have returned to a path of more synchronous growth. A widespread emerging-market crisis is not to be expected. Thus, the growth environment is intact, inflation remains low, and the aggregate global effect of central bank policies is still expansive. A recession leading to a larger and more sustained correction of equity markets (ie a bear market) in the next 12 months remains improbable. But the challenges are multiplying. Growth can be expected to slow somewhat and wages and core inflation will probably rise slowly, even if baseline effects like those from the oil price increase, for example, will fade for now. The liquidity supplied by central banks will decrease further. This year’s strong increase in stock buybacks and dividend payments in the US was due, at least in part, to the tax reform and will probably not repeat.

Directionless and weak markets in Q3: only US equities shine thanks to good profits and record-high share buybacks

<table>
<thead>
<tr>
<th>Total return</th>
<th>Year-to-date and in Q3 (in %, in EUR)</th>
<th>12-month periods of the last 5 years (in %, in EUR)</th>
<th>CAGR*</th>
<th>Std. dev.*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>YTD (31/12/17 - 18/09/2018) = Q2 (30/06/18 - 18/09/2018)</td>
<td>18/09/17 - 18/09/16, 18/09/15 - 18/09/14, 17/09/13</td>
<td>19/06/13 - 19/06/18</td>
<td></td>
</tr>
<tr>
<td>Brent</td>
<td>7.5</td>
<td>15.6</td>
<td>27.4</td>
<td>-9.6</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>2.9</td>
<td>11.8</td>
<td>21.0</td>
<td>16.7</td>
</tr>
<tr>
<td>USD/EUR</td>
<td>3.1</td>
<td>13.7</td>
<td>24.5</td>
<td>17.0</td>
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<tr>
<td>US Sovereigns</td>
<td>2.2</td>
<td>6.7</td>
<td>9.3</td>
<td>11.0</td>
</tr>
<tr>
<td>Eonia</td>
<td>0.4</td>
<td>1.3</td>
<td>2.5</td>
<td>0.8</td>
</tr>
<tr>
<td>EUR Sovereigns</td>
<td>0.6</td>
<td>3.5</td>
<td>4.4</td>
<td>0.0</td>
</tr>
<tr>
<td>EUR Corporates</td>
<td>0.4</td>
<td>3.2</td>
<td>4.4</td>
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</tr>
<tr>
<td>EM Sovereigns</td>
<td>0.0</td>
<td>3.2</td>
<td>4.4</td>
<td>0.1</td>
</tr>
<tr>
<td>Stoxx Europe 50</td>
<td>5.3</td>
<td>4.4</td>
<td>4.4</td>
<td>0.0</td>
</tr>
<tr>
<td>Gold</td>
<td>-0.1</td>
<td>0.4</td>
<td>0.4</td>
<td>0.2</td>
</tr>
<tr>
<td>DAX</td>
<td>2.7</td>
<td>3.0</td>
<td>3.0</td>
<td>2.5</td>
</tr>
<tr>
<td>MSCI EM</td>
<td>2.6</td>
<td>1.8</td>
<td>2.0</td>
<td>1.9</td>
</tr>
</tbody>
</table>

Source: Bloomberg; * CAGR = Annualised return (in %, in EUR); Std. dev. = Annualised standard deviation (in %, in EUR)
Whereas the 10% profit growth expected for the US in 2019 is indeed solid, it is less than half of the 23% profit growth registered in 2018. On the other hand, the Fed will now reduce its balance sheet at a faster rate. In addition, the ECB will no longer expand its balance sheet from the end of this year and Japan too can be expected to scale back its purchasing programme. In this environment, the yields of safe-haven bonds will probably rise, but only slowly, because speculative investors have already built up strong short positions and market participants generally believe that the capital markets are late in the cycle.

**US congressional elections - starting signal for a year-end rally?**

Congressional elections will be held in the US on 6 November. All 435 members of the House of Representatives and 35 of 100 Senators are up for re-election. It will be exciting to see whether the Republicans can defend their majorities in both chambers or whether the Democrats will take control of the House of Representatives. The former outcome would probably lend strong support to the US dollar and also US equities. After that, however, fears of an overheating US economy could gain the upper hand. The second outcome, which we consider to be the most probable, would probably be good for markets in the medium term. The status quo of the tax reform and deregulation would be cemented and Trump’s political flexibility would be limited. The scenario of the Democrats taking over both houses is the least probable, but would probably cause a strongly negative reaction in the markets. The Democrats could initiate impeachment proceedings against the President. Tax cuts and deregulation could possibly be rolled back and stock buybacks could be taxed.

Historically, the US equity market has trended sideways on average in the 180 days before the 17 mid-term congressional elections since 1950, due to heightened uncertainty. After the election, US equities have usually performed well, regardless of the outcome. In 16 of 17 cases, the S&P 500 rose by an average of 8% in the 90 days after the election. In all cases, moreover, the S&P 500 rose on average by an impressive 15% 180 days after the election, compared with right before the election. This result is undoubtedly due to the positive seasonal trend of equities in the November-to-April period. Be that as it may, these historical trends, coupled with the solid fundamental picture, suggest a heightened probability of an end-of-year rally, even in an environment of less central bank support and generally lower profits.

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Dr Bernd Meyer, Chief Strategist, Wealth and Asset Management
UPSWING SOMEWHAT DAMPENED BY POLITICAL RISKS

IN A NUTSHELL

• The upswing continues. Growth in Europe (but not in the US) has been temporarily dampened by worries about world trade, Brexit and Italy, as well as the emerging-markets crisis.
• Interest rate policy is slowing reversing. Central banks can stick to their timetables. The Fed will gradually raise rates further; the ECB will end its bond purchases in December.
• The outlook is clouded by political uncertainties. On the other hand, inflationary pressure remains within narrow bounds.

The transatlantic divergence will remain in effect for now
A divergence opened up between the robust economy in the US and the more subdued upswing in Europe and Japan during the course of 2018. This divergence could narrow somewhat again at the end of 2018 and in 2019. However, this will probably only happen slowly because the trade disputes and emerging-market risks are worse for Europe and Japan. In the US, the reduction of regulations is helping the sentiment of many companies, while the tax reform enacted late in 2017 is boosting investment propensity and stimulating consumer demand. For this reason, households and businesses can easily absorb the losses caused by President Trump’s trade restrictions at this time. US growth will probably remain at levels around 3% and then gradually swing back to a pace of around 2.5% in 2019. Unlike the US, the major trading partners that have not afforded themselves any fiscal stimulus are feeling the damage of Trump’s trade policy. Many companies are unsettled by the crisis in some emerging-market countries and by worries about Italy and the still unanswered Brexit questions. For these reasons, business climate and consumer confidence have dimmed somewhat, even though the economic situation in the eurozone is still very good and domestic demand is being supported by rising employment. Also in the third quarter, Germany and the eurozone will probably not grow faster than roughly 1.5%, which corresponds to the long-term trend for Germany and the eurozone.

The Turkish crisis
In past issues of “Horizon”, we pointed out that Turkey as a country dependent on capital imports has put itself in a precarious position. Under the additional pressure of an escalating dispute with the US, this latent risk has developed into a full-blown crisis. The collapse of the Turkish lira will probably drive inflation even higher than the current level of 18% (August 2018). If the consumer price index follows the exchange rate, as it usually does in such cases, consumer prices in Turkey could rise by well over 50% in the next two years. The situation can only be permanently stabilised if Turkey tightens its monetary policy considerably and eases tensions with the US. Even though Turkey is resisting such steps, the threat of a deep recession should force it to change course in just a few months.
Contagion risks for other emerging markets
The outlook for other emerging-market countries is mixed, but not generally bad. Strong exporting countries with low debts in USD are benefitting from the robust domestic demand in the US and the eurozone and the higher exchange rate of the US dollar. This group includes many countries in southeast Asia and central and eastern Europe. On the other hand, countries with high current account deficits and high levels of US dollar-denominated debt are prone to crises of confidence. It is harder for them to service their debts and attract fresh capital. For this reason, the financial markets have already punished not only Turkey, but also other at-risk countries like Argentina, South Africa, and Brazil. Even if some other countries are caught up in the market overreaction, we think that a widespread emerging-market crisis is not very probable, considering the strength of many countries.

Some countries are shaking as they should, but other emerging-market countries seem to be stable

China remains on a course of growth. While it is true that this country is putting off the major problem of its massive public-sector and private-sector debts, it can afford to do so for the foreseeable future thanks to its high savings rate of 40%.

Italian risk
The moment of truth is drawing near for the Italian government coalition of left-wing and right-wing populists. They had promised their voters to increase government spending, reduce taxes, and lower the statutory retirement age. Highly indebted as it already is, Italy truly cannot afford any of these plans. We expect that by mid-October, market and EU pressure will force the radical government to submit a government budget in mid-October that keeps the deficit well below 3% also in 2019. This way, Italy will be able to avert a full-blown debt crisis for now.

A veritable cocktail of risks and opportunities
Some risks could dominate the news in the coming weeks. Italy is preparing its budget for 2019, Brexit negotiations are hoped to be completed by mid-November, and some emerging markets could come under even more pressure. Trump’s Republicans could be weakened by the US congressional elections on 6 November. But investors should have more clarity by mid-November. If the US and China return to the negotiating table instead of imposing more and more punitive tariffs on each other, both the sentiment in financial markets and the business climate in Europe could brighten again before the end of the year.

Gradual return to normal monetary policy
The subdued inflation pressure makes it possible for central banks to gradually exit from their extremely expansive monetary policies. In the US, the Fed will probably raise its reference rate in September and December 2018 by 0.25ppt each time. Despite the somewhat weaker growth momentum, the ECB will be able to completely end its bond purchases at the end of the year. If the economy remains stable, it could then cautiously raise its refinancing rate in the autumn of 2019.

Dr Holger Schmieding, Chief Economist

Growth and inflation forecasts

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP Growth (in %)</th>
<th>Inflation (in %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>2.9</td>
<td>2.9</td>
</tr>
<tr>
<td>Eurozone</td>
<td>2.0</td>
<td>2.1</td>
</tr>
<tr>
<td>Germany</td>
<td>1.9</td>
<td>1.9</td>
</tr>
<tr>
<td>France</td>
<td>1.6</td>
<td>1.7</td>
</tr>
<tr>
<td>Italy</td>
<td>1.1</td>
<td>1.2</td>
</tr>
<tr>
<td>Spain</td>
<td>2.7</td>
<td>2.7</td>
</tr>
<tr>
<td>UK</td>
<td>1.4</td>
<td>1.3</td>
</tr>
<tr>
<td>Japan</td>
<td>1.2</td>
<td>1.0</td>
</tr>
<tr>
<td>China*</td>
<td>6.6</td>
<td>6.6</td>
</tr>
<tr>
<td>World**</td>
<td>3.0</td>
<td>3.8</td>
</tr>
</tbody>
</table>

* 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 19/09/2018.
END-OF-YEAR RALLY WILL BE BUMPY, BUT IT’S COMING

IN A NUTSHELL

- US equities climbed to an all-time high in the third quarter, while equity markets in other regions came under pressure.
- The numerous political risks will probably fuel volatility spikes in the autumn.
- Thanks to robust fundamental data, we anticipate an end-of-year rally and consider European equities to be attractive.

US equities are still unbeatable

The US equity market again performed better than equity markets in all other regions in the third quarter, driven by a strong Q2 reporting season, robust US economic data, and big stock buyback programmes. European and emerging-market equities were hard hit by the ongoing talk of tariffs and idiosyncratic risks like the Turkey crisis. In euro terms, US small caps have gained 16% since the beginning of the year, while the DAX lost 6% of its value, mainly due to the poor performance of the heavily weighted automobile stocks in the index. The performance difference is therefore 22ppt. Within Europe, defensive stocks performed much better than cyclicals. European equity markets were weighed down by the trade disputes and, in particular, the still pending Italian budget negotiations and the uncertainties surrounding Brexit.

Increase in corporate profit estimates for the industrialised nations

Analysts’ profit estimates for the industrialised nations have recently improved somewhat; they were mostly downgraded in the eurozone, while the revisions for Japan, the US, and especially the UK have been positive. Within emerging markets, the profit estimates for Asia in particular were revised down. The consensus expectation for “MSCI World” profit growth is currently 16% for 2018 and 9% for 2019. We see greater risks of downward revisions of profit estimates in the coming months because analysts now seem to have already priced in all the positive factors, even as potential negative factors for corporate profits are numerous (e.g., trade tariffs, Brexit, sanctions, rising interest rates, and rising wages).

Upside potential with a wider range of fluctuation

In line with historical seasonal trends, we expect a wider range of fluctuation in the equity markets in the autumn. After all, there is no shortage of political risk factors. For example, it is unclear how the Italian budget negotiations and the Brexit process will unfold, what will happen with Iran, and what trade tariffs will actually be imposed. Moreover, the US congressional elections to be held in November will probably cause increased political uncertainty. However, the fundamental environment for equities remains constructive, especially considering that valuation ratios are far from being stretched thanks to rising corporate profits. Furthermore, there has recently been a convergence of growth surprises in the US and the rest of the world (in Europe in particular, economic data have improved markedly compared with...
consensus expectations). In view of the numerous risks, many investors have been cautious in their positioning. If the equity market rises, underinvested investors will probably want to increase their equities allocation again.

**Catch-up potential for Europe, emerging markets are strategically attractive**

Looking at the world’s regions, we find Europe to be attractive after the recent phase of weakness. Besides the enticing valuations, we like the catch-up potential for European equities that could be realised in the event of a soft Brexit (baseline scenario of our economists) and a benign outcome to Italian budget negotiations. In addition, emerging-market equities could well be attractive in the fourth quarter given our expectation that the dollar’s strength will fade. Moreover, the seasonally favourable period for emerging-market equities will begin soon as investors increasingly turn their attention to 2019. Economists and investors often become more optimistic around the turn of the year, which usually means that riskier equity market segments like small caps and emerging-market stocks outperform other segments. We see the trade dispute between the US and China as a risk. However, the low valuations of emerging-market equities suggest that much uncertainty is already priced in. We would therefore regard an easing of the trade dispute as an opportunity. If the US central bank proceeds more cautiously than expected, that would also create an opportunity. A pausing of the Fed’s interest rate-raising cycle would likely be a positive surprise for emerging-market equities.

Ulrich Urbahn, Head of Multi Asset Strategy & Research

**WHAT'S ON THE MIND OF COMPANIES**

**Companies’ pricing power is important**

The past half-year reporting season painted a very positive picture for Europe. In aggregate, the Stoxx 600 companies reported profit growth of more than 5% in the second quarter. As described in the last issue of “Horizons”, higher material costs were one of the main points raised in our discussions with companies. In addition to rising input costs, however, the scarcity of skilled workers in Europe is also a problem. Despite a willingness to pay higher wages for qualified workers, companies are struggling to fill all their open positions. Investments in companies that are able to offset this cost pressure by raising prices are all the more important in this environment. The latest reports still contain no sign of fears related to an economic slowdown in China. Companies in the “luxury goods” and “industry” sectors in particular cited an extremely strong environment in China. However, caution is advisable specifically in the more cyclical sectors, because companies will only report weakening growth after it has happened and prices have fallen. A balanced portfolio with a focus on very robust business models is preferred in the current environment.

Matthias Born, CIO Equities

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**Underlying conditions in Europe have improved**

Relative performance of S&P 500 Index vs. Stoxx Europe 50 Index (01/01/2017 = 100), Citi’s surprise indicators, EUR/USD spot market & profit estimate revisions

<table>
<thead>
<tr>
<th>Time period</th>
<th>Jan 2017</th>
<th>Jul 2017</th>
<th>Jan 2018</th>
<th>Jul 2018</th>
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</thead>
<tbody>
<tr>
<td>Relative 3M Eco Surprises USA vs Europe (rhs)</td>
<td></td>
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<tr>
<td>S&amp;P 500 vs Stoxx Europe 600</td>
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<td></td>
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<tr>
<td>Relative 3M Changes 12M fwd Earn. USA vs Europe (%) (rhs)</td>
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<tr>
<td>3M EUR/USD Change (rhs)</td>
<td></td>
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</table>

*Average, consensus, as of 18/09/2018. Source: Bloomberg, Factset, Berenberg.*
**VOLATILE TIMES FOR BONDS**

**IN A NUTSHELL**

- Government bonds: US Treasuries makes sense as a diversifier; other “safe havens” remain unattractive.
- Corporate bonds: we are defensively positioned and expect considerable volatility in the fourth quarter.
- Emerging-market bonds: economic reforms could calm turbulent markets and create new potential.

**Government bonds: a differentiated view is needed**

The market for euro-denominated government bonds showed different faces in the third quarter. On the one hand, the “safe havens” benefitted from persistent risks, including the trade conflicts with the US, the Brexit negotiations, and uncertainty about the future Italian budget policy. In this context, demand for European core bonds remained strong and the “interest rate reversal” in German Bunds still did not occur. The 10-year Bund yield approached the 0.5% mark three times, but was also pushed down twice to less than 0.3%. On the other hand, Italian government bonds in particular suffered from investors’ fears of the fiscal antics of the Italian government, which caused the 10-year yield to fluctuate between roughly 2.5% and 3.2% and pushed it to its highest level since May 2014. Yields on UK gilts also trended higher. US Treasuries overcame their technical resistance level and recently yielded over 3.0%.

**Corporate bonds: further volatility ahead**

In many subsegments of the corporate sector, risk spreads have been widening, in some cases significantly, since the beginning of the year. Investors have been able to generate positive income only with US high-yield bonds and bonds with single-B ratings. This makes it all the more interesting to compare these with the higher-volume and presumably more defensive BB segment in Europe, which has exhibited a weaker performance than single-B bonds, with spreads having widened by 63bp at mid of September. The reason for this spread widening could be the return of capital flows from so-called “high-yield tourists”, who have increasingly ventured into the high-yield market, and especially the BB segment of that market, in recent years in their search for yield in the low interest rate environment. This hypothesis is supported by the trend of capital flows in Europe, considering the outflows of EUR7.1bn, or 9.5% of investments at the time,

**“Save havens”: Treasuries beat Bunds**

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

<table>
<thead>
<tr>
<th></th>
<th>4%</th>
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<th>0%</th>
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<tbody>
<tr>
<td>German Bunds</td>
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<td>TR until 30/06/2019 &quot;Consensus&quot;</td>
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<td>US Treasuries</td>
<td>TR Year-to-date (YTD)</td>
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<tr>
<td>UK Gilts</td>
<td>TR</td>
<td>YTD</td>
<td></td>
<td></td>
<td></td>
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</tbody>
</table>

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

Comparison of Berenberg and consensus forecasts, values at the middle of 2019 and end of 2019

<table>
<thead>
<tr>
<th></th>
<th>18/09/2018</th>
<th>30/06/2019</th>
<th>31/12/2019</th>
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<tbody>
<tr>
<td>USA</td>
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<td></td>
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</tr>
<tr>
<td>Base interest rate</td>
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<td>2.00</td>
<td>2.75</td>
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<td>10Y US yield</td>
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<td>3.30</td>
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<td>Eurozone</td>
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<tr>
<td>Base interest rate</td>
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<tr>
<td>10Y Bund yield</td>
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<td>UK</td>
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<td>Base interest rate</td>
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<tr>
<td>10Y Gilt yield</td>
<td>1.57</td>
<td>1.80</td>
<td>1.83</td>
</tr>
</tbody>
</table>

that have occurred since the beginning of the year. Even though the profits of the affected companies have been satisfactory, rating trends have been stable, and default rates have remained low, we expect the credit markets to be volatile in the fourth quarter. We have assumed a defensive position with a relatively high cash allocation in order to seize the opportunities that could arise in the event of market turmoil. Given the persistent outflows, we are also avoiding BB-rated issuers while selectively adding subordinated bonds of insurance companies following their significant underperformance compared with the subordinated bonds of banks.

**Emerging markets: investment-grade and Middle East bonds are gaining**

Strong at first, weak at the end: this is a good way to describe the performance of emerging-market bonds in the third quarter to date. Whereas hopes for a sustained recovery were still prevalent in July, numerous negative events in August pushed the yields of many emerging-market bonds to, or close to, their highs for the year. Growing doubts about the solvency of certain heavyweights like Turkey and Argentina were further fuelled by the sharp rise in current account deficits and the rapidly depreciating currencies. Therefore, emerging markets have become more volatile again. Taking a closer look, however, two factors stand out. First, the investment-grade segment has clearly outperformed the riskier high-yield bonds in the past two months. Middle Eastern countries like the United Arab Emirates and Qatar in particular were completely immune to the negative market trend in certain phases. The second factor lies in the fact that the extremely negative market sentiment in certain cases has hardly led to capital outflows. Whereas the negative market sentiment manifested as substantial capital outflows at the end of the second quarter, capital outflows were nearly unchanged in the month of August. With a view to the fourth quarter, it remains to be seen if the currency component of emerging-market countries becomes calmer. This will require far-reaching economic reforms and constructive cooperation with the IMF in the graver cases. In addition, investors must keep a close eye on the risk of a strong US dollar, especially if US yields rise further.

**Bottom line: emerging markets have the most potential, relatively speaking**

In anticipation of advantageous economic policy developments, the abatement of risks and the waning of US dollar strength, we have a strategic preference for emerging-market bonds. By contrast, the outlook for corporate bonds and safe government bonds in general is not very good due to the imminent cessation of the ECB’s purchasing programme, with the sole exception of US Treasuries, which are exhibiting interesting parameters and are also suitable as a hedge against temporary (geo-)political risks.

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**BB and B-rated high-yield bonds: converging risk premiums**

Development of risk premiums in the European BB and B segment and the difference between the two rating segments

![Graph showing the development of risk premiums and differences between BB and B segments.](image)

**Emerging market bonds: investors brave the stress**

Capital flows into emerging-market bonds have been relatively stable in the third quarter despite negative market sentiment

![Graph showing capital flows into emerging-market bonds.](image)

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Robert Reichle, Head of Emerging Markets Selection

Christian Bettinger, Head of Fixed Income

Martin Mayer, Senior Portfolio Manager Multi Asset

Source: Bloomberg

Source: JP Morgan.
FOCUS ON TRADE CONFLICTS AND IRAN SANCTIONS

Oil price to be determined by the effects of Iran sanctions
After rising sharply in the first half of the year, the price of oil fluctuated widely in the third quarter without rising further. The oil price was weighed down in the summer months by rising OPEC production, worries about weaker oil demand in the US and China, which are embroiled in a trade dispute, and the reduction of speculative positions. Since mid-August, however, the US sanctions against Iran, due to take effect in November, have taken a toll. The pressure exerted by the US on other countries not to purchase any more Iranian oil and worries among petroleum producers that they could be shut out of the US market are already having an effect. Iran’s petroleum exports have been declining since April. A global supply shortage could result from these sanctions because other countries will not be able to offset larger supply outages. Oil prices could rise further in the short term, also considering that hurricane season is not yet over.

Gold has recovery potential
Precious metal prices have fallen sharply since the early summer. The decline in the price of gold can be attributed to the strength of the US dollar, robust US equity markets, and the net sales of ETF investors and financial investors. In addition, the fundamental situation has worsened due to growing supply from mining and recycling coupled with declining demand from central banks and the jewellery industry. Gold is relatively expensive in the domestic currencies of the major buying countries, India and Turkey, and that is slowing demand further. Furthermore, the numerous uncertainty factors have not helped the price of gold, although it normally benefits from uncertainty as a safe-haven asset. However, the price of gold could recover if investors have to cover their extremely high net short positions.

Trade conflicts and growth worries take a toll on industrial metals
The prices of most industrial metals have been declining tenden
tially since June. The combined effect of the escalating trade dispute between the US and China, the other US trade conflicts, and growth worries in China and other emerging-market countries has put downward pressure on prices. The smouldering trade disputes, in particular, could prove to be negative for industrial metals in the coming months as well. Temporary gains are possible because investor positioning, especially that of speculative investors, is already at low levels for some metals such as copper. However, the risks for investors remain high.

Guido Urban, Senior Analyst Multi-Asset Strategy & Research

Iranian oil exports are already declining before US sanctions
The graph shows Iranian oil exports by buyer, in thousands of barrels per day. The demand of customary buyers has been falling since April.

Gold has been adversely affected by speculative positioning
Financial investors have increasingly positioned themselves for a falling gold price in the last few months, contributing to the price decline.

Industrial metals are declining in lockstep with Chinese equities
China is responsible for 50% of worldwide demand for industrial metals. Both Chinese equities and industrial metals have been adversely affected by the trade dispute and growth worries.
TURKEY CRISIS CAUSES MOVEMENT IN CURRENCY MARKETS

The Turkey crisis has rattled the currency markets. Some emerging market currencies in particular have come under considerable pressure, including not only the Turkish lira, but also currencies like the Argentine peso and the South African rand. On the other hand, so-called safe-haven currencies have benefited from the events in Turkey, with the US dollar, the Swiss franc, and the Japanese yen making gains.

Euro comeback delayed
The European single currency has suffered repeated setbacks since April 2018. The trade conflict unleashed by US President Trump and the new Italian government have overshadowed the actually robust eurozone economy and pushed the euro’s exchange rate down. The Turkey crisis has worsened market sentiment even more, although the euro recovered very quickly from the negative headlines. Nevertheless, the overall situation is diabolically complex: the combined effect of the Turkey crisis, lax Italian budget policy, and fears of a hard Brexit will probably prevent the euro from returning to its fundamentally appropriate value above USD1.20 per euro in the foreseeable future. If the economy gets back on track and the said risks are either overcome or lose their importance for market players, the exchange rate will probably rise above 1.20 again. We expect this to happen in the first half of 2019.

Pound afflicted by Brexit discussions
For the pound sterling, the long phase of relative exchange rate stability has come to an end. As we had expected, the exchange rate remained within a range of GBP0.86-0.90 per euro for nearly a year. The resignations of the Brexit Minister David Davis and Foreign Secretary Boris Johnson (among other developments) caused serious irritations in the summer. Theresa May put additional pressure on the pound’s exchange rate in early September when she said there would be no second referendum and therefore no retreat from Brexit. As a result, the value of the single currency rose repeatedly above the level of GBP0.90 per euro, despite the fact that the euro itself is not particularly strong now. At the same time, the UK economy is still not very robust. If our main scenario of a semi-soft Brexit comes to pass, the pound could be expected to stage a moderate recovery. We expect exchange rates to be around GBP0.86 per euro in 2019.

Exchange rate forecasts
The euro could rise in the medium term if the Turkey crisis and worries about Italian budget policy and a hard Brexit dissipate. Dr Jörn Quitzau, Senior-Economist

INTERVIEW WITH DR RUPINI RAJAGOPALAN

Dr Rajagopalan, you moved from the University of Hamburg to Berenberg in March 2018. What was your motivation for this change?
As an academic, I always wanted to put my theoretical knowledge and my research findings about ESG topics into real practical use. When I got the chance to develop and build the ESG capabilities in the second oldest bank in the world and head up the “ESG Office” at Berenberg, I considered it as a great opportunity and honour. Having worked some years in the finance sector before my PhD, I had missed the excitement of being in the industry and close to the market, so I couldn’t wait to be back.

You just mentioned the abbreviation “ESG”. Could you define and explain that term for our readers?
ESG stands for “environmental, social and governance”. “ESG investing”, in essence, is a term that is used synonymously with “socially responsible investing”, “sustainable investing”, and even at times “impact investing”. ESG investing means portfolio managers aiming to incorporate ESG factors (e.g., climate change, human rights, executive pay) into investment decisions, to better manage risk and generate sustainable, long-term returns. Overall, there is growing momentum in the financial community to integrate such ESG factors, so as to better understand company performance and behaviour.

At Berenberg you are in charge of the “ESG Office”. What is behind it and what are your tasks?
An “ESG Office” takes care of all tasks related to ESG topics. At Berenberg the ESG office was created in March 2018 to bundle existing competencies in these fields. Berenberg realises the growing importance of ESG matters and is increasing its efforts to integrate ESG aspects into asset management. Sustainable investing has been growing rapidly in the last few years. My overarching responsibilities include driving our ESG policy and strategy, supporting our ESG investment positioning, increasing our ESG product offering, and streamlining our ESG capabilities. I am very proud to say that, as of August 2018, Berenberg is a signatory of the UN-supported “Principles of Responsible Investment” (PRI), which further affirms our commitment to responsible investment practices.

What does your working day look like with all these different tasks?
In the last six months, each day has been exciting! As I am developing the ESG office, every day is different and sometimes challenging. On some days, it involves speaking to everyone in the bank from our wealth management team, our portfolio managers and even our support functions to make sure that our understanding of ESG is commonly shared and to create our various ESG policies. On other days, it involves working on ESG requests for investment proposals with the different teams from equities, bonds and multi-asset. Here, I perform research on the suitability of companies: whether they are ESG-compliant as a portfolio investment. This also means the daily check of ESG controversy reports on companies. The most exciting initiative at the moment, on which I am working together with colleagues, is the writing of our very first ESG white paper, which is related to the perceptions of sustainable investing.

You are sitting right next to portfolio managers and product specialists in Asset Management. What are the advantages of this?
Usually, ESG teams do not sit directly within Asset Management. For me, being able to interact with portfolio managers and product specialists on a daily basis is a big advantage. It means that I am able to build our ESG framework, taking into account the views and suggestions of all stakeholders. Due to this close proximity, I often have open discussions surrounding ESG topics. I believe this structure allows the ESG office to be fully integrated within the Asset Management Division.

How do you define ESG-compliant investments? How does Berenberg’s Asset Management view this?
I believe there are many ways one can consider investments to be ESG-compliant. One way is the use of negative screens, which means excluding companies that are engaged in non-ethical business. This can differ according to one’s own ethical perspective. Berenberg generally excludes cluster bomb producers, landmine producers, and investments in agricultural commodities. For our
sustainable offerings, we do also have additional exclusion criteria such as tobacco, pornography, firearms, etc. The other way would be making sure to invest in companies that do not violate certain principles, for example the UN’s Global Compact principles on human rights, labour, the environment, etc, or even not investing in companies involved in severe controversies. However, to me, the most important part is the actual integration of ESG issues into our investment process.

There is much talk about ESG investment criteria. What do they really mean and how does Berenberg Asset Management implement them? Do you still have challenges ahead?

As I mentioned previously, one part of being ESG-compliant is looking at exclusion criteria and severe controversies. However, the other part is actually integrating ESG. This is what Berenberg intends to do. It means analysing ESG information of companies using ESG scores or data (on top of traditional factors) to identify potential ESG impacts and risks on company and even country performance. On the other hand, part of ESG integration also involves engagement on ESG issues with companies. One of the challenges I face involves the ESG data provided. Though there are numerous providers of ESG data, I feel there is still a lack of good quality ESG data, especially for small and mid-cap companies.

Aren’t sustainability criteria more of a “feel-good component” for soothing consciences, if each provider defines them differently?

In the past, sustainability was indeed often felt as investments that are only for a “feel-good” factor. However, times are changing. More and more people are embracing sustainability and are using ESG factors when choosing their stocks and funds. It is only a matter of time before so-called “mainstream” investors also embrace ESG fully. We are definitely seeing a stronger push in this direction. Even though each provider might define ESG differently, especially when it comes to ESG scoring, the foundation of ESG is the same. The use of ESG data is to enable investors to examine companies’ strategies and even their governance structures, including examining management quality.

Don’t these criteria reduce the return opportunities for investors?

It is a common misperception that investing in ESG-related investments reduces returns. The whole idea of ESG is to have sustainable, long-term investment returns. There has been increasing evidence that companies that deliver good returns are those that actually put more effort into their own ESG issues. George Sarafeyim, a professor from Harvard, has said that “Sustainable companies outperform over the long term because they are better at adapting to a changing world”. I agree with that statement, as ESG is about understanding how companies are adapting to a transformational change, especially in the current shift to a low-carbon economy.

What opportunities does Berenberg offer for ESG-investments?

Berenberg has been managing sustainability mandates from churches and foundations since 1948. We offer several multi-asset strategies and the mutual fund Berenberg-1590-Stiftung that invest according to pre-defined ESG criteria. Moreover, we offer bespoke mandates for clients that have individual investment restrictions or sustainability beliefs. We are proud that we launched our first ESG bond fund in January. The Berenberg Sustainable EM Bonds fund is managed by our quantitative portfolio management team in Hamburg. Looking forward, we plan to expand our ESG-compliant fund offering.

What should investors pay attention to when selecting sustainable financial products?

With the continuously growing number of sustainable financial products, choosing the right one is getting harder. Moreover, I believe it is very important that sustainability is not the only criterion in selecting individual securities or funds. Sustainability should rather be an additional criterion complementing a sound fundamental and economic analysis. Thus, when choosing a sustainable financial product, you have to first decide if you want it to tilt toward environmental, social or governance issues, or all three equally. You have to understand your ESG investing purpose: is it more of an ethical or a thematic approach (eg, focused on renewable energies, etc). If you are choosing an ESG manager, understand how they evaluate the companies from an ESG perspective: for example, if their ESG investment approach is based on quantitative scoring only or a qualitative decision.

BIOGRAPHY

Dr Rajagopalan has headed Berenberg’s ESG Office since March 2018. She supports the portfolio managers in the further development of our range of sustainable investment products. Before joining Berenberg, she was a junior professor of business administration, particularly social investing, at the University of Hamburg. Dr Rajagopalan holds a PhD in finance from the University of Reading (UK).
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