HORIZON

The Berenberg Capital Market Outlook · Wealth and Asset Management

RECESSION FEARS

Economic woes increasingly dominate inflation fears. Markets are increasingly pricing in a recession, while inflation expectations are falling.

SENTIMENT LOWS

Sceptical sentiment, low positioning and more attractive valuations suggest a bottoming out. But a recession, lower profits and the withdrawal of liquidity are still looming. Final sell-off therefore not ruled out.

SURPRISE EFFECT

With easing supply constraints, declining inflation and less restrictive tones from central banks overly pessimistic investors may be surprised.

Q3 | 2022

BERENBERG

PARTNERSHIP SINCE 1590

FOREWORD

Prof Dr Bernd Meyer
Chief Investment Strategist

Dear reader,
Will the inflation and yield shock be followed by the growth shock? Putin's war and the COVID-19 lockdowns in China have further fuelled inflation. Markets expect central banks to tighten ever faster – and the banks do not contradict them. Bond yields are rising, weighing on markets and, together with the loss of real purchasing power, on growth expectations. A slowdown in economic growth is already evident. But are we heading for mid-cycle weakness or recession? Markets are increasingly assuming the latter and consider a recession much more likely than the current economic data indicate. Our economists now also expect a recession for Europe and the US.

However, stock market developments are already anticipating a sharp decline in the global manufacturing purchasing managers' index from 52.4 at the end of May to well below the 50 growth mark. The price-earnings ratio of equities is below the 30-year average in the US and even well below in Europe. Sentiment and positioning are very pessimistic across the board. Many investors could be caught on the wrong foot if a recession is avoided or is very mild. We believe that equities could bottom out in the second half of the year. For the time being, however, economic data are likely to deteriorate further and earnings expectations will be reduced. Volatility is therefore likely to increase rather than decrease in the third quarter.

The future mix of growth and inflation is difficult to assess. What happens next depends largely on the robustness of the consumer and the persistence of inflation. These are likely to determine the US Federal Reserve's policy from here. An end to China's COVID-19-lockdowns or Putin's war would also lead to fewer economic and probably inflation concerns – even if China's opening is likely to lead to a surge in demand for commodities. Fewer supply bottlenecks would also help the industry-heavy eurozone. There should also be signs of declining, albeit still high, inflation in the second half of the year. Central banks could then send less hawkish signals with less inflation and growth. The rise in bond yields should then slow down markedly. Therefore, we think it would be wrong to completely subscribe to the widespread pessimism and miss a possible market recovery. Even if the situation remains opaque and volatile in the short and medium term, and it may still take a final capitulation by investors to approach or surpass the old lows, we remain constructive for the long term. We therefore have a balanced position, slightly underweight equities, with broad and global diversification

In the Insights interview starting on page 14, I discuss which developments are making this year so complicated for investors and which of them are likely to be structural. Investors should adapt their behaviour to these. I hope you enjoy reading this issue of Horizon.

CONTENTS

Multi-asset strategy — Page 3
Markets in the wake of recession fears

Economics — Page 6
Putin, China, Fed, inflation: mild recession ahead

Equities — Page 8
Volatility more likely to rise than fall in Q3

Bonds — Page 10
Isolated glimpses of light in the valley of tears

Commodities — Page 12
Lack of supply everywhere one looks

Currencies — Page 13
Euro rate: no land in sight

Berenberg Insights — Page 14
Interview with Prof Dr Bernd Meyer

Publishing information — Page 16

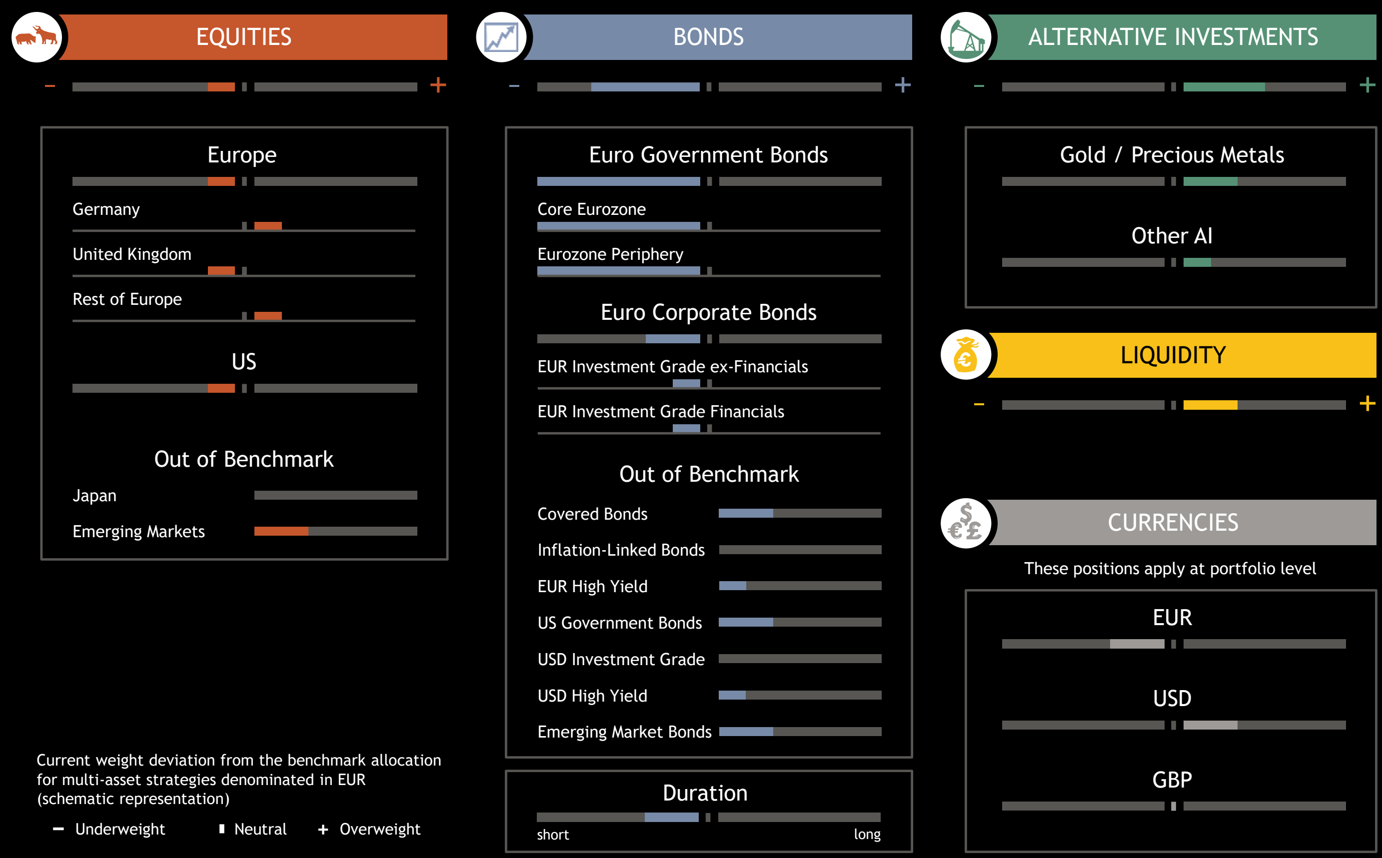
MARKETS IN THE WAKE OF RECESSION FEARS

IN A NUTSHELL

- Uncertainty about growth and inflation is higher than ever before. Economic woes increasingly dominate over inflation fears. A recession in the US and the Eurozone is becoming increasingly likely.
- Investor sentiment and positioning are very pessimistic. Markets are already pricing in significant economic weakness, but not yet a full-blown recession.
- China's opening up, fewer supply bottlenecks, declining inflation figures, slower interest rate hikes and more stable bond yields would be developments that would support a bottoming out of equities in the second half of the year.

Portfolio positioning at a glance

We took advantage of the market correction after the start of the war at the end of February/beginning of March to raise our equity quota back to a slight overweight. We were thus initially able to profit from the market recovery at the end of March. However, the market environment in Q2 became increasingly difficult. In view of the advancing war, the COVID-19 lockdowns in China and rising inflation, we took advantage of small market recoveries to reduce the equity exposure to below neutral. We also increased the position in the tail hedge certificate and with yields becoming more attractive again, built up an initial position in US Treasuries as a hedge in the event of a recession. We also see many risks in the short and medium term. In the long term, however, the opportunities dominate for us, especially in view of the pessimistic sentiment and positioning at more attractive valuations. Therefore, despite the high uncertainty, we are not positioned too defensively. In equities, we prefer emerging markets to the US and Europe. We continue to favour alternative investments, especially gold and other commodities, over bonds, even if the latter have become somewhat more attractive as yields have risen.



Review of second quarter: a perfect storm

The recovery in equity markets at the end of March did not last long, as inflation fears continued to rise with the COVID-19 lockdowns in China. Just in time for the beginning of the second quarter, 10-year real yields in the US surpassed their pre-war highs, rising from -0.4% to +0.8% by mid-June, as expectations of interest rate hikes continued to rise. This was again a heavy burden on all financial assets and especially on interest-sensitive growth stocks and bonds. As in the first three months of the year, equities and bonds fell simultaneously and to the same extent in the second quarter. Globally, value stocks outperformed growth stocks by more than twelve percentage points. With recession fears emerging in Q2 and especially weak economic data from China, industrial metals gave back some of their Q1 gains and gold also only moved sideways in the face of rising real yields and US dollar appreciation. Q2 was accordingly even more difficult for multi-asset investors, with all assets except cash, energy commodities and energy stocks losing value – diversification was almost non-existent – and investors almost unable to escape the downtrend anywhere.

Economic outlook: uncertain as seldom

Uncertainty about growth and inflation is higher than ever before. Economic data continued to surprise positively heading into May, only then showing more signs of cooling. The Q1 reporting season of companies in the US and Europe also surprised positively on average. Only towards the end of May did reporting from US retail companies cause more concern. The burden on consumers from the real loss of purchasing power, also reflected in low consumer confidence, began to show more and more. We are now likely to see a period of weak economic data and reductions in earnings expectations. Market consensus is increasingly betting on an immediate recession and our economists also expect a decline in economic output in the US and Europe following the Fed's aggressive response to the rise in US inflation to 8.6% in May and the renewed rise in gas prices in Europe.

Economic slowdown or recession? Crucial for markets

Inflation and monetary policy remain the dominant themes. However, a sharp rise in interest rates is already priced into the market. Moreover, the US Fed seems to have convinced markets that it will fight inflation, even if it means a significant drag on growth. Recession fears have therefore taken over the baton from inflation fears. This can be seen in the clear outperformance of defensive over cyclical equities and in the fact that medium- and long-term inflation expectations in the US have already been falling again since the end of April (top chart, p. 5). Markets are already betting on a more pronounced economic slowdown and are pricing in more than just a downturn. For example, equity market performance is already anticipating the decline of the global manufacturing purchasing managers' index to a level well below 50 (middle chart). If there are positive surprises, if a recession is avoided or is mild, the stock markets should find a bottom in the second half of the year. However, if a full-blown recession does occur, equities would probably slide even further, mainly because of high valuations and low interest rates at the beginning of the correction.

Q1 trends largely continue in Q2: oil & US dollar up, bonds and equities down! But Europe held up better than America

Total return	YTD and in Q2 22 (in %, in EUR): YTD (31/12/21-14/06/22)	Q2 22 (31/03/22-14/06/22)	12-month periods of the last 5 years (in %. in EUR): 14/06/21 14/06/22	14/06/20 14/06/21	14/06/19 14/06/20	14/06/18 14/06/19	13/06/17 14/06/18	CAGR* 13/06/17 14/06/22	Std. dev.* 13/06/17 14/06/22
Brent	85.6	25.8	126.9	68.7	-37.2	-12.0	54.9	26.8	39.3
USDEUR	9.2	6.2	16.3	-7.1	-0.4	3.2	-3.1	1.5	6.7
Gold	7.9	-0.8	12.8	0.0	28.6	6.3	-0.4	9.0	12.6
Euro Overnight Deposit	-0.3	-0.1	-0.6	-0.5	-0.4	-0.4	-0.4	-0.5	0.0
MSCI EM	-8.8	-4.6	-12.4	32.6	-0.6	-4.0	9.8	4.0	16.6
Stoxx Europe 50	-9.1	-7.2	-1.4	24.3	-3.9	3.7	1.0	4.3	16.5
EUR Sovereigns	-9.6	-6.3	-10.2	0.9	1.0	3.4	-0.5	-1.2	2.5
EM Sovereigns	-11.0	-4.5	-5.9	0.2	1.7	14.0	-6.7	0.4	8.1
US Sovereigns	-11.9	-6.7	-11.2	-3.4	11.0	7.4	-1.4	0.2	4.0
EUR Corporates	-13.0	-8.1	-13.6	3.7	0.4	3.9	0.4	-1.3	2.8
S&P 500	-13.7	-12.0	3.6	31.7	7.2	9.9	12.0	12.5	20.9
DAX	-16.2	-7.7	-15.1	31.2	-1.2	-7.7	2.7	0.8	20.2

Time period: 13/06/2017–14/06/2022
Source: Bloomberg * CAGR = annualised return (in %, in EUR); Std. dev. = annualised standard deviation (in %, in EUR).

So far no outflows in equity funds and a lot of dry powder

In the first quarter, investors had reallocated from bonds and money market funds into equities and commodities, and funds in the aggregate had recorded inflows. In the second quarter, bond and money market funds in particular recorded outflows (lower chart). Outflows from equity funds were only observed in April. Most recently, there were even inflows again. There is still USD 4.6 trillion in US money market funds, closed-end funds have a record USD 3.5 trillion of uninvested capital and systematic investment strategies are only very lowly positioned in equities. This offers potential for a recovery if there are positive surprises compared to the very pessimistic sentiment. In the short term, however, uncertainty remains high and the fact that equity funds have not been sold on a large scale so far poses a risk in the event of a full-blown recession. In this case, a final sell-off, panic and capitulation would be needed for a bottom to be reached.

Where do we see opportunities for positive surprises?

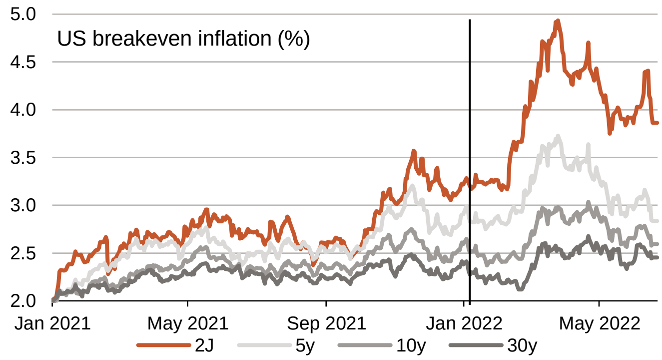
An opening in China, also against the background that head of state Xi Jinping is seeking to be elected for a third term in November, could bring an improvement in supply bottlenecks. This should then favour the decline in inflation and interest rate fears should then ease, especially with weakening growth. After the foreseeable further interest rate steps over the summer by the Fed and ECB, they could send less hawkish signals from October and slowdown interest rate hikes. The rise in bond yields should then also slow down noticeably.

Overall, in the still uncertain environment – with the coming withdrawal of liquidity through the reduction of the Fed's balance sheet, interest rate hikes, war and the weak newsflow expected for the coming months – broad diversification and a balanced positioning remain important for us, with a clear focus on real investments such as equities or commodities. The loss of purchasing power in nominal investments should not be underestimated.

Prof Dr Bernd Meyer, Chief Investment Strategist

Inflation expectations are falling! Has the Fed convinced markets?

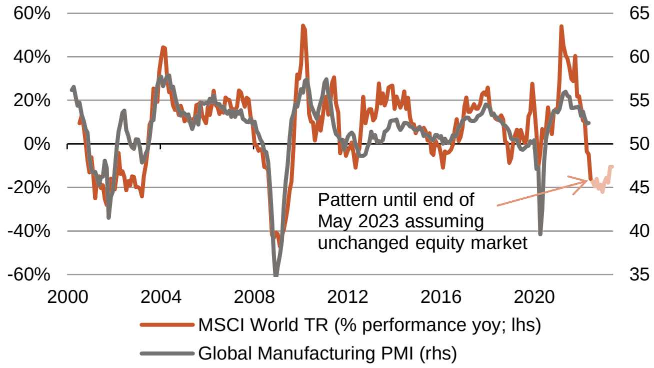
Longer-term inflation expectations, priced into inflation-indexed bonds, have fallen to year-ago levels since the end of April.



Time period: 01/01/2021-20/06/2022.
Source: Bloomberg.

Stock market already pricing in significant economic slowdown

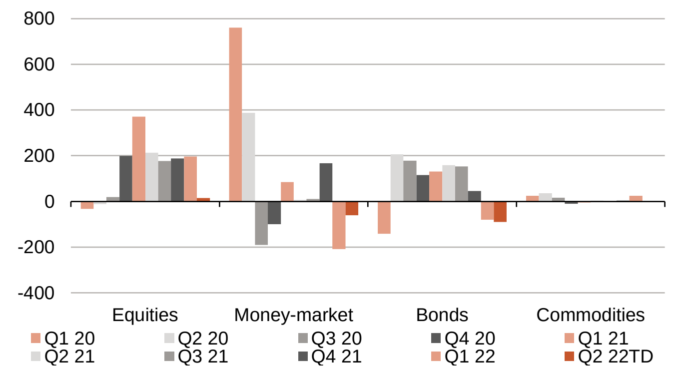
The correction in global equities is already anticipating a decline in the global manufacturing purchasing managers' index (PMI) to well below 50 (May: 52.4).



Time period: 01/01/2000-31/05/2023; Status: 20/06/2022.
Source: Bloomberg, own calculations.

No equity fund outflows in Q2 after notable inflows in Q1

Global fund flows by asset class in billions of US dollars. Investors continue to sit on a lot of liquidity.



Time period: 01/01/2020-15/06/2022.
Source: Bank of America, own calculations.

PUTIN, CHINA, FED, INFLATION: MILD RECESSION AHEAD

IN A NUTSHELL

- Putin's war and new supply chain bottlenecks are hitting the economy hard, consumers more than businesses. In Europe, high gas prices are a particular burden.
- Central banks react to inflation, US Fed much more than ECB, which does not have to fight home-made inflation.
- Recession likely, but it could remain mild.

Europe: Stagflation now, mild recession in autumn and winter

The spike in energy, food and key commodity prices following Putin's brutal attack on Ukraine is hitting the economy hard. The strong rebound in economic output in the Eurozone that began to emerge in February as the pandemic omicron wave subsided is being held back by the inflation shock and renewed supply bottlenecks as a result of Chinese lockdowns. With exceptionally high inflation, economic output in the Eurozone and the UK may have declined slightly in the second quarter.

There is a threat of further upward pressure on prices in the coming months. Unlike with oil, the high gas prices have probably not yet fully reached households, as electricity and gas suppliers are only gradually adjusting their sales prices to the market situation. After Russia cut its gas supplies through the Nord Stream 1 pipeline in mid-June, the price pressure increased once again. Apparently, Russia has earned well from higher oil and gas prices so far this year, despite lower sales volumes. Putin may believe he can afford to restrict gas supplies to Europe. Since gas – unlike oil – is mostly tied to pipelines and thus cannot be quickly replaced by other suppliers on the world market, gas prices in Europe are thus likely to be even higher than we had previously expected, even if a complete gas freeze remains unlikely. Putin would then lose a lot of money.

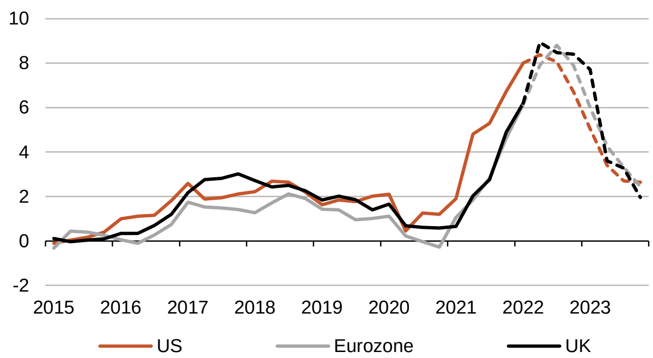
By the end of the coming winter, inflation in the Eurozone is likely to exceed the rise in incomes. At the same time, the global economy is slowing down noticeably in the face of a US Federal Reserve that is treading comparatively hard on the monetary brakes, so Europe – like the US – is likely to experience at least a mild recession. In the Eurozone, the return of tourists to the beaches after two Corona years may still give a small growth boost in the summer. But from autumn to next spring, economic output will probably decline.

Not everything points to recession. Some of the classic buoyancy forces of the economy remain strong. Households have built up considerable additional savings during the pandemic, which they can now use as a buffer. Companies and governments want to invest more. Even though new orders are currently declining, order books are still well filled. Although a recession is likely, there is therefore a chance that it will be relatively mild.

In the recession, private consumption of goods, private investments and foreign trade in goods are likely to decline. In contrast,

The big inflation hump

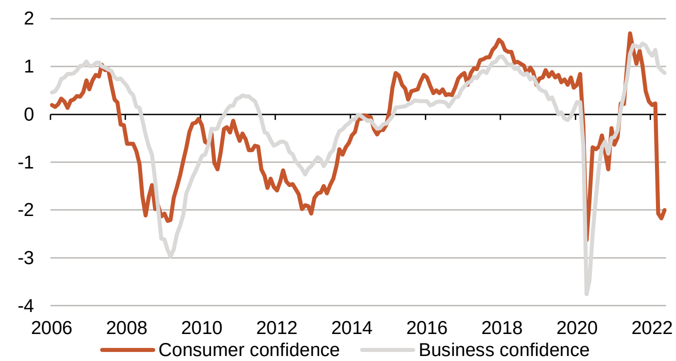
Year-on-year increase in consumer prices in %. Dashed: Berenberg forecast



Time period: 01/01/2015 – 31/12/2023. USA: CPI-U, Eurozone: HICP, UK: CPI.
Sources: BLS, Eurostat, ONS, Berenberg.

Eurozone: the divided economy

Consumer confidence and business climate in standard deviations from the long-term average



Time period: 01/01/2006 – 31/05/2022.
Sources: European Commission Monthly Survey, Haver Analytics, Berenberg.

governments will continue to expand their investments. Given the currently very high demand for labour, unemployment is likely to rise only slightly in the euro area during the recession. This limits the downside risks.

Over time, the decline in demand can contribute significantly to solving the current supply chain problems to a large extent. Commodity prices and transport costs are also likely to fall again somewhat in the course of the coming year. This will help to both dampen inflation and strengthen growth forces. We therefore expect the euro area to return to growth in the middle of next year, which may then be strong again in late 2023 and 2024. After a 0.8% decline in economic output in the euro area in 2023, we expect growth of 2.1% in 2024.

Recession likely – but many reasons argue for a mild course.

Transatlantic difference

Consumers in the US are also groaning under high prices. But unlike Europe, the US is not dependent on Russian natural gas. In contrast, the US is suffering from home-made inflationary pressure. With its late but more forceful interest rate turnaround, the US Fed is likely to dampen demand in such a way that the US economy stagnates in the final quarter of 2022 and the US then falls into a mild recession until autumn 2023 with declining consumption and less investment.

The highest inflation in 40 years

In the US, there are first signs that the price and wage pressure may soon have passed its peak. In contrast, consumers in Europe will have to adjust to noticeably higher electricity, gas and food prices for the time being. From around October onwards, inflation rates on both sides of the Atlantic may fall. Then the rise in energy prices, which picked up speed in autumn 2021, will gradually drop out of the year-on-year comparison. Further declining inflation will help end the recession in 2023.

Central banks shift course: Fed more aggressive than ECB

To prevent high inflation from becoming entrenched, the major central banks are tightening their monetary policy. The US Fed is even deliberately putting on the brakes. In the US, the key interest rate could reach 3.75% in early 2023 before the Fed pauses in the face of the recession. As soon as the Fed sees enough signs that the recession has sufficiently dampened wage and price pressures, it will then cut rates again somewhat, probably starting in autumn 2023. By the end of 2024, the Fed could have arrived at 3%.

With inflation very high for the time being, the ECB has announced that it will raise its key rates in July, September and probably also in December, probably by as much as 50bp in September instead of 25bp. If the eurozone does slip into recession, the ECB will go no further in 2023 and then keep its main refinancing rate at a low 1%.

Dr Holger Schmieding, Chief Economist

Growth and inflation forecasts

	GDP Growth (in %)						Inflation (in %)					
	2022		2023		2024		2022		2023		2024	
		Ø**		Ø**		Ø**		Ø**		Ø**		Ø**
US	1.9	2.6	-0.4	1.9	1.0	1.9	7.8	7.5	3.4	3.5	2.7	2.3
Eurozone	2.3	2.6	-0.8	2.0	2.1	1.9	7.7	7.0	4.0	2.9	2.1	2.0
Germany	1.1	1.8	-1.0	2.2	2.2	2.0	7.7	7.2	4.1	3.3	2.2	1.9
France	2	2.7	-0.4	1.8	2.1	1.7	5.5	5.0	3.6	2.5	2.1	1.8
Italy	2.4	2.7	-0.9	1.8	1.3	1.6	7.1	6.5	4.0	2.5	2.2	1.6
Spain	3.8	4.4	-0.9	3.0	1.9	2.5	7.9	7.6	3.2	2.6	2.2	1.9
UK	2.8	3.7	-1.0	1.2	1.7	1.7	8.0	8.0	4.1	4.4	1.9	2.1
Japan	1.8	1.8	1.9	1.8	1.4	1.0	1.8	1.8	0.9	1.1	0.7	0.8
China	4.3	4.3	4.9	5.2	4.5	5.1	1.9	2.2	2.3	2.3	2.3	2.3
World*	2.8	3.2	1.8	3.2	2.5	3.0	-	-	-	-	-	-

* * Berenberg data at actual exchange rates, not by purchasing power parity (PPP). PPPs give more weight to fast-growing emerging markets.
** Average, Bloomberg consensus as of 20/06/2022.

VOLATILITY MORE LIKELY TO RISE THAN FALL IN Q3

IN A NUTSHELL

- Still optimistic earnings expectations are likely to be reduced in line with worsening economic data.
- Valuations have fallen across the board, especially for US technology stocks. Beneath the surface, there are already attractive equity market segments.
- Volatility is likely to increase further in Q3. We continue to focus on a barbell strategy of quality growth and commodity-heavy equity segments. Valuations now important again.

Cyclicals behind in the second quarter

Stubbornly high inflation rates, tighter central banks coupled with increasing economic disappointments have weighed on equity markets in Q2 2022. Cyclically sensitive and expensively valued equity market segments, especially unprofitable tech companies, suffered. Europe and especially the UK were the relative winners. After the market hardly looked at valuations in times of cheap money, they are now more relevant again – to the advantage of the more favourably valued Europe.

Earnings expectations too optimistic

Since the beginning of the year, the 2022 earnings estimates for Europe and the US have risen. In the process, many companies have already revised down their guidance during the Q1 reporting season. Retail chains have pointed to higher inventories and falling profit margins, other companies like Amazon have cut advertised jobs. The perfect environment for profit margins is definitely over. Higher raw material and labour costs are weighing as well as increased planning uncertainty due to supply shortages and geopolitical risks. Taking into account the China lockdowns in April and May, analysts are likely to reduce earnings estimates, which have risen so far this year. Especially as our economists are now also forecasting a recession for Europe and the US. Currently, market are assuming 2022 earnings growth of just under 13% year-on-year for Europe and 10% for the US. Realistic estimates are likely to be at least 5% lower. The Q2 reporting season, which is about to start, should bring more clarity.

Recession now partly priced in

The sharp and rapid rise in real interest rates coupled with quantitative tightening by central banks has led to a valuation adjustment, especially for expensive US equities. The P/E ratio for the S&P 500 has fallen from 22.7 to 16.3 since the beginning of the year. This means that US equities are now no longer priced expensively compared to their own history. In this context, European equities are even attractively priced at the index level. They are already pricing in a significant economic slowdown, but not yet a full-blown recession. Cyclical equity market sectors in particular are relatively inexpensive, while defensive sectors such as utilities are ambitiously valued and thus vulnerable to further valuation corrections. Many investors have hidden in "safe" business models this year.

Q3 should not be an easy quarter

After volatility has decreased somewhat at the beginning of June, we expect a renewed increase in Q3, when the Fed will continue

Large dispersion between equity regions: value-heavy and defensive segments ahead in Q2; cyclicals and small caps behind

Total return	YTD and in Q2 22 (in %, in EUR)		12-month periods of the last 5 years (in %. EUR)					P/B*	Div.*	P/E*
	YTD (31/12/21-14/06/22)	Q2 22 (31/03/22-14/06/22)	14/06/21 14/06/22	14/06/20 14/06/21	14/06/19 14/06/20	14/06/18 14/06/19	13/06/17 14/06/18	14/06/22	14/06/22	14/06/22
MSCI UK	-1.4	-5.3	6.8	25.6	-15.6	-2.9	8.5	1.6	4.4	9.7
Stoxx Europe Defensives	-2.0	-4.1	6.3	14.8	0.7	5.1	2.6			
MSCI EM Asia	-8.9	-2.8	-13.0	33.4	7.2	-8.8	14.0	1.5	2.7	12.1
Stoxx Europe 50	-9.1	-7.2	-1.4	24.3	-3.9	3.7	1.6	2.0	3.6	11.9
MSCI Japan	-11.7	-7.4	-6.9	16.2	5.6	-4.9	8.5	1.2	2.6	12.3
S&P 500	-13.7	-12.0	3.6	31.7	7.2	9.9	12.8	3.4	1.8	16.3
MSCI US Small Caps	-14.4	-11.4	-8.9	53.5	-6.6	-1.2	15.8	1.8	1.8	15.1
DAX	-16.2	-7.7	-15.1	31.2	-1.2	-7.7	2.4	1.4	3.7	11.0
Euro Stoxx 50	-17.5	-9.4	-13.7	34.0	-5.1	-1.6	2.1	1.6	3.8	11.0
Stoxx Europe Cyclicals	-19.2	-12.4	-13.5	43.2	-7.6	-8.0	7.0			
Stoxx Europe Small 200	-23.3	-14.3	-19.8	43.4	-2.6	-6.2	10.3	1.3	3.1	13.1
MSCI EM Eastern Europe	-81.7	-17.7	-80.9	25.8	-11.5	23.2	10.7	1.0	5.0	6.4

Time period: 13/06/2017-14/06/2022.
Source: Bloomberg * PBV = Price/book value ratio; Div. = Dividend yield (%); PER = Price/earnings ratio. Values based on estimates for the next 12 months.

to withdraw liquidity from the market and will no longer be on autopilot but will determine monetary policy depending on data. In particular, investors will focus on the Q2 reporting season in terms of profit margins and outlook. In addition, the mid-term elections in the US are still on the agenda in November, which has historically also caused increased uncertainty on the markets. If, contrary to expectations, volatility decreases significantly and equities recover more strongly, more systematic strategies are likely to be pushed into equities again. This should then again increase the drop height and thus also the volatility in the event of adverse news. In view of all the uncertainty, we continue to be very broadly positioned in terms of equity regions. In addition to the US and Europe, we are invested in China and Latin America. For us, China offers enormous catch-up potential should the economy reopen and the zero-COVID policy come to an end. Latin America should also benefit from the ongoing commodity boom and cheap valuations. It also has a low correlation to the rest of the equity exposure. In Europe, we are structurally invested in quality growth companies whose earnings are generally less at risk even in the event of economic downturns. Especially since we are convinced that long-term sustainable and above-average earnings growth is the decisive success factor in stock selection.

Ulrich Urbahn, Head of Multi-Asset Strategy & Research

WHAT IS ON COMPANIES' MINDS?

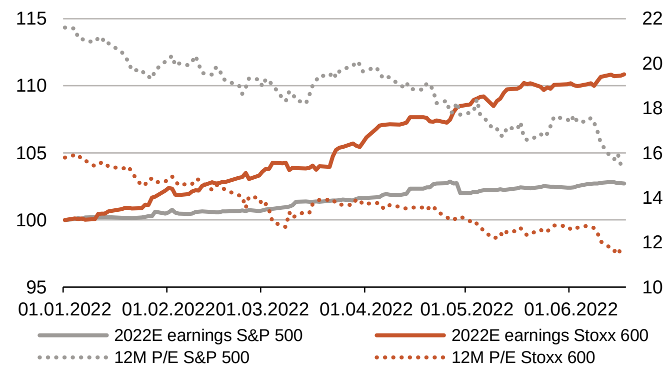
Planning for a possible recession

The widespread pessimism on the markets is not reflected to this extent in the discussions with our companies so far. Cautious optimism continues to prevail. This is nothing unusual. The market is usually a better early warning system than the companies themselves. In addition, we are of course talking mainly to very solid companies that are benefiting from structural growth and can therefore look to the future with a little more serenity. In order not to be surprised by profit warnings after the collapse in the valuation of our shares, we have nevertheless checked our companies for their resilience in recent months. Companies such as outsourcing service provider Teleperformance, data provider The London Stock Exchange Group and payment service provider Worldline, where we agree with management on the resilience of the business model, are therefore also in our top 10. Of course, some of our holdings will also suffer in such an environment. Some industrial and consumer goods companies will not be able to build on the strong performance of recent years. However, as long as the structural trend remains intact and the valuation adequately prices in any earnings declines, we will stay with the companies.

Matthias Born, CIO Equities

Profit forecasts too optimistic? Equities now significantly cheaper

P/E valuation based on earnings estimates for the next twelve months, consensus estimates for 2022 earnings (01/01/2022 = 100)



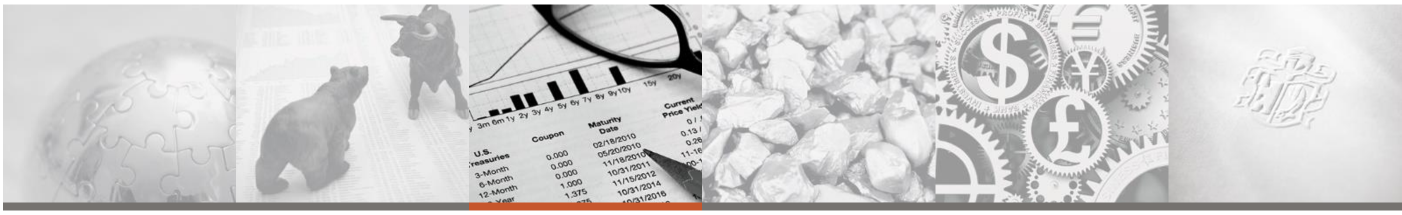
Time period: 01/01/2022–17/06/2022.
Source: Factset, Berenberg.

Forecast summary: Equities likely to recover only somewhat in H2

Berenberg and consensus forecast in comparison, values at year-end 2022 and mid-year 2023

Index forecasts	Currently 14/06/2022	31/12/2022	30/06/2023	Ø* in 12 months
S&P500	3,735	3,900	4,100	4,998
Dax	13,304	14,500	15,800	18,545
EuroStoxx 50	3,475	3,800	4,000	4,833
MSCI UK	2,076	2,200	2,350	2,565
Index potential (in %)				
S&P500	-	4.4	9.8	33.8
Dax	-	9.0	18.8	39.4
EuroStoxx 50	-	9.3	15.1	39.1
MSCI UK	-	6.0	13.2	23.6

* Average, bottom-up consensus as of 14/06/2022.
Source: Bloomberg, Factset, Berenberg.



ISOLATED GLIMPSES OF LIGHT IN THE VALLEY OF TEARS

IN A NUTSHELL

- Safe government bonds are not yet attractive again even at higher yield levels – exception: for hedging.
- In European corporate bonds, we continue to favour the financial sector and remain defensively positioned.
- Rising risk premiums as well as manageable issues and positioning speak in favour of emerging market securities.

The old risks are also the new ones

Bond markets around the globe are exposed not only to economic but also to geopolitical, monetary and pandemic risks. Inflation and central banks, war and Covid – all fixed-income sub-segments continue to be influenced by the associated uncertainties. In the following, we show where we can find opportunities for bonds in this difficult environment.

No green light for safe government bonds despite rise in yields

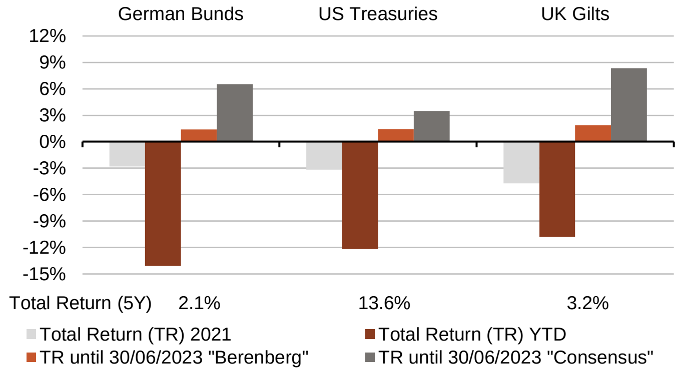
In the second quarter, government bonds with high credit ratings extended their losses from the first months of the year. Neither intensifying recession concerns nor a need for security resulting from the ongoing Ukraine war were able to sustainably break the trend of rising yields. Rather, persistently high inflation and the repeatedly upwardly adjusted expectations of market participants regarding the coming interest rate steps of the major central banks proved to be the dominating factors. Although some of this seems to have been priced in by now, the end of the line has not yet been reached with regard to the rise in yields – safe government bonds remain fundamentally unattractive in themselves. The situation is different in a multi-asset context, where US government bonds in particular provide a useful diversification contribution in turbulent market phases. Within the eurozone, a first cautious look at the southern periphery could also be worthwhile from a relative perspective, after the risk premia compared to German Bunds have widened again recently.

Long dry spell for European corporate bonds

In the European investment-grade corporate bond markets, as of the end of May, we are looking back at both the worst start to the year and the biggest price decline over a five-month period in more than two decades (left-hand chart on the following page). The toxic combination of rising interest rates and spread widening pushed the asset class down -13.1%. Even an effective yield of almost 3.3% p.a. in the meantime has not been able to attract new investor money so far. In the current negative situation, neither the healthy corporate balance sheets with high liquidity cushions and low debt ratios nor the still positive trends in credit ratings by the rating agencies are being taken into account. This is because uncertainty about the consequences of the ECB's withdrawal from the bond-buying programmes is also hovering over markets. With a well-filled new issue pipeline and a simultaneous buyers' strike on the part of investment banks and international investors, European corporate bonds lack a marginal investor. Although we believe that most of the spread widening is behind us, the prevailing

Government bonds with slightly better outlook

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



Time period: 20/06/2017-20/06/2022.
Source: Bloomberg, own calculations, iBoxx Government Bond Indices (7-10 years, TR)

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

Berenberg and consensus forecast in comparison, values at year-end 2022 and mid-year 2023

	20/06/2022	31/12/2022		30/06/2023	
	Currently		∅*		∅*
US					
Base interest rate	1.50-1.75	3.25-3.50	3.45	3.50-3.75	3.75
10Y US yield	3.23	3.20	3.14	3.50	3.24
Eurozone					
Base interest rate	0.00	1.00	1.15	1.00	1.55
10Y Bund yield	1.75	1.70	1.21	1.90	1.30
UK					
Base interest rate	1.25	2.00	1.90	2.50	2.00
10Y Gilt yield	2.60	2.70	2.03	2.80	2.01

* Average, consensus as of 20/06/2022.
Source: Bloomberg.

illiquidity means that further moderate adjustments are possible in the short term before we become more constructive on the asset class again. Accordingly, we continue to position ourselves defensively. We continue to favour financial bonds, comparatively low-energy sectors and issuers with high pricing power, which can more easily pass on cost increases from disrupted supply chains and high commodity prices to their customers.

Heterogeneity in emerging market bonds continues

Behind us lies one of the most difficult half-years in recent history, which not only brought stagflationary impulses in many countries, but also seriously tested the risk appetite of many market participants. The negative factors are not evenly distributed either regionally or within the investment segments. While hard currency sovereign and corporate bonds have fallen sharply in value due to the higher weighting of Russian and Ukrainian assets as well as their high sensitivity to rising US government bond yields, local currency bonds have performed much better. The currency component has been the main driver of the significant outperformance to date, and we expect this trend to continue throughout the year. At the country level, commodity exporters such as Middle Eastern countries have benefited the most, while commodity importers and countries at war or in close geographical proximity to war have suffered the most. We expect this heterogeneity to continue in the second half of the year, albeit in a much more moderate form. From a fundamental perspective, stabilising inflation figures and a slowdown in the rise of US government bond yields should provide reassurance. The currently manageable investor positioning is also positive. We think the bulk of the capital outflows are behind us. Risk premiums have also generally risen to very attractive levels. If the market calms down, as we expect, an entry would appear to be worthwhile. In addition, issuance activity in the second half of the year also remains manageable, which should support the asset class.

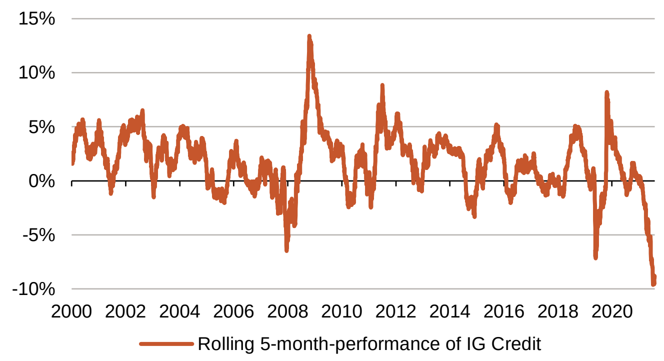
Conclusion: emerging market bonds have the edge

In an overall risky environment, we consider emerging market paper – both in hard and local currency – to be the most interesting bond segment in the coming quarter. This is especially true for countries that benefit from rising commodity prices. In Europe, we favour financial bonds, but generally remain defensively positioned in the corporate sector. Despite higher yields, we do not yet give the green light for safe government bonds, but use US securities as a hedging instrument.

Martin Mayer, Senior Portfolio Manager Multi Asset
Christian Bettinger, Head Fixed Income Euro Flexibel
Robert Reichle, Head Fixed Income Global & Emerging Markets

Corporate bonds: historically poor start to the year

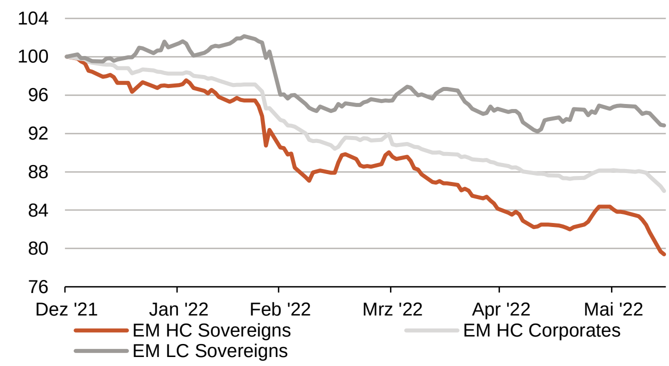
The past five months saw the biggest loss in over two decades for European investment grade (IG) corporate bonds.



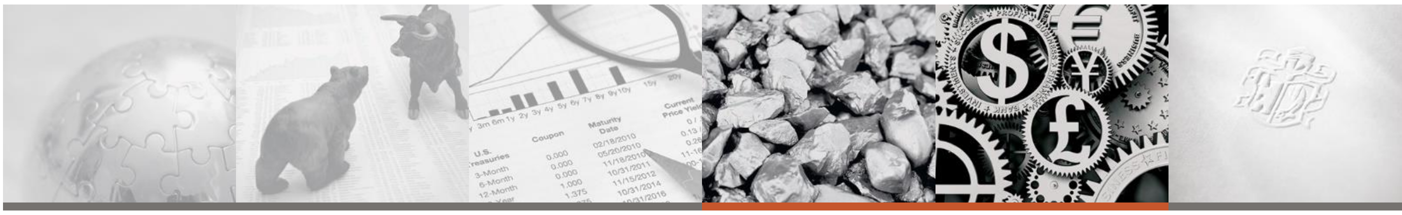
Time period: 31/05/2000-31/05/2022, rolling 5-month periods; Status: 14/06/2022.
Source: Bloomberg.

Emerging markets: local currency bonds particularly favoured

The better performance of local currency bonds (LW) year-to-date compared to hard currency securities (HW) should continue in the second half of the year.



Period: 31/12/2021-14/06/2022, indexed to 100
Source: Bloomberg.



LACK OF SUPPLY WHEREVER YOU LOOK

Oil price remains high and volatile

Crude oil continued its rollercoaster ride in the second quarter. The market fluctuated between recession fears in the West, the covid lockdowns in China and the negotiations on an EU oil embargo. The latter will require a large-scale redistribution of Russian oil towards Asia in the coming months. Irrespective of this, supply is likely to remain tight even in the absence of a recession. While demand typically rises in the summer months due to the US driving season, many OPEC+ members are already having problems meeting their quotas. Also, inventories are at very low levels, as the typical seasonal build-up has been absent in recent months. The oil price and its volatility may therefore remain elevated for the time being.

Between higher real interest rates, recession worries and inflation

In the second quarter, gold had to give up almost all the gains it had made in the wake of the outbreak of war. Headwinds came mainly from the direction of the strong US dollar, so that euro investors can still report a return of around 8% since the beginning of the year. Meanwhile, the burgeoning recession worries have offered little support to gold so far. Although investors are increasingly worried about the economy, they still expect – untypically from a historical perspective – further restrictive central banks. Since real interest rates are rising as a result of the latter, gold is experiencing headwinds. If the recession does not materialise but inflation remains high, gold would benefit as a real investment. If the recession comes and inflation falls markedly, gold would benefit as a safe haven. In our base scenario of an inflation-induced recession, the potential for gold remains limited for the time being. Due to the great uncertainty, however, it remains an important component of our portfolios as a hedge.

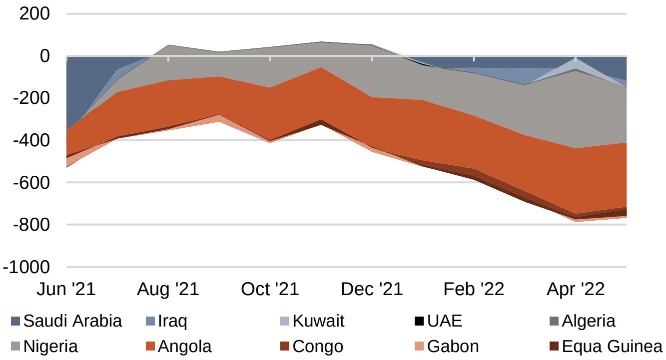
Long-term upward trend fully intact

Industrial metals were hit twice in Q2. On the one hand, recession concerns weighed on the demand outlook. On the other hand, the lockdowns in China put pressure on actual demand. For example, residential construction activity fell 42% year-on-year in May. In the short term, China's likely recovery is offset by the probable recession in the West, so that overall the potential is limited. The long-term upward trend remains unaffected by all this. Commodity-hungry investments in green technology, defence and supply chains are being met with insufficient supply due to low investments in the past decade.

Ludwig Kemper, Analyst Multi-Asset Strategy & Research

OPEC members have difficulties meeting their quotas

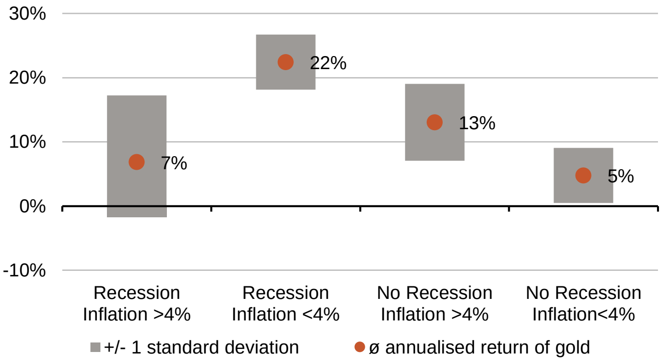
Difference between actual production and official quota of core OPEC countries (in thousands of barrels).



Time period: 30/06/2021-31/05/2022
Source: Bloomberg, own calculations.

Gold's potential is limited during recession and high inflation

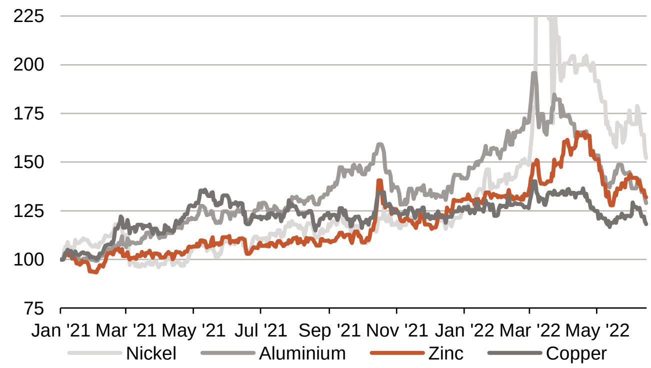
Annualised return of gold depending on the level of inflation (US CPI) and the state of the global economy (OECD leading indicator)



Time period: 01/01/1970-31/05/2022
Source: Bloomberg, own calculations.

Industrial metals only with short-term dampener

Development of nickel, aluminium, zinc and copper indexed to 100 on 01/01/2021.



Time period: 01/01/2021-14/06/2022
Source: Bloomberg, own calculations.

EURO RATE: NO LAND IN SIGHT

The ECB is lagging behind

The euro exchange rate reached a new low in the second quarter. The common currency temporarily fell below 1.04 US dollars per euro – the lowest rate in more than five years. Despite a brief recovery, the euro could not quite pull away from its low and was quoted at 1.05 US dollars per euro at the end of the second quarter. The European Central Bank (ECB) is largely responsible for the weakness of the euro. Its hesitant stance compared to the other major central banks is weighing on the exchange rate. The US Federal Reserve and the Bank of England were also late with the monetary policy turnaround. In the meantime, however, they have tightened the interest rate reins considerably and are thus far ahead of the ECB. At its last meeting, the ECB announced the end of net bond purchases on 1 July and a first rate hike of 25 basis points for the meeting on 21 July, but while the ECB is announcing, other central banks are putting their money where their mouth is: the Fed raised key interest rates by 75 basis points in June. Only a few weeks ago, few observers would have considered such a large rate hike conceivable. In addition, the Swiss National Bank (SNB) surprisingly raised the key interest rate by 50 basis points in June – and this already with an inflation rate of 2.9%, which is still very moderate by international standards. Thus the announcement of the ECB's interest rate turnaround fizzled out on the foreign exchange market. Worse still, there is concern in the market that after the end of net bond purchases, market interest rates for some euro-area countries – Italy, for example – will rise so sharply that they will no longer be able to bear the interest burden in the medium term. To prevent a recurrence of the euro crisis, the ECB announced at a special meeting that it would intensify its work on an "anti-fragmentation instrument".

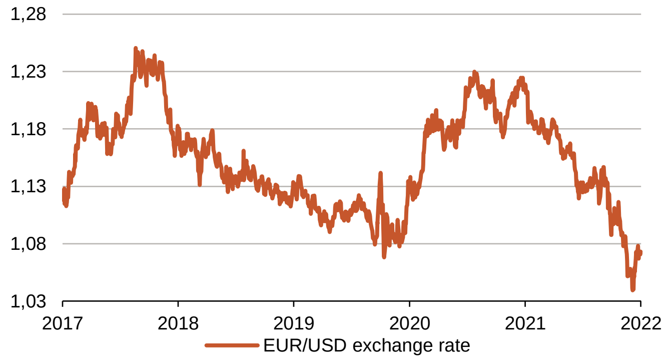
Economic downturn ties ECB's hands

The ECB is likely to raise interest rates several times this year, so that a key interest rate of 1.0% is likely by the end of the year. After that, however, the Frankfurt-based monetary guardians are likely to take a long break because the foreseeable recession in the Eurozone does not allow for an even tighter monetary policy. At the same time, it is likely that both the US Federal Reserve and the Bank of England will continue to tighten monetary policy. In this environment, the upside potential for the euro in the current year is very limited. We do not expect higher euro exchange rates again until 2023.

Dr Jörn Quitzau, Senior Economist

EUR/USD: Hesitant interest rate turnaround cannot help euro rate

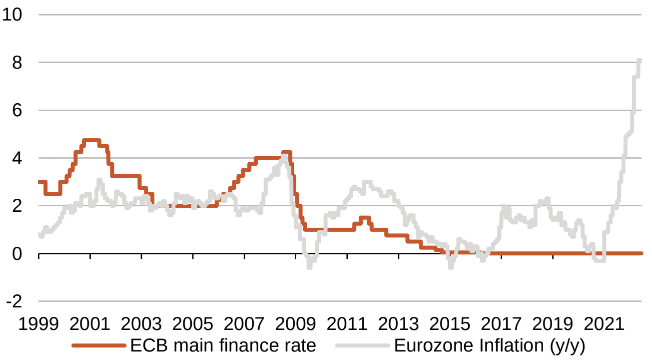
The ECB's hesitant stance has weighed on the euro. In addition, the US dollar is in demand as a safe haven and therefore tends to be strong.



Time period: 14/06/2017-14/06/2022
Exchange rate in US dollars. Source: Macrobond.

Key interest rate decoupled from inflation data

Despite the rapid rise in prices, the ECB has not yet changed its interest rate policy. This is a major contribution to the weakness of the euro.



Time period: 01/01/1999-14/06/2022
ECB key interest rate and inflation rate, both in %. Source: Macrobond.

Exchange rate forecasts

Berenberg and consensus forecast in comparison, values at year-end 2022 and mid-year 2023

	20/06/2022	31/12/2022		30/06/2023	
Exchange rate forecast	**Currently**		∅*		∅*
EUR/USD	1.05	1.05	1.08	1.08	1.11
EUR/GBP	0.86	0.85	0.86	0.85	0.86
EUR/CHF	1.02	1.02	1.05	1.04	1.05
EUR/JPY	142	147	139	151	140
Change against the euro in %					
USD	-	0.1	-2.7	-2.7	-5.3
GBP	-	1.0	-0.2	1.0	-0.2
CHF	-	-0.3	-3.1	-2.2	-3.1
JPY	-	-3.4	2.1	-6.0	1.4

* Average, consensus as of 20/06/2022.
Source: Bloomberg.

INTERVIEW WITH PROF DR BERND MEYER

The year 2022 has been very challenging for investors so far. What are the reasons for this and where were the difficulties?

Equities experienced one of the weakest starts to the year in the last 100 years. The main driver was high inflation, which was further fuelled by Putin's war and the COVID-19 lockdowns in China. These developments, along with the rapid policy reversal by the US Federal Reserve, caught most investors on the wrong foot. As a result, bond yields soared and the strongest bond bear market in more than 50 years ensued. Bonds lost as much value as equities. With such synchronisation, diversification in multi-asset portfolios becomes more difficult. Moreover, the rise in expected real yields in particular triggered one of the strongest rotations ever measured in equities. Interest-rate-sensitive growth and quality stocks were sold and value stocks bought.

In other words, a perfect storm of concerns about inflation, interest rates, the economy and geopolitics. What did this mean for our strategies?

We had forecast that 2022 would be challenging. We had expected rising bond yields and higher synchronisation of equities and government bonds, as higher inflation and more restrictive central banks have historically led to this on a regular basis. Therefore, we have been heavily underweight in bonds for some time, focused on short duration, overweighted alternative investments and were only moderately overweight in equities going into the year. In addition, we had already noticeably increased the diversification in our strategies in 2021.

However, our multi-asset strategies suffered from the strong rotation in equities, as we at Berenberg focus on high-growth, quality companies and small caps. With a gradual normalisation of the interest rate landscape, our stock selection could also have coped well, but the speed was problematic. However, we remain convinced that long-term sustainable and above-average earnings growth is the decisive success factor in stock selection.

Nevertheless, we were able to cushion the negative performance somewhat by adding selected investments. These included commodities, direct, individual commodity stocks or commodity-heavy regions such as Latin America. For a large number of commodities, there is also a lot to be said for a structural price increase – we mapped this trend at an early stage through a significant addition of broad commodity investments and industrial metals. We have considered gold to be an essential component of a multi-asset portfolio for some time now.

We have also reduced the equity quota to slightly below neutral in several steps since the beginning of the year during recovery phases. Furthermore, we took up an additional hedging investment at the beginning of February, which is primarily intended to help cushion abrupt and rapid sell-offs on the stock markets (tail hedge certificate). This has already proven its worth.

Is the sharpness of the market movements an indication of the changed market behaviour that you have repeatedly pointed out?

Correct – the change in market behaviour presents investors with new challenges. In our view, the focus is on three developments: more pro-cyclical investor behaviour, increasingly passive investing and stronger synchronisation between equities and supposedly safe government bonds.

What do you mean by increased pro-cyclical behaviour of investors and where does this behaviour come from?

Investors are inclined to take more risks in the low interest rate environment in order to achieve a sufficient return – for example, through higher equity quotas or the replacement of government bonds with corporate or emerging market bonds. Ultimately, however, they have thus taken more risks than they are willing to hold strategically in the long term. If market phases are weaker, these investments are reduced and vice versa. This is a very pro-cyclical, trend-reinforcing behaviour that did not exist in the past. In addition, there are more and more systematic investment strategies with momentum, risk parity and target volatility approaches, which are also frequently used by robo-advisors. Simply put, they increase the equity exposure when momentum is positive and volatility is low, and vice versa. There are also fewer and fewer value investors who act counter-cyclically, buying stocks cheap and selling them dear. Value companies have significantly underperformed growth companies since the financial crisis, and money has been withdrawn from value funds accordingly. And the baby boomers who made private provisions with value funds are now gradually retiring and selling their fund units.

And how should investors react to this now?

They have to adapt to the changing market behaviour. The good thing is that you can simulate the equity exposure of rule-based strategies. When most of these strategies are almost fully invested in equities, the downside potential for the markets is higher, such as in the early 2020s. Therefore, we monitor this very closely. Currently, these strategies are positioned very low in equities, which is a support factor for the markets. We focus on flexibility, the use of degrees of freedom and the recognition of opportunities – even contradictory ones.

What are the consequences of the rise of passive investing? Should investors avoid ETFs completely?

Index fund and ETF providers are now the largest asset managers in the world. They are estimated to control at least 30 per cent of the US equity market. This is of enormous importance because the greater the passive penetration of the market, the higher the correlation of individual stocks and the more volatile the markets. Active investors should be aware of the opportunities and risks of passive and systematic capital flows and make use of this knowledge by analysing sentiment, investor flows and positioning data. ETFs should be used especially for tactical positions or in efficient markets. Investors should also increasingly move into niches that are not or are only slightly passively tracked. These are usually less influenced by global risk-on-risk-off movements and offer more diversification.

The performance of our multi-asset strategies this year could not match the good results of previous years. How satisfied are you with the development?

We cannot be satisfied with this development, even though we made many correct decisions. In retrospect, we started 2022 too optimistically with a moderate overweight in equities and should also have reduced the equity quota more quickly and more strongly and parked it in cash or commodities. An allocation to bonds would not have helped. Certainly, there are many investors who had a lower equity allocation but more bonds, with which they then lost just as much. Nevertheless, we were usually able to achieve additional returns in our strategies compared to the benchmark through asset allocation. The reason for this was our strong underweighting of bonds in favour of a strong overweighting of alternative investments. In addition, the selection in bonds and especially in alternative investments helped. For the former, the focus was on short duration and special themes such as domestic bonds from China or catastrophe bonds, and for the latter on gold, broad commodity exposure and the tail hedge certificate.

Our stock selection with a focus on high-growth, quality companies and small caps, which has helped us a great deal in recent years, has weighed heavily this year. Unfortunately, our addition of, for example, commodity-heavy equity regions was not able to compensate for this. In retrospect, we should have acted more courageously here as well. Nevertheless, we remain convinced that the focus on long-term, strongly growing business models remains the decisive factor in stock selection. Despite the weaker start to the year, our multi-asset strategies have continued to perform very well in comparison with the competition over the last few years.

BRIEF BIOGRAPHY

Prof Dr Bernd Meyer, CFA, has been Chief Strategist of Wealth and Asset Management since 2017 and is responsible for Berenberg's discretionary multi-asset strategies. They also include the asset management mandates. Prof Dr Meyer was initially Head of European Equity Strategy at Deutsche Bank and built up Global Cross Asset Strategy Research at Commerzbank from 2010. He has received several awards. He and his team were ranked among the top three multi-asset research teams worldwide in the renowned Extel Survey from 2013 to 2017.

BERENBERG
PARTNERSHIP SINCE 1590

PUBLISHING INFORMATION

PUBLISHER

Prof Dr Bernd Meyer | Chief Investment Strategist

AUTHORS

Christian Bettinger, CFA | Head of Fixed Income Euro Flexibel
manages the Berenberg Euro Bonds and Berenberg Credit Opportunities funds and focuses on corporate bonds

Matthias Born | Head Portfolio Management Equities
is responsible for the investment strategy for asset management equities with a focus on the selection of specific European equities

Ludwig Kemper | Analyst Multi Asset Strategy & Research
analyses financial markets. supports the multi-asset investment process and participates in capital market publications

Martin Mayer, CEFA | Senior Portfolio Manager Multi Asset
manages multi asset mandates and analyses bond markets. with a special emphasis on government bond markets

Prof Dr Bernd Meyer, CFA | Chief Investment Strategist
is in charge of Multi Asset and responsible for Wealth and Asset Management capital market assessments

Dr Jörn Quitzau | Senior Economist
analyses longer-term economic trends. with a special emphasis on foreign exchange market developments

Robert Reichle, CFA, CQF | Head of Fixed Income Global & EM
is in charge of Fixed Income Emerging Markets and Global Bonds ex Euro

Dr Holger Schmieding | Chief Economist
is the head of Economics and analyses economic and political trends with an influence on investment decisions

Ulrich Urbahn, CFA | Head of Multi Asset Strategy & Research
focuses on the multi-asset investment process. the development of investment ideas and capital market communications

IMPORTANT NOTICES

Date: 20 June 2022

Joh. Berenberg. Gossler & Co. KG
Neuer Jungfernstieg 20
20354 Hamburg (Germany)
Phone +49 40 350 60-0
Fax +49 40 350 60-900
www.berenberg.com
multiasset@berenberg.com