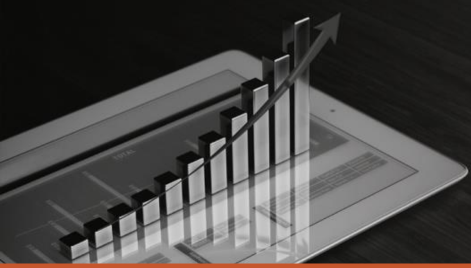

BERENBERG
Funds and Solutions

A golden age for active and multi-asset

Over the past decade, investors have increasingly turned to equities as falling interest rates have made bonds more and more unattractive. Meanwhile, commodity prices have also been in a steady decline following the commodity super-cycle that came in the wake of the opening of China's economy and increasing globalisation at the beginning of this century. Many successful multi-asset funds have consequently had an increased equity allocation in recent years and often focused on managing this share of the portfolio relative to the cash ratio.

COVID-19, war, de-globalisation, the fight against climate change, demographic change and the implemented interest rate turnaround are now causing a realignment of markets that is calling into question many of the patterns and strategies of the past decades. Even if the acute problems are overcome, an environment comparable to that of the past decades is not to be expected. Investors must be prepared for this. We are convinced, therefore, that we are at the beginning of a golden decade for "true" multi-asset portfolios, that is, an active and broad diversification across all asset classes. We identify the following three main reasons for this.

- The starting point for "true" multi-asset portfolios is more favorable than it has been for a long time, with cheaper equity valuations, higher interest rates and risk premia on bonds, and the onset of a commodity super-cycle.
- Higher inflation over the medium term, and especially higher inflation volatility, requires broad diversification across asset classes, segments and regions, as well as flexibility across all assets.
- Changes in market structure and behaviour offer increased opportunities across all asset classes.

We believe that the focus of investors should, therefore, shift from equities and the tactical management of equity exposure to a broad positioning in order to exploit the return and diversification opportunities of all asset classes. Especially as we also expect that government bonds and equities will not quickly find their way back to the negative correlation of the last two decades.

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- ► Insights
  - Equities
  - Fixed Income
  - Multi Asset
  - Risk-focused solutions
  - Sustainability
  - Consulting

*Within **Insights** we provide you with a deeper understanding of our investment philosophy and thinking.*

Starting point for multi-asset portfolios is better now than for a long time

Equities, bonds and commodities offer positive expected returns over the coming years – and these are closer together than they have been for a long time.

While bonds and commodities were not very attractive alternatives to equities for a long time, all three asset classes now seem similarly interesting to us. On the one hand, this is due to the fact that the prospects for bonds and commodities have improved significantly. On the other hand, it is also since no significant increase in valuations is expected for equity markets in the coming years. We think that there are two reasons for this. On the one hand, we should not assume that interest rates will fall significantly again in the medium term and thus boost equity valuations. Second, in an environment of increased inflation volatility, we expect shorter, stronger and more erratic economic cycles, which is why investors demand a higher risk premium. Without a widening of valuations, however, the potential for equity markets thus corresponds at best to aggregate earnings growth, which is unlikely to be accelerated by a widening of margins in view of currently record-high profit margins. On the contrary, higher corporate refinancing costs, higher wage inflation and perhaps at some point higher corporate taxes for the purpose of reducing government debt are likely to put pressure on profit margins.

At the same time, we do not expect a significant valuation squeeze either. The share of non-fundamental equity investors (e.g., ETF savings plans, systematic strategies) has risen significantly in recent years and is likely to increase in the coming years. In our view, this should mean that valuation ratios will not fall significantly. After all, regardless of pandemics, war and inflation figures, billions flow passively into equity markets every month via retirement savings.

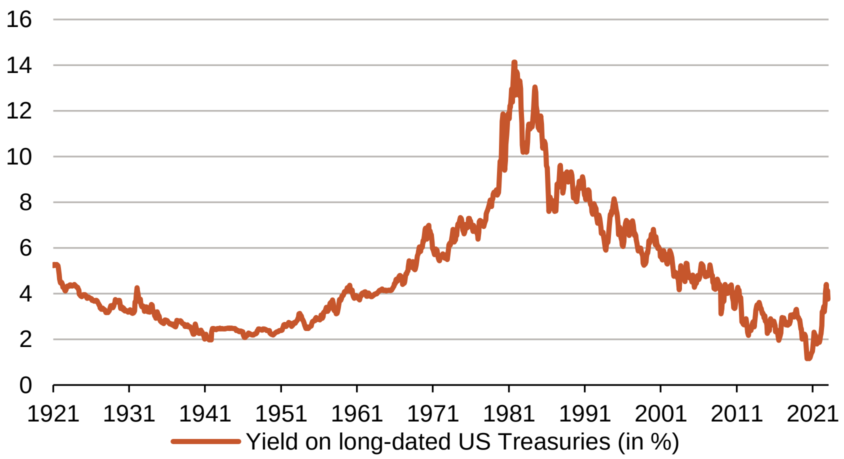
For equities, we expect neither a significant valuation expansion nor a valuation contraction in the medium term.

In the case of bonds, it is clear that interest rates are back. The volume of globally outstanding bonds with negative yields has fallen from a level close to EUR16trn in the years 2019-2021, to zero at the beginning of 2023. Currently, almost all outstanding global bonds have positive nominal yields again. The turnaround in interest rates seems to be complete, and inflation and interest rates have probably bottomed out in recent years. Above all, however, interest rate trends do not run for months or years, but for decades (Fig. 1). Particularly in conjunction with the sometimes still above-average risk premiums, corporate and emerging market bonds once again offer an investment alternative to equities. A comparison of the average dividend yield of European equities with the yield of European bonds – both government and corporate – shows that bonds are more attractive relative to equities than they have been since 2008. The yield on high-quality (investment grade) corporate bonds significantly exceeded the dividend yield in Europe in early 2023. Yields on corporate and emerging market bonds, on average, are also likely to more than compensate for higher inflation over the medium term – unlike many government bonds.

The interest rate reversal is complete, rates are back. Bonds, therefore, offer an alternative to equities again.

Commodity prices develop in long cycles, which is particularly due to the fact that an adjustment of supply to a change in demand is only possible with a time lag of many years. Therefore, the behaviour known in economics as the "hog cycle" occurs – phases of oversupply with low prices and little investment activity on the supply side are followed by years of supply shortages when demand picks up, which causes significant price rises. Figure 2 (overleaf) illustrates the historical super-cycles triggered, for example, by industrialisation towards the end of the 19th century, rearmament during the Second World War, or the opening of the economies of China and India – and the subsequent wave of globalisation – at the beginning of the 21st century.

Fig. 1: The long-term interest rate reversal seems to be complete



Source: Haver Analytics, Bloomberg.
Time period: 01/01/1921 – 31/12/2022.

In our view, we have been in the first phase of a new commodity super-cycle since 2020.[1] A lack of investment on the supply side for both industrial metals and energy commodities in the last decade, recently exacerbated by the supply restrictions caused by Putin's war of aggression on Ukraine, is meeting with structurally rising demand from the growing world population, the expanding middle class in emerging markets, de-globalisation and, above all, the energy transition. These megatrends require high investments and cause a race for scarce raw materials. For example, inventories of industrial metals have continuously shrunk in recent years, despite weak global growth, while prices have risen at the same time. The fact that, unlike in the past, the majority of commodity futures are in so-called backwardation – i.e., prices for deliveries further in the future are lower than prices for near-term delivery – also reflects the tight supply/demand balance of many commodities, despite the current gloomy economic situation.

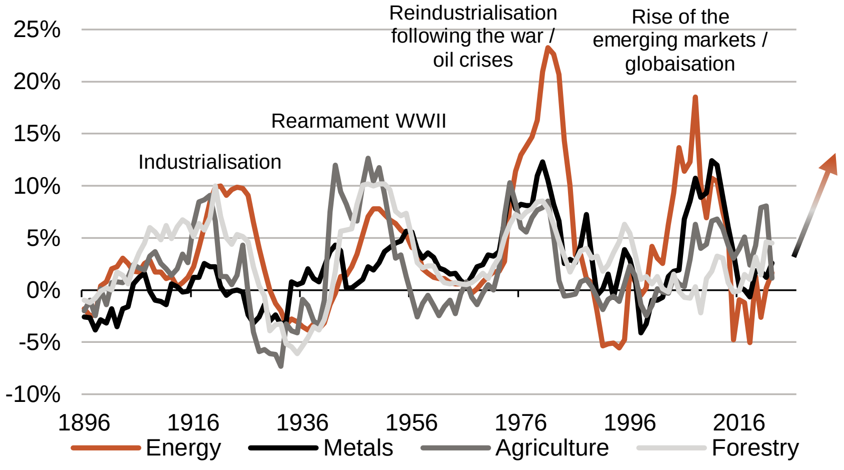
Commodities are in the first phase of a new super-cycle – a lack of investment and supply constraints meet structurally rising demand.

Therefore, we believe that all asset classes offer positive return expectations for the coming years and these are closer together than they have been for a long time, especially when viewed on a risk-adjusted basis. A broad, balanced positioning for the risk-reducing use of all diversification advantages thus seems more sensible than ever and should not weigh on the achievable returns.

A broad positioning for the risk-reducing use of all diversification advantages seems to make more sense than ever before.

Fig. 2: Commodity super-cycle intact and accelerating

Rolling annualised 10-year percentage change in prices of commodities from the energy, metals, agriculture and forestry sectors.



Source: Statistics Canada, own calculation.
Time period: 01/01/1895 – 31/12/2022, annual data.

[1] See "Industrial metals – at the beginning of a new super-cycle", Berenberg Markets Focus, 13 April 2021, and "The industrial metals super-cycle has accelerated, not slowed down", Berenberg Markets Focus, 11 August 2022.

Future higher inflation volatility requires broad diversification and flexibility across all assets

Inflation volatility is likely to remain elevated over the next decade...

The inflation hump seems to be over – inflation in the US and the Eurozone is on the retreat (for now). However, investors should not succumb to the illusion that we will quickly return to a low-inflation environment. In the coming years, we can expect not only higher inflation on average, but also increased inflation volatility (Fig. 3).[2] This is mainly due to longer-term supply constraints for commodities, deglobalisation and demographic developments that are likely to lead to increasing labour shortages. These should ensure that inflation picks up quickly with a recovery in growth. For if the economy recovers, both commodity prices are likely to rise again quickly and labour markets are likely to tighten again quickly. Renewed upward pressure on inflation, therefore, seems inevitable.

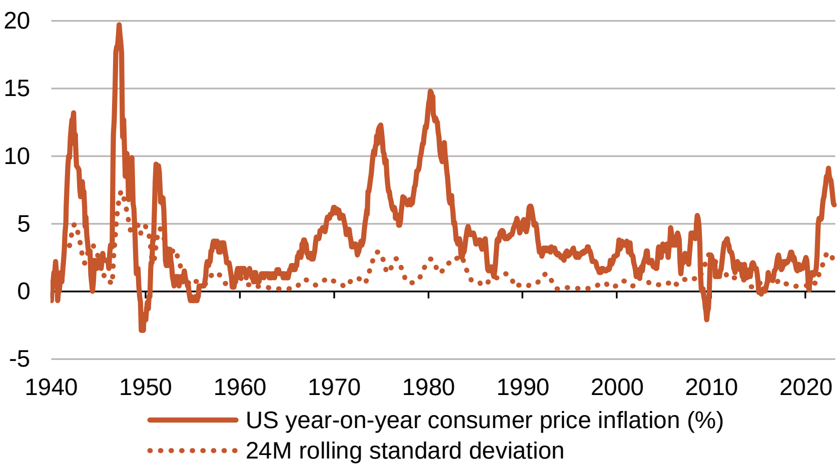
...which should be accompanied by shorter and sharper economic cycles.

The consequence of stronger movements in inflation is likely to be stronger and faster monetary policy cycles and thus shorter, more pronounced and more erratic economic cycles. This environment would not be entirely dissimilar to the 1960s and 1970s, in our view. The result of this is increased planning uncertainty weighing on valuations as investors then legitimately demand a higher reward for the risks taken. This should also lead to increased volatility across all asset classes. The experience of the 1970s shows that the long-term potential for equity markets in such an environment is limited. However, it is worth noting that there were three bear markets and three bull markets of significant magnitude during those years. For active investors, there were significant return opportunities during this phase, while static index investments would have lost value in real terms during this period.

With increased inflation, the synchronisation between equities and bonds also increases.

Another major consequence in such an environment is a stronger synchronisation of risk assets and safe havens, as well as a lower synchronisation between risk assets such as equities and commodities, but also between equity regions.[3] The long-term relationship (Fig. 4, overleaf) effectively demonstrates that the synchronisation

Fig. 3: Inflation and inflation volatility likely to remain high this decade
US consumer price inflation over time.



Source: Bloomberg, own calculation.
Time period: 01/01/1940 – 31/01/2023, annual data.

[2] See "What comes after the inflation hump? Implications for investors" Berenberg Markets Focus, 3 November 2022.

[3] See "Stronger synchronisation of equities and government bonds is also likely to shape the coming years", Berenberg Markets Focus, 30 August 2021.

between equities and bonds increases with higher inflation. Historically, when core inflation is above 3%, a positive correlation between equities and government bonds has been almost exclusively observed. When correlation increases, diversification through bonds decreases. This means that multi-asset portfolios that rely purely on equities and bonds will have a more difficult time in this environment. Consequently, broader diversification is needed. Figure 5 illustrates the low correlation of commodities with equities or government bonds, on average. The developments in 2022 effectively demonstrated this. Investors should therefore consciously leverage the diversification effect between risk assets and do so across all asset classes, segments and regions ("true multi-asset").

A strong focus on real assets remains appropriate.

Moreover, we believe that a strong focus on real assets remains appropriate against the backdrop of high government debt in both the US and Europe, as higher inflation rates are likely to be further leveraged by governments to reduce debt through financial tightening. This is achieved by the real interest rate on government bonds either remaining negative or, at least on average, not keeping pace with real growth. So, in this respect, too, commodities, especially precious metals, seem opportune alongside equities. Higher inflation volatility in the coming decade thus harbours risks for the capital markets, but also opportunities, especially for flexible multi-asset investors.

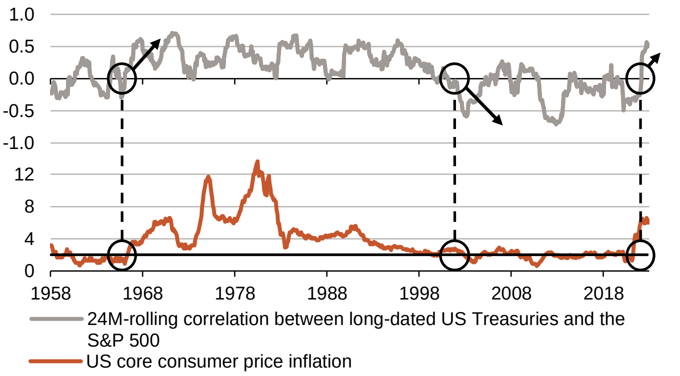
Changed market environment offers increased opportunities for flexible investors in all asset classes

Structural trends have changed market behaviour since the financial crisis.

Many structural trends have significantly changed the market structure and behaviour since the global financial crisis.[4] From our point of view, in addition to the stronger synchronisation of risk assets and safe government bonds, two other developments in particular are in focus: (1) increasingly passive investing and the growing dominance of derivatives markets and (2) increased procyclical behaviour of many investors, especially systematic investment strategies, with at the same time less anti-cyclical value investors.

Fig. 4: Higher inflation historically led to stronger synchronisation of risk assets and government bonds

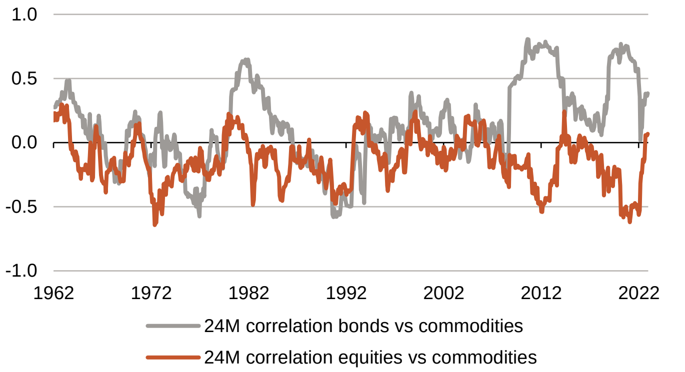
24M rolling correlation between long-dated US government bonds and the S&P 500 Index and path of US core consumer price inflation.



Source: Bloomberg, own calculation.
Time period: 01/01/1958 – 31/12/2022.

Fig. 5: Commodities offer a real diversification benefit in a multi-asset context

24M rolling correlation between commodities and long-dated US government bonds and between commodities and the S&P 500 Index.



Source: Bloomberg, own calculation.
Time period: 31/01/1962 – 31/12/2022.

[4] See " Attention risk: the vulnerability of the markets is growing", Berenberg Markets Focus, 11 October 2018, and "How Black Swans Became a Plague", Berenberg Markets Focus, 20 April 2020.

1. **Increasingly passive investing and increasing dominance of derivatives markets**

Index funds and ETFs already control an estimated 30-40% of the US equity market and the trend towards passive investments continues unabated, especially in equities.[5] The greater the passive penetration of the market, the higher the correlation of individual stocks and the more volatile the markets. The increasing volume in the derivatives markets, especially in the case of index derivatives, further amplifies the effects of passive investing. Over the past 20 years, large indices such as the S&P 500 have witnessed an increasingly uniform movement of all stocks. Daily movements are, therefore, becoming increasingly strong. Consequently, realised volatilities have been significantly higher, on average, in the last 20 years than in the 50 years prior (Fig. 6).

Increased synchronisation of individual stocks has led to increased index volatility in recent years.

With increasing option volumes, the influence of the options markets on the cash markets is also increasing. Option expiration dates and positioning in the options market are gaining in importance. In recent years, the markets have often experienced a turning point at the end of a quarter – i.e. on the key option expiration dates (and the key rebalancing dates of US pension funds, for example[6]). In our view, clear examples of this were in December 2018, March 2000, December 2021, June 2022 and September 2022.

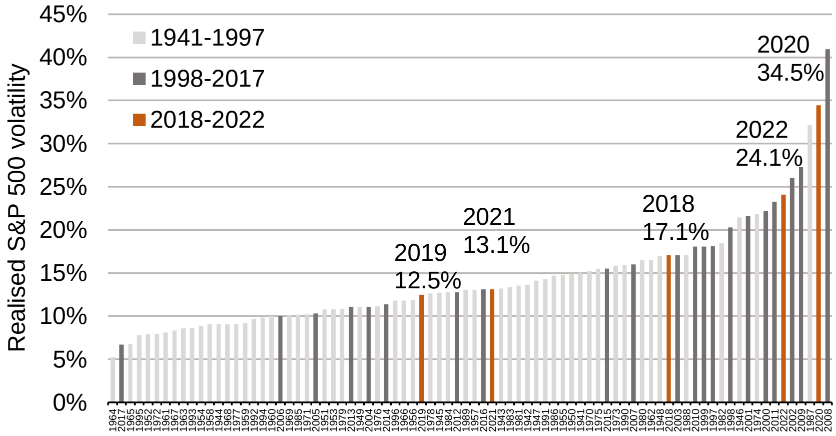
2. **Increased pro-cyclical investor behaviour**

The share of pro-cyclical investment strategies has increased significantly due to the enormous growth of index funds and the development of systematic strategies (e.g., robo advisors). Momentum, risk parity and target volatility approaches also do not consider fundamental valuations in their investment decisions and often invest mainly in index products. Simply put, they increase the equity exposure when momentum is positive and volatility is low, and reduce it when momentum decreases and volatility increases. They therefore

Pro-cyclical strategies amplify upward and downward exaggerations.

Fig. 6: Volatility of large stock indices increases

Sorted annualised standard deviation of daily returns of the S&P 500 Index by calendar year since 1941.



Source: Bloomberg, own calculation.
Time period: 01/01/1941 – 31/12/2022.

[5] See "Passive investments change market structure and market behaviour", Berenberg Markets Focus, 5 May 2021.

[6] See "The rising influence of target date funds on markets", Berenberg Markets Focus, 14 September 2022.

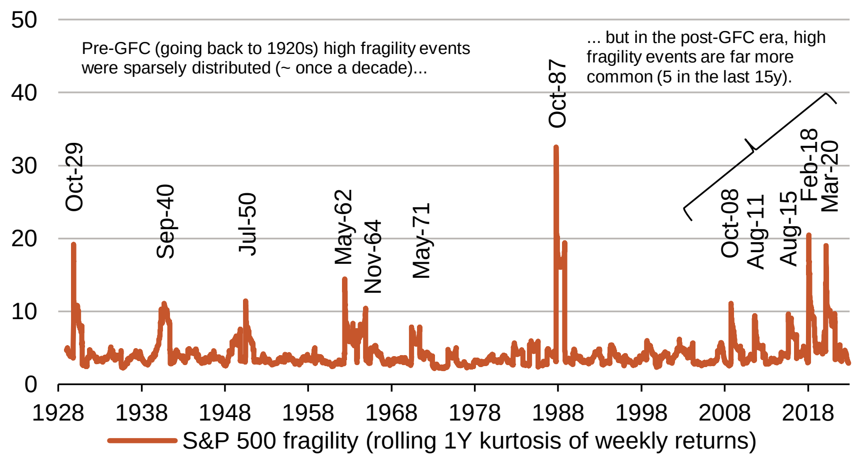
behave very pro-cyclically and amplify trends upwards and downwards – there are more exaggerations and deteriorating liquidity. As an active investor, one can track the equity exposure of these rule-based strategies and thus assess the vulnerability of the markets. When most of these strategies are almost fully invested in equities, the downside potential for markets is higher, such as in early and mid-2018 and early 2020. For this reason, we monitor the positioning of these strategies very closely.

In this changed market environment, with increasingly sharp movements and regular fluctuations (Fig. 7), both upwards and downwards in all asset classes, investors should be able to act flexibly, recognise opportunities and leverage degrees of freedom – also anti-cyclically and away from the benchmark. This, as well as the need to diversify broadly and look for investments with a hedging character outside of government bonds, speaks for the construction of true multi-asset portfolios.

Felxibility and broad diversification are trumps in this new market environment.

Fig. 7: Number of extreme market movements increases

Kurtosis is a measure of the kurtosis of a distribution. A distribution with a high kurtosis has so-called "fat tails", i.e. high or low values (here weekly returns) occur more frequently.



Source: Bloomberg, own calculation.
Time period: 01/01/1928 – 31/12/2022.

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IMPORTANT NOTICE

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