HORIZON

The Berenberg Capital Market Outlook · Wealth and Asset Management

RECESSIONS AHEAD

Market expectations of a quick turnaround by central banks were premature. They continue to prioritise the fight against stubborn inflation. Recessions in the US and Europe seem inevitable.

DOWNSIDE POTENTIAL LIMITED

Earnings estimates are likely to be reduced further. However, at least in Europe, valuations already take much of the downside into account. Defensive positioning of investors limits the drop in equities.

OPPORTUNITIES ARISE

Only with a more pronounced weakening of the economy and declining inflation in Q4 2022/Q1 2023 are central banks likely to act less restrictively. Investors should then become more optimistic about an economic recovery in 2023. An equity rally into the new year seems possible.

Q4 | 2022

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FOREWORD

Prof Dr Bernd Meyer
Chief Investment Strategist

Dear reader,
"Easy come, easy go" applied to the majority of capital market developments in the third quarter. After growing fears of recession in June, the markets were betting on a quick pivot by the Fed and were pricing in interest rate cuts as early as the first half of 2023. Bond yields fell significantly – the yield on 10-year Bunds even fell by one percentage point. Equity markets rallied strongly, boosted by previously pessimistic sentiment and positioning. We considered this development premature and remained cautious. Then, from mid-August, the picture turned. More robust economic data in the US and more stubborn inflation in Europe meant that central banks' top priority remains fighting inflation, which Fed chair Powell and ECB director Schnabel made clear at the central bank conference in Jackson Hole. Regaining their credibility now takes priority over supporting the economy and markets. Interest rate cuts for 2023 were priced out again, bond yields rose back to June levels and equities largely gave back their gains. The ongoing energy crisis, slumping consumer confidence, further hikes in central bank interest rates and quantitative tightening are making recessions in the US and Europe look increasingly inevitable. Economic data is likely to deteriorate further and earnings estimates to be cut further.

We maintain our view that a more sustained equity market recovery seems more likely towards the end of the year. By then, at the earliest, the economy is likely to have weakened sufficiently, to be in or close to recession and the weakening demand to favour a more pronounced decline in inflation. Only then are central banks likely to act in a less hawkish manner. The Fed's attention is likely to be on the labour market in particular, because as long as there are still almost twice as many job vacancies as unemployed, the danger of significant wage inflation is not averted. With less hawkish central banks and with a view to a possible recovery from recession in 2023, investors should then become more optimistic about equities and the stock markets should rally - after all, they usually price in expected developments six to nine months in advance. 2023 could then be a better year for multi-asset investors. Bond yields are clearly in positive territory for the first time in years, the commodity super-cycle is likely to continue and equity valuations have fallen markedly. Until then, the cautious positioning of the mass of investors and the low equity ratios of systematic investment strategies will limit further falls. Therefore, we stick to our view that equities should form a bottom in the second half of 2022. Against this backdrop, we are positioning ourselves less defensively into the fourth quarter with a now neutral equity quota, with broad and global diversification.

In the Insights interview starting on p14, our fund manager Katharina Raatz explains her fascination for small and micro caps, what distinguishes them and what she focuses on in the selection process. I hope you enjoy reading this issue of Horizon.

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FOURTH QUARTER SHOULD OFFER OPPORTUNITIES

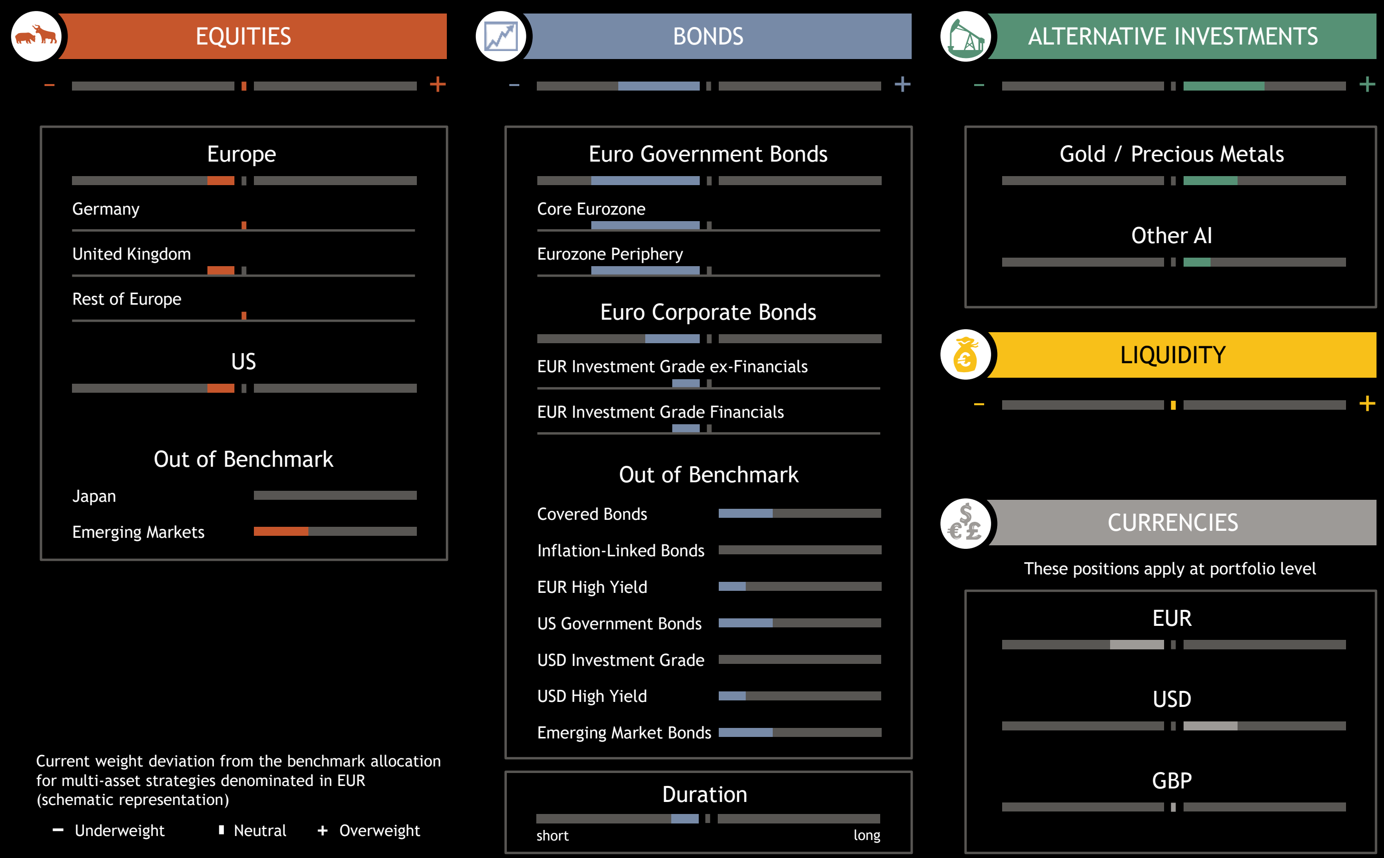
IN A NUTSHELL

- The summer rally in equities was replaced by a renewed sell-off from August onwards. This was triggered by restrictive central bank comments, rising bond yields and negative earnings revisions.
- Volatility is likely to remain elevated heading into the US mid-term elections, partly because central banks are becoming even more restrictive, thus removing liquidity from the market.
- We are slightly optimistic for Q4 because most investors expect poor economic data and are cautiously positioned. Towards the end of the year, optimism should increase again as we look ahead to next year.

Portfolio positioning at a glance

In the third quarter, we made little change to our slightly defensive asset allocation. We took advantage of the sharp rise in interest rates to add to long-dated government bonds in Europe at the expense of cash, so that the duration of our portfolios has risen towards the benchmark duration. This should help in the event of a recession, when long-term interest rates in particular are likely to fall. However, we remain underweight in bonds. In equities, we have closed our moderate underweight after the sell-off in September.

Overall, we are sticking to our Barbell strategy: we have added commodity-heavy equity segments and direct commodity exposure to our high-growth quality equities and small cap stocks. Commodity-related products reduce our portfolio volatility and serve as an inflation hedge. In addition, we are still invested in a flexible hedging product. A significant gold position also remains part of our multi-asset portfolios. In equities, we continue to favour emerging markets over the US and Europe. In bonds, we continue to favour emerging market bonds. Safe haven bonds remain underweight, but have recently been added to.



Third quarter review - equities first up, then down

The equity rally at the beginning of the third quarter was mainly driven by technical factors such as short covering by hedge funds and building equity positions through systematic strategies. Falling volatility until mid-August supported this trend. Relatively robust US economic data and peak inflation hopes due to a declining July US inflation rate, high retail inventories and falling commodity prices led to stronger pricing in a soft landing scenario – i.e. that the economy will not slide into recession and inflation will come down. At their peak, US 10-year government bond yields fell by about 90 basis points and futures markets were already pricing in interest rate cuts for the first half of 2023 (top chart on p5). However, the US central bankers then countered investors' lack of concern and emphasised that the fight against inflation was not over and would continue to enjoy top priority. Together with stabilising commodity prices, this led to a renewed rise in interest rates, a decline in the stock markets and a strong US dollar. In Europe, the worsening of the energy crisis and rising inflation were aggravating factors.

Economy likely to deteriorate further in autumn

In line with weak leading indicators such as falling new orders, the economy is also likely to weaken further. Our economists expect a recession for the Eurozone, the UK and the US. Besides the worsening of the energy crisis in Europe and the high inflation rates, which are unpleasant for consumers, the drivers are the increasingly restrictive monetary policies of central banks. In September, the Fed significantly reduced its bond purchases. This drains liquidity from the market and increases volatility.

Midterm elections could cause uncertainty

Although the US midterm elections will not take place until November, they are likely to increase volatility in the run-up. Current polls suggest that the Democrats will lose at least one chamber to the Republicans. However, the forecasting quality of supposed experts and polls in US elections has not been particularly good, especially in the recent past. Given the political variables that depend on the outcome of the election, such as taxes, healthcare and regulation, this could create uncertainty below the surface.

Central bank policy and thus inflation figures decisive

The key question for the market will be whether the Fed and the other central banks manage to contain inflation without plunging the economy into a severe recession with high unemployment. If a recession were avoided altogether, we would have a positive goldilocks environment for equity markets – which we think is unlikely, but not impossible. More likely, however, would be a mild recession in the US and a sharper but probably shorter recession in the Eurozone, both in combination with falling inflation. In that case, unemployment is unlikely to rise much either, as companies, still under the impression of the COVID-19 pandemic, will try to retain as many workers as possible to avoid having to hire expensive new workers in the next upswing. This trend will be supported by demographic developments in the coming years. After all, the

USD strength continued in Q3, lifting US assets, oil slipped slightly, while equity performance was mixed

Total return	YTD and in Q3 22 (in %, EUR): YTD (31/12/21-19/09/22)	Q3 22 (30/06/22-19/09/22)	12-month periods of the last 5 years (in %, in EUR): 19/09/21 19/09/22	19/09/20 19/09/21	19/09/19 19/09/20	19/09/18 19/09/19	19/09/17 19/09/18	CAGR* 19/09/17 19/09/22	Std. dev.* 19/09/17 19/09/22
Brent	60.3	-6.2	78.6	79.3	-40.0	-9.8	57.0	22.1	39.9
USDEUR	13.5	4.6	17.0	1.0	-6.7	5.7	2.8	3.7	6.8
Gold	3.9	-3.0	11.7	-9.2	21.4	31.6	-5.6	8.9	12.7
Euro Overnight Deposit	-0.3	0.0	-0.5	-0.6	-0.5	-0.4	-0.4	-0.5	0.0
S&P 500	-5.9	8.3	4.6	37.2	4.7	11.6	21.2	15.3	21.3
EM Sovereigns	-7.3	5.2	-6.4	5.7	-3.4	19.1	-2.2	2.2	8.2
Stoxx Europe 50	-7.4	0.5	0.7	21.3	-5.0	10.2	0.2	5.1	16.7
US Sovereigns	-8.9	0.3	-9.6	-2.5	8.9	10.3	-2.2	0.7	4.3
EUR Sovereigns	-9.2	-2.3	-10.1	0.0	0.2	5.2	-0.4	-1.1	2.9
MSCI EM	-11.3	-0.9	-11.6	19.1	3.8	7.0	-2.5	2.7	16.8
EUR Corporates	-13.1	-0.8	-14.0	1.7	0.7	5.9	0.0	-1.4	3.1
DAX	-19.4	0.2	-17.3	18.1	5.3	2.0	-2.7	0.4	20.6

Time period: 19/09/2017-19/09/2022.
Source: Bloomberg * CAGR = annualised return (in %, in EUR); Std. dev. = Annualised standard deviation (in %, in EUR).

baby boomers with the highest birth rates are retiring. The big unknown, however, remains the inflation rate. If it is more persistent than expected, central banks are likely to become even more restrictive and interest rates will continue to rise. Especially in the Eurozone, inflation is likely to remain elevated for longer because of the energy crisis. Accordingly, the market's attention is clearly on central banks and the upcoming inflation figures. Downward surprises are likely to lead to a recovery rally in equity and bond markets, while upward surprises are likely to lead to a further sell-off. In a multi-asset context, a pronounced commodity exposure makes all the more sense as diversification (middle chart). On the one hand, to hedge against a sustained high inflation rate; on the other hand, to participate in the coming super cycle of commodities due to the energy transition. Accordingly, our commodity weighting remains high.

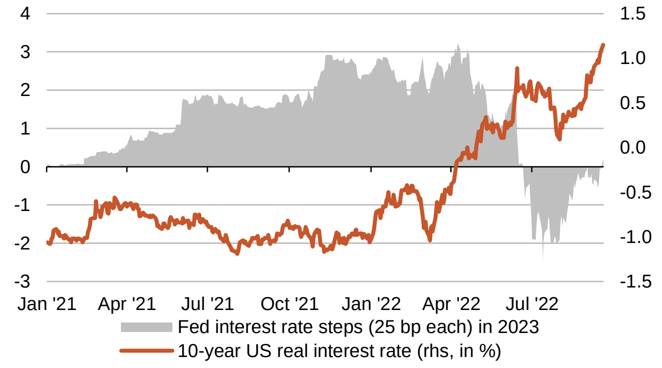
Cautiously optimistic for Q4

We are cautiously optimistic about the further development of equity markets in Q4. The economy is likely to cool down and along with it earnings estimates are likely to be further adjusted downwards. In addition, the upside potential is likely to be limited by the continued restrictive central banks for the time being and the accompanying withdrawal of liquidity. The positive side, however, is that most market participants are expecting this anyway and are cautiously positioned. The vast majority of banks are also still sceptical and advise caution. This should limit the further downward potential, especially since there is also positive surprise potential, for example from China's party congress in November. There is also hope towards the end of the year, when the market is increasingly looking towards next year and focusing on a possible recovery out of recession in the course of 2023. As soon as the market smells that central banks are becoming less restrictive, it is likely to rise due to overly bearish positioning. The precise timing of this is difficult to say, but the market is likely to react significantly at that point, so it makes sense to be at least neutrally positioned in equities beforehand. We also see light at the end of the tunnel for bonds. The now higher yields should support bonds even if interest rates continue to rise slightly. And maybe interest rates will fall even when the economy weakens and inflation rates fall.

Ulrich Urbahn, Head of Multi Asset Strategy & Research

Expected Fed rate cuts for 2023 were priced out again

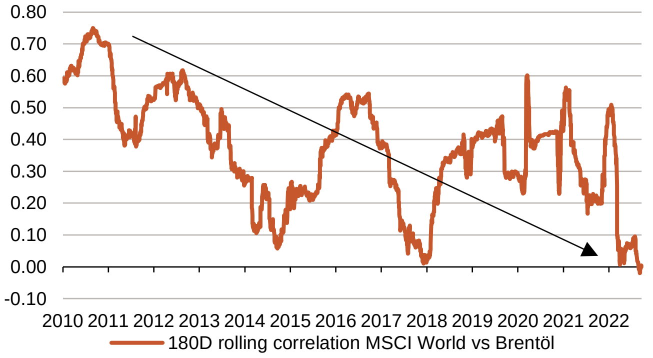
Interest rate expectations, priced into Fed Fund futures, and the market's expected real yield on 10-year US treasuries.



Time period: 01/01/2021–19/09/2022.
Source: Bloomberg, own calculations.

Oil with increased diversification effect in multi-asset portfolios

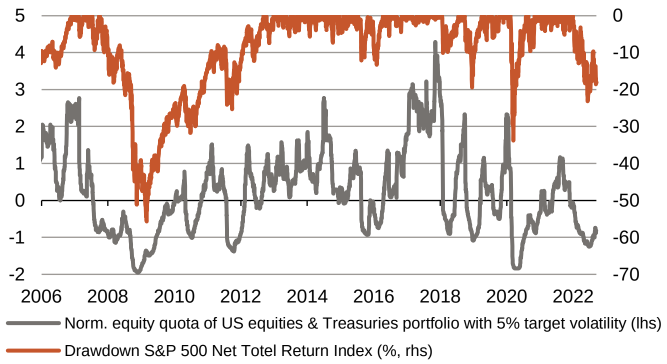
Rolling 180-day correlation of global equities (MSCI World Index) and Brent oil recently fell below zero.



Time period: 01/01/2010–19/09/2022.
Source: Bloomberg, Factset, own calculations.

Systematics currently have little equity exposure

Low equity position of systematic investment strategies (target volatility, risk parity) speaks for only limited fall of markets from current level.



Time period: 01/01/2006–19/09/2022.
Source: Bloomberg, FactSet, own calculations.

WAR, INFLATION AND HIGHER RATES: RECESSION AHEAD

IN A NUTSHELL

- Putin's war: Higher prices for energy and food hit consumers and businesses. In Europe, the gas and electricity price shock is the main burden.
- Central banks react to the extraordinary inflation: US Fed hits the brakes hard, ECB follows.
- Mild recession in the US, harsh winter in Europe

Europe: Recession until spring 2023

The spike in energy and food prices is hitting the economy hard. After recovering strongly in the first half of 2022 as the as the Omicron wave subsided, economic output in the Eurozone is likely to slide into recession as the summer travel season comes to an end. With high energy costs, consumers are left with less money to spend on other goods and services.

There is a threat of further trouble in the coming months as far as price increases are concerned. 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 suspended its gas deliveries through the Nord Stream 1 pipeline for an indefinite period at the end of August, the price pressure has increased again. Even if governments cushion this with interventions and aid packages, consumers will have to bear even higher costs.

After two years of COVID-19, a buoyant travel season saved the Eurozone economy from a slump in the summer. After that, however, hard-pressed consumers are likely to curb their spending considerably. We now expect euro GDP to decline by about 2.2% up to and including Q1 2023. However, as storage facilities continue to fill up, the risk that gas will have to be rationed in Germany in winter has diminished. Otherwise, the recession would be even sharper.

In a recession, private consumption of goods, private investment and foreign trade in goods are likely to decline in particular. In contrast, the states will continue to expand their investments. Given the currently very high demand for labour, unemployment is likely to rise only marginally in the Eurozone during the recession. This limits the downside risks.

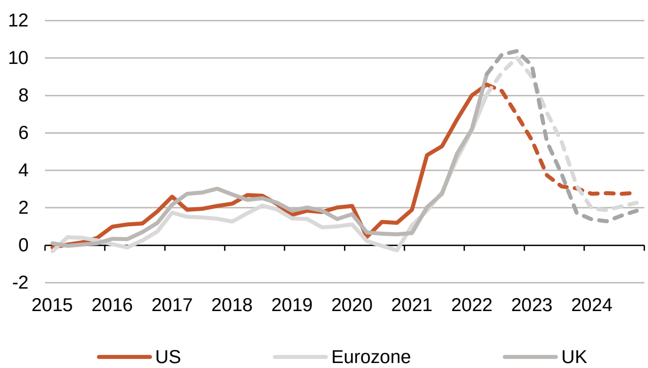
Over time, the decline in demand can contribute significantly to solving most of the current supply chain problems. Transport costs are also likely to fall again somewhat over the coming year. This helps both to dampen inflation and to strengthen upward forces again.

New upswing in summer 2023

Once the winter is over and the gas market has eased somewhat, the euro economy may pick up again in the summer of 2023. From then on, the rise in incomes could also be above the inflation rate again, so that consumers will have a little more money in their pockets in real terms after a severe setback. As soon as the

The big inflation hump

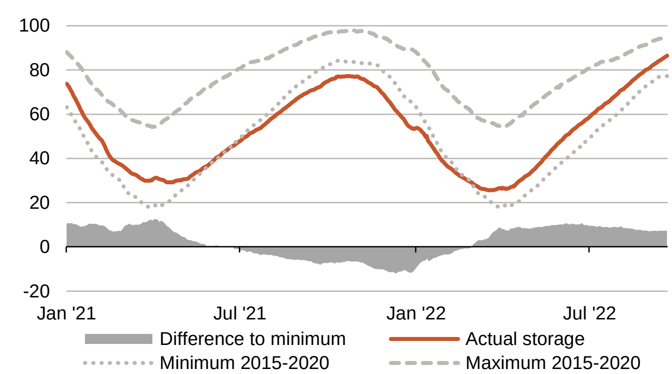
Increase in consumer prices year-on-year in %.



01.01.2015-31.12.2024. Dashed: Berenberg forecast. US: CPI-U, Eurozone: HICP, UK: CPI.
Sources: BLS, Eurostat, ONS, Berenberg.

EU gas storage

Level in percent; difference to the minimum in percentage points



01/01/2021-20/09/2022. EU-27.
Sources: AGSI, Berenberg.

presumably mild US recession comes to an end in autumn 2023, exports could also pick up again. After a decline in euro economic output of around 1.3% on average in 2023, we expect growth of 2.5% in 2024. For the UK, we expect a similar course as for the euro area.

Major differences between countries

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 will probably dampen demand in such a way that the US economy will stagnate in the final quarter of 2022 and the US will then fall into a mild recession until autumn 2023 with declining consumption and less investment, especially in residential construction. In contrast, government spending, including public investment, should support the economy.

Mild US recession, hard winter in Europe – followed by an upswing in the summer.

The highest inflation in 40 years

In the US, price pressure has apparently already passed its peak. While wage growth remains high for the time being, somewhat lower prices for petrol and used cars are providing relief to consumers. Since the labour market is slowly losing momentum, wage pressures could also ease in a few months.

Unlike in the US, consumers in Europe will have to adjust to noticeably higher electricity and gas prices for the time being. This is because the prices for natural gas imports and electricity, which rose again in the summer, have not yet fully reached consumers. Inflation in Europe could reach 10% in autumn before declining in 2023. The exact inflation profile also depends on the extent to which governments absorb the energy price shock, shifting some of the costs from today's consumers to future taxpayers.

Next year, inflation rates on both sides of the Atlantic could decline noticeably. Then the rise in energy prices in 2022 will gradually drop out of the year-on-year comparison. How much inflation then approaches the central bank target of 2% also depends on the extent to which employees can push through higher wages, which in turn would intensify cost pressures for companies.

Central banks shift - Fed more energetic than ECB

To prevent high inflation from becoming entrenched, the US Fed and – somewhat more hesitantly – the ECB are also putting the brakes on interest rates. In the US, the key interest rate could reach or even slightly exceed 4.5% in early 2023. As soon as the Fed sees sufficient signs that the recession has sufficiently dampened inflationary pressures, it will then lower interest rates again somewhat, probably starting in H2 2023. However, the Fed will not hold this in prospect for the time being. The ECB main refinancing rate could reach 2.5% or even 2.75% in February 2023, followed by a recession-related pause in the rest of 2023.

Dr Holger Schmieding, Chief Economist

Growth and inflation forecasts

	GDP Growth (in %)						Inflation (in %)					
	2022		2023		2024		2022		2023		2024	
		∅**		∅**		∅**		∅**		∅**		∅**
USA	1.5	1.6	-0.4	0.9	0.9	1.6	7.9	8.0	3.6	3.7	2.5	2.4
Eurozone	2.8	2.9	-1.3	0.3	2.5	1.9	8.4	8.1	6.2	4.8	2.1	2.1
Germany	1.1	1.5	-1.8	-0.1	2.6	1.9	8.6	8.0	6.6	5.2	1.9	2.0
France	2.1	2.5	-1.1	0.5	2.4	1.7	5.9	5.9	4.9	4.0	1.9	1.9
Italy	3.0	3.3	-1.7	0.4	1.5	1.5	8.0	7.6	6.1	4.5	1.8	1.8
Spain	4.2	4.5	-0.6	1.8	2.4	2.4	9.2	9.0	4.7	4.3	2.0	2.0
UK	3.1	3.5	-1.0	-0.1	1.9	1.3	9.0	9.2	5.1	6.6	1.5	2.1
Japan	1.7	1.6	0.5	1.5	1.4	1.2	2.1	2.1	1.3	1.3	0.7	0.8
China	3.0	3.5	4.0	5.2	4.0	5.0	2.1	2.3	2.4	2.3	2.3	2.1
World*	2.6	2.9	0.9	2.5	2.4	3.0	-	7.2	-	4.6	-	3.3

* * Berenberg data at actual exchange rates, not purchasing power parities (PPPs). PPPs lend more weight to the fast-growing emerging-market countries.
** Average, Bloomberg consensus as of 19/09/2022.

OPTIMISM LIEKY TO INCREASE TOWARDS YEAR-END

IN A NUTSHELL

- Negative earnings revisions are likely to continue during the Q3 reporting season, in line with the economic slowdown and typical revision seasonality.
- Higher risks in Europe are accompanied by lower valuation metrics. The discount to US equities is now more than 30%.
- Low investor positioning should limit downside potential. Year-end rally seems possible..

US equities in the lead in the third quarter

After equity markets and especially US as well as emerging market equities had rallied in the summer, there was a countermovement from mid-August onwards. Stubbornly high inflation figures in Europe, restrictive tones from central bankers and a reduction in earnings estimates led to a correction. US equities, supported by a stronger US dollar, held up best along with Latin American equities; European equities barely gained as the energy crisis worsened.

Negative profit revisions likely to continue

High inventories and weakening demand are increasingly weighing on corporate profits. The sharp rise in energy prices, especially in Europe, is weighing on consumers and companies alike. Three months ago, the consensus was still assuming 2022 earnings growth of around 10% year-on-year for the US. At the time, we argued that more realistic estimates should be at least 5% lower. With the latest earnings revisions, this growth has now slipped below 8%. In the Q3 reporting season coming up soon, estimates are likely to be reduced further. This would also be in line with the typical seasonality of earnings revisions. However, one should not forget that earnings are nominal numbers and thus supported by high inflation. In addition, the very profitable energy sector helps. We therefore do not expect aggregate corporate profits to collapse by 10-20% as in recent recessions.

Strong valuation differences

The US equity market remains expensively valued with a price-earnings ratio of around 17. The reasons for this are the concentrated index structure (expensive growth companies with high index weights), the stronger equity culture in the US and the high proportion of non-fundamental investors (share buybacks, passive investing, etc.). A new addition is the geopolitical component. Europe is regionally much closer to Putin's war and suffers more from the energy crisis, as does Japan as a large net energy importer. The China risk (high dependence on exports) is also much higher. The strong US dollar has also made imports more expensive for the rest of the world. European equities are now trading more than 30% cheaper than those from the US at index level, the highest discount since 2005. However, this also means that if all risks do not materialise or the crisis is overcome, there is relative catch-up potential for Europe. In terms of valuation, the US seems more vulnerable.

Volatility should decrease towards year-end

While there are many political risks lurking in the fourth quarter (elections in China, US, Brazil, etc.), the key issues are likely to be

German equities and European small caps were the relative losers in Q3, worsening energy crisis took its toll

Total return	YTD and in Q3 22 (in %, EUR): YTD (31/12/19-19/09/20)	Q3 20 (30/06/20-19/09/20)	12-month periods of the last 5 years (in %, EUR): 19/09/21 19/09/22	19/09/20 19/09/21	19/09/19 19/09/20	19/09/18 19/09/19	19/09/17 19/09/18	P/B* 19/09/22	Div.* 19/09/22	P/E* 19/09/22
MSCI UK	-1.2	-0.3	7.9	28.8	-19.9	4.9	4.4	1.5	4.4	8.9
Stoxx Europe Defensives	-3.5	-2.0	3.5	15.7	-3.4	11.2	4.3			
MSCI USA Small Caps	-5.0	11.6	-0.1	50.9	-8.2	1.7	22.2	1.9	1.5	17.1
S&P 500	-5.9	8.3	4.6	37.2	4.7	11.6	21.2	3.6	1.7	17.1
Stoxx Europe 50	-7.4	0.5	0.7	21.3	-5.0	10.2	0.2	2.0	3.6	11.0
MSCI Japan	-11.0	2.6	-15.4	26.4	0.3	2.9	11.6	1.2	2.6	12.4
MSCI EM Asia	-12.7	-2.9	-13.0	15.9	13.9	4.2	-0.5	1.5	2.9	11.7
Euro Stoxx 50	-16.7	1.5	-13.0	28.0	-5.6	8.4	-2.1	1.5	3.8	10.5
Stoxx Europe Cyclicals	-19.3	2.0	-15.7	36.8	-4.0	-0.6	1.1			
DAX	-19.4	0.2	-17.3	18.1	5.3	2.0	-2.7	1.4	3.9	10.4
Stoxx Europe Small 200	-26.8	-3.0	-26.1	36.6	1.0	1.9	6.0	1.3	3.5	13.5
MSCI EM Eastern Europe	-83.2	-6.5	-83.8	48.2	-21.7	24.5	6.5	1.0	4.8	6.1

Time period: 19/09/2017-19/09/2022.
Source: Bloomberg * PBV = Price/book value ratio; Div. = Dividend yield (%); PER = Price/earnings ratio. Values based on estimates for the next 12 months.

whether there is a (strong) recession, inflation has peaked and how central banks react. Overall, the market is likely to be more macro-driven. Our economists expect recessions in many western countries, which should lead to further adjustments in earnings estimates. In addition, the reduction of bond purchases and the interest rate hikes by central banks should lead to less liquidity. On the positive side, most market participants are expecting this anyway and are positioned cautiously accordingly. At the same time, non-fundamental investors are likely to continue buying equities (savings plans, buybacks) or adding to equities (systematic strategies) if price momentum improves and volatility declines. This could be the case especially towards the end of the year. At the same time, there are also a lot of upside risks for fundamentally oriented investors. Inflation could fall faster and more than expected, the economy could surprise positively, China could stimulate more after the elections or abandon the zero-COVID policy and even the Ukraine war could improve. So there are not only downside risks. Also, since many investors tend to become more optimistic towards the turn of the year, given the very pessimistic investor sentiment, the chances of a recovery rally towards the end of the year are not bad. Against this background, we have positioned ourselves with a neutral equity quota into the fourth quarter.

Ulrich Urbahn, Head of Multi-Asset Strategy & Research

WHAT IS ON COMPANIES' MINDS?

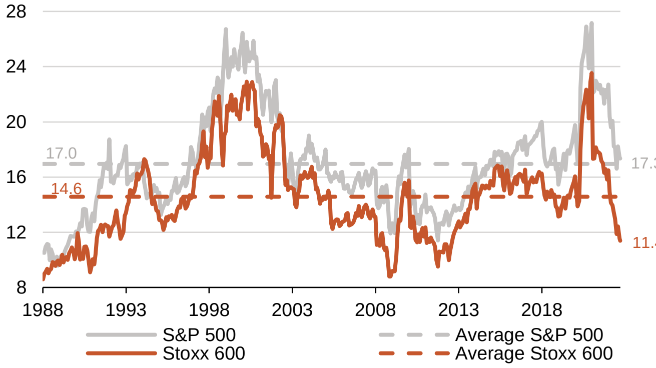
First clouding of the outlook

In conversations with our companies about the past first half-year, the majority were optimistic despite the approaching recession and pointed to robust growth trends. This optimism is partly explained by different end markets. For example, manufacturers of high-priced luxury goods and spirits – widely represented in our portfolios – were still able to report continued strong demand. On the other hand, if you talk to consumer goods companies in the low-price segment, which we tend to avoid, you already hear about significant drops in demand. Another reason is the more defensive business models in our portfolios. For example, companies in the healthcare sector or manufacturers of food and their ingredients tend to be relatively independent of the economic cycle. Our latest conversations give no reason to change this assessment. On the other hand, we are hearing a gloomier outlook from the more cyclical companies in our portfolios. This mainly concerns companies in the semiconductor, chemical and private equity industries. But here, too, we are optimistic about the coming quarters, as we can rely on a strong competitive position and solid capitalisation.

Matthias Born, CIO Equities

In Europe, a lot of negativity is already priced in

Price-earnings ratio (P/E) based on earnings estimates for the next twelve months and the respective average since 1988 for Europe and the US

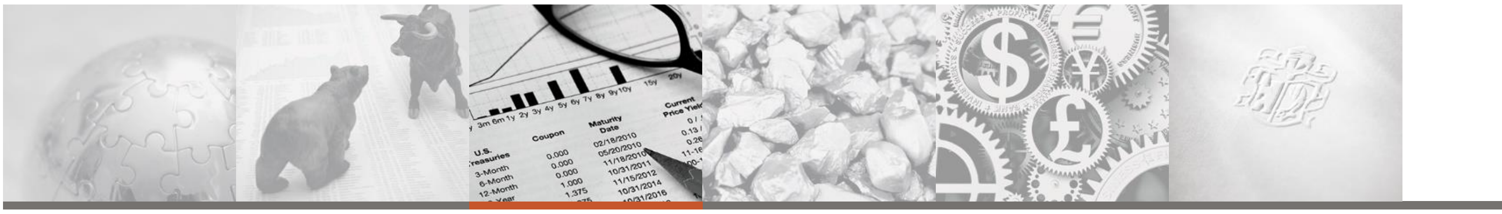


Time period: 31/12/1978–19/09/2022
Source: Bloomberg, Berenberg; for the Stoxx 600 the history before 2000 was taken from MSCI Europe.

Forecast summary: Equities with recovery potential

Index forecasts	Currently 19/09/2022**	30/06/2023	31/12/2023	Ø* in 12 months
S&P500	3,900	4,250	4,500	4,732
Dax	12,803	15,000	15,800	17,841
EuroStoxx 50	3,499	4,000	4,200	4,635
MSCI UK	2,081	2,350	2,400	2,556
Index potential (in %)				
S&P500	-	9.0	15.4	21.3
Dax	-	17.2	23.4	39.4
EuroStoxx 50	-	14.3	20.0	32.5
MSCI UK	-	12.9	15.3	22.8

* Average, consensus as of 19/09/2022.
**MSCI UK due to holiday on 19/09/2022 per 16/09/2022.
Source: Bloomberg, FactSet, Berenberg.



CHALLENGING ENVIRONMENT OPENS UP OPPORTUNITIES

IN A NUTSHELL

- Safe government bonds: Longer maturities have become more interesting – flattening of yield curves ahead.
- European corporate bonds: We favour the financial sector and see opportunities in the subordinated segment.
- Emerging market bonds: Papers in local currency remain favoured, gradually higher duration opportune.

Key interest rates rise, opportunities arise

Not surprisingly, the topics that dominated the discussion on the bond markets in the past quarter were those that had already dominated in the months before. However, the question of the prioritisation of monetary policy in the area of tension between stubborn inflation and looming recession has moved more into focus. In this context, there will be further interest rate hikes on both sides of the Atlantic for the time being. However, we show below that this does not have to be negative for bonds in general, but rather offers opportunities in individual sub-segments.

Government bonds: maturity management is in demand

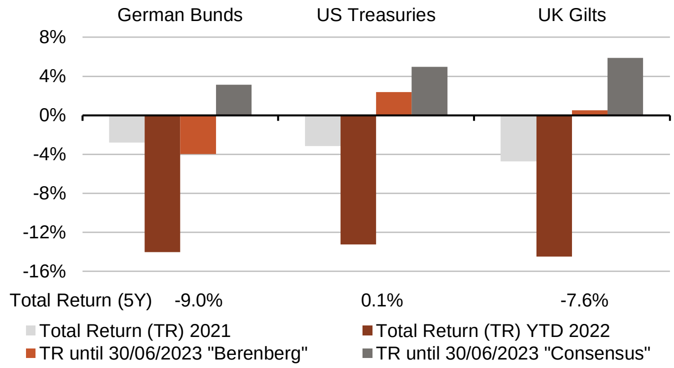
As expected, safe government bonds were not a profitable investment in the third quarter. Although the downward trend of the first half of the year was temporarily reversed in both Europe and the US, it was not enough for a sustained turnaround. The imminent recession in the Eurozone and the further rise in inflation rates due to energy prices do not send any clear signals for the autumn either. At the short end, the interest rate hikes by the European Central Bank should lead to higher yields, while longer-dated bonds will react negatively to the rising price level on the one hand, but will be in demand in the economic downturn on the other. The unchanged geopolitical risks also support the longer maturity segment. Overall, the US and European yield curves are likely to flatten. Accordingly, in our strategies we have supplemented our position in longer US government bonds with European government securities with high credit ratings.

Corporate bonds: easy come, easy go

The start of a summer rally in corporate bonds proved to be short-lived. However, after a hopeful phase of falling risk premiums, the mood tipped again in mid-August in the face of high energy costs and a still uncertain supply situation (left-hand chart on the following page). As long as the latter remains fragile in Europe and inflation figures do not fall sustainably, we expect the negative factors to prevail in the short term and cause yield spreads to widen further. In the medium term, however, we remain constructive. Companies' balance sheets are tidy and there are sufficient liquidity reserves. Moreover, so far neither the development of default rates nor the rating trend point to a significant deterioration. Interest rates and risk premiums in the investment grade segment have also provided attractive entry levels of currently around 3.3%. We pay particular attention to issuer analysis in an economic downturn. We continue to avoid cyclical sectors and particularly energy-intensive companies. On the other hand, we continue to favour

Selected safe government bonds with positive return potential

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



Time period: 19/09/2017–19/09/2022.
Source: Bloomberg, own calculations, iBoxx Government Bond Indices (7-10 years, TR)

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

Comparison of Berenberg and consensus forecasts, values at mid-year and end of 2023

	19/09/2022	30/06/2023		31/12/2023	
	Currently		∅*		∅*
USA					
Base interest rate	2.25-2.50	4.25-4.50	4.00	3.75-4.00	4.10
10Y US yield	3.49	3.50	3.17	3.70	3.18
Eurozone					
Base interest rate	1.25	2.50	2.29	2.50	2.53
10Y Bund yield	1.80	2.50	1.67	2.70	1.62
UK					
Base interest rate	1.75	3.00	2.90	2.50	3.00
10Y Gilt yield	3.13	3.40	2.73	3.50	2.51

* Average, consensus as of 19/09/2022.
Source: Bloomberg.

financial bonds issued by European banks and insurers with a strong financial base. Especially in the subordinated segment, attractive entry opportunities can be identified at the short end due to the pronounced market illiquidity.

Emerging market bonds in local currencies stay ahead

In the course of the third quarter, there was a broad recovery in emerging market bonds. Nevertheless, achieving an absolute positive performance this year seems doubtful, as a recession in Europe and the US would lead to falling risk-free interest rates, but would also be accompanied by widening risk premia. The still high degree of risk aversion is unevenly distributed, both at the country level and between government and corporate bonds in hard currency and government securities in local currency. In particular, the latter segment, which we have favoured in the recent past, has clearly outperformed its hard currency counterpart this year. We expect this to continue in the final quarter and that the active positioning in the currency component will remain the determining driver for performance despite already strongly increased local yields. When the key interest rate hike cycles come to an end in many emerging markets and inflation expectations have peaked, the current yield will become more important in the medium term - in this respect, a successive increase in the duration of local currency bonds seems opportune to us. From a market perspective, we are encouraged by the low investor positioning. We see most of the capital outflows caused by the market turmoil behind us. Despite the recovery in July and August, risk premia are still at attractive levels. An entry, especially in countries with little sensitivity to US yields and only small amounts of debt outstanding over the next one to two years, seems worthwhile. Last but not least, general issuance should remain manageable despite seasonally higher activity, which further supports the asset class.

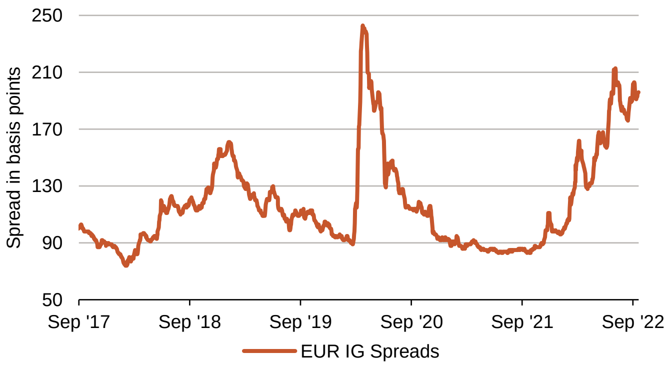
Conclusion: Opportunities available in several bond areas

In the segment of safe European government bonds, we consider the longer maturity segment to be interesting in anticipation of flattening yield curves, and the same applies to emerging market bonds in local currency with the gradual expiry of the interest rate increase cycle there. Attractive risk premiums, low positioning and rather low issuing activity speak in favour of the latter - the segment remains our favourite. We are still generally cautious about European corporate bonds for the time being, but we like short subordinated paper and issuers with a strong financial base from the financial sector.

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

Corporate bonds: One swallow does not make a summer

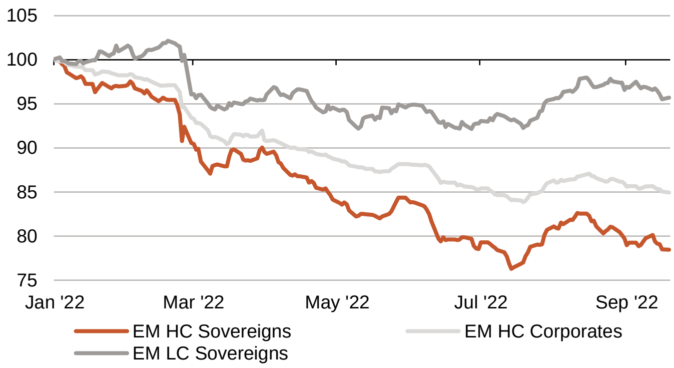
After an initially friendly phase from early July, risk premiums ("spreads") in the euro investment grade segment (IG) rose again from mid-August onwards.



Time period: 01/09/2017–19/09/2022.
Source: Bloomberg.

EM countries: Local currencies remain favoured

In the third quarter, the better performance of local currency (LC) securities compared to hard currency (HC) securities continued – continuation expected.



Time period: 31/12/2021-19/09/2022, indexed to 100 as of 31/12/2021
Source: Bloomberg, EM = Emerging Markets.

COMMODITIES WITH UPSIDE POTENTIAL

Mild recession does not imply a collapse in demand

In the third quarter, the oil market gave back all the gains since the beginning of the Russian invasion of Ukraine – from the high point in June to the end of August, the WTI oil price fell by almost 27%. The reason for the price drop was the strong US dollar, weaker demand from China due to COVID-19, and recession concerns. The severity of a possible recession is decisive for the further oil outlook. In a mild recession, demand growth declines but does not usually collapse. The worsening energy crisis in Europe is also likely to support oil prices on the demand side by switching from gas to oil. On the supply side, the situation remains tense. While a possible Iran agreement would mitigate the supply deficit, the resumption of production cuts by OPEC+ is likely to significantly exacerbate the supply situation, especially since, as things stand, the US will not release any further strategic reserves from November. For crude oil, we continue to expect increased volatility in the short term, but higher prices in the medium term.

Gold under the spell of Fed policy

After five weeks of uptrend, gold suffered a trend reversal in mid-August. The more restrictive Fed policy led to a significant rise in the US dollar and long-term real interest rates. Looking ahead, the direction of the gold price is likely to depend heavily on the Fed. Should the Fed remain restrictive due to stubborn inflation rates, gold is likely to have a difficult time. However, if recession concerns gain the upper hand, gold could rise as real interest rates fall. With already low investor positioning, especially the low net futures position of speculative investors, gold thus holds positive surprise potential.

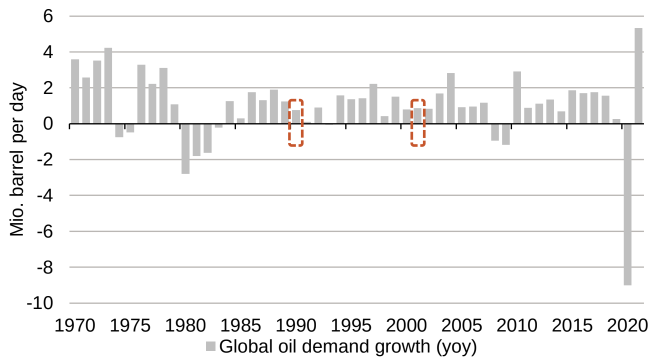
Industrial metals - long-term drivers intact

Industrial metals stabilised in August. A scorching heatwave in China caused power shortages and strained metal plant operations, heightening fears of disruptions. The energy crisis is already affecting metal production in Europe. While metals are likely to remain weighed down in the short term by the stronger US dollar and ongoing recession concerns with a restrictive Fed, the long-term drivers such as decarbonisation not only remain intact but are picking up speed. In addition, China's renewed friendly economic policy in the wake of the party congress in November could provide support.

Philina Kuhzarani, Analyst Multi-Asset Strategy & Research

Mild recession only means slight drop in oil demand

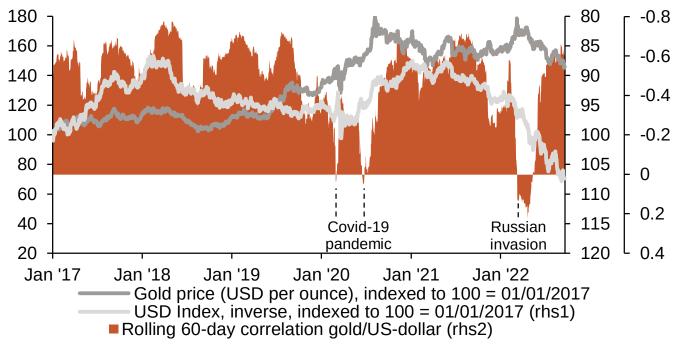
In a mild recession like in 1990 and 2001, global oil demand growth would be strained but would not collapse.



Time period: 1970-2021.
Source: Bloomberg.

US dollar recently determined the gold price

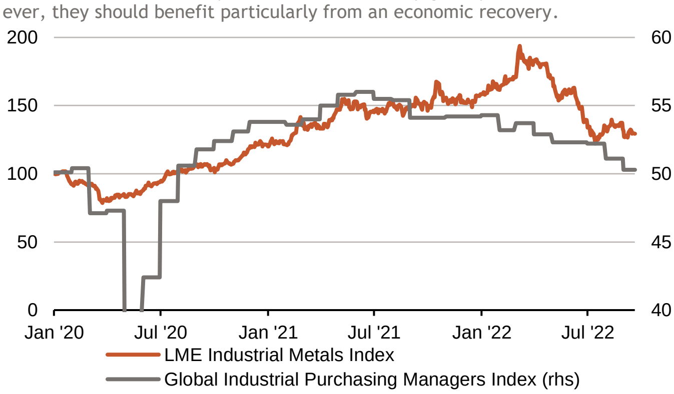
With a correlation of about -0.6, the gold price suffered greatly from the massive US dollar-appreciation. Only in times of crisis did the relationship turn positive.



Time period: 01/01/2017–19/09/2022.
Source: Bloomberg, own calculations.

Industrial metals driven by global economic downturn

Industrial metals are likely to remain burdened by gloomy economic data. However, they should benefit particularly from an economic recovery.



Time period: 01/01/2022–19/09/2022
Source: Bloomberg, indexed to 100 = 01/01/2020

TOUGH TIMES FOR THE EURO

Political and economic environment weighs on the euro

The mixture of political uncertainty, towering energy prices and a European Central Bank that has been very hesitant for too long have further weakened the euro in the past quarter and pushed it below parity against the US dollar. At current levels, the euro may be undervalued and the US dollar overvalued by fundamental criteria, but the exchange rate reflects current sentiment and economic and political risks quite well. While Europe starts the autumn with considerable energy supply risks and extremely increased energy prices, the situation in the US is much more relaxed. The US is not dependent on Russian gas for its energy supply and only has to pay a fraction of the European prices for energy. The economic consequences of the European energy crisis are not yet foreseeable, so it is very understandable that capital is currently tending to flow into the US dollar and other safe havens.

After all, the ECB has now clearly positioned itself for the fight against inflation. After the first rate hike of 50 basis points in July, the ECB made an even bigger move of 75 basis points in September. Apart from these rate hikes, the rhetoric of the ECB leadership has also changed. It is clearly trying to regain lost confidence. Whether this will be achieved quickly remains to be seen. In the short term, inflation is more likely to be dampened by political price brakes than by interest rate hikes – because monetary policy transmission takes time.

We do not expect any more big jumps from the euro this year. Only next year do we see some recovery potential for the common currency.

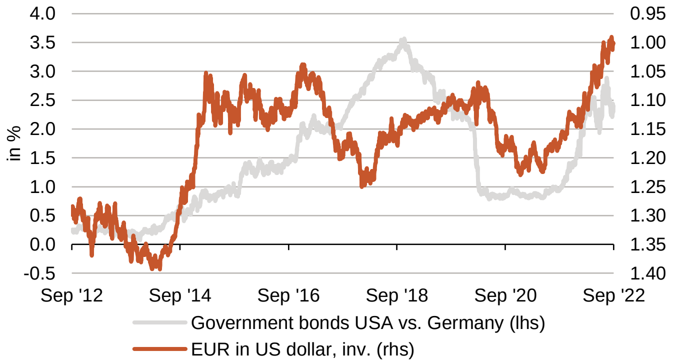
Swiss franc remains strong as an ox

The Swiss National Bank (SNB) gave the already strong franc an even stronger tailwind with an unexpected interest rate hike in June. In addition, the SNB no longer sees a strong franc as a burden on the economy, but as a welcome helper against further rising inflation rates: The stronger the currency, the cheaper goods can be imported from abroad. At just under 3.5% in August, the inflation rate is still at a moderate level. However, the share of administered prices in Switzerland is high at 28. % (euro area: 12.6%). It could therefore be that the state is artificially depressing the price level through its interventions.

Dr Jörn Quitzau, Senior Economist

EUR/USD: The euro fights for parity

The euro exchange rate has not stopped at the magic mark of 1.00 US dollar per euro. Can the euro at least stabilise here?



Time period: 19/09/2012–19/09/2022
Interest rate differential 2-year government bonds. Source: Macrobond.

EUR/GBP: Switzerland is betting on a strong franc

U-turn by the Swiss National Bank: Strong franc now desired as inflation damper

Time period: 19/09/2012–19/09/2022
Source: Macrobond.

Exchange rate forecasts

Euro: Moderate upside potential in the coming year.

	19/09/2022	30/06/2023		31/12/2023	
Exchange rate forecast	Currently		∅*		∅*
EUR/USD	1.00	1.05	0.99	1.10	1.03
EUR/GBP	0.88	0.85	0.86	0.85	0.87
EUR/CHF	0.97	1.02	0.96	1.04	0.98
EUR/JPY	144	142	136	145	136
Change against the euro in %					
USD	-	-4.5	1.3	-8.9	-2.7
GBP	-	3.2	2.0	3.2	0.8
CHF	-	-5.2	0.7	-7.0	-1.3
JPY	-	1.1	5.5	-1.0	5.2

* Average, consensus as of 19/09/2022.
Source: Bloomberg.

INTERVIEW WITH KATHARINA RAATZ

Ms Raatz, you are a portfolio manager for micro and small cap equities. What fascinates you about your work?

My job is very versatile, because it includes the analysis of various business models and the market situation, the portfolio construction and the exchange with our clients. My job is to select the most attractive investment ideas according to risk-return expectations from an investment universe of more than 12,000 European and international stocks. The most exciting business models include, for instance, a producer of OTC iron deficiency products, a consulting company in the field of robot-controlled process automation and a creative agency for the development of perfume concepts – this shows the diversity. In addition to our portfolio companies, we also analyse their customers, suppliers or competitors in order to draw cross-comparisons. This illustrates what the challenge of a portfolio manager is: on the one hand, to cover the market breadth, both on a micro and macro level, and on the other hand, the depth, that is, the details of the value drivers of relevant companies. In addition to analysing the business models, it is important to understand and anticipate the market phase, because not every quality and growth company offers the same potential in terms of risk-adjusted return at every point in time.

What is the unique appeal of small caps? Why should investors invest in micro and small caps?

The appeal of micro and small cap companies is the high level of market inefficiency, which we use specifically to create sustainable added value for our clients. This inefficiency is already evident in the very time-consuming procurement of information. Many small caps report only a selection of financial ratios on a quarterly basis, or only in local language. In addition, there is often no information provided by analysts. The most important source of information for us is therefore the direct exchange with the management teams. On average, each portfolio manager from our team has 200 management meetings a year.

In addition to market inefficiency, I am also drawn to the dynamics. The average earnings growth of our portfolio companies is 20% p.a.. This reflects the very high innovative strength and the good market positioning. We focus on small companies that have the potential to become the standard stocks of tomorrow and beyond. With such growth dynamics come higher return opportunities, but also higher volatility. It is therefore important to have a long investment horizon and to manage risk through strict adherence to investment criteria and high diversification. Over the medium to long term, an investment in micro and small caps should be rewarded with a higher average absolute and risk-adjusted return.

You launched the International Micro Cap Fund last year. What exactly is behind it?

With this new concept, we invest in small companies in niche markets such as Australia, New Zealand, Israel, Singapore and South Korea, as well as in undiscovered companies in inherently efficient markets such as the USA/Canada and Japan.

The advantage of investing across countries is that we can set the bar higher on growth, quality and valuation factors. This is because we compare and discuss companies with similar growth drivers within a larger investment universe. The average weighted market capitalisation of a portfolio company in the Berenberg International Micro Cap Fund of EUR600m differs significantly from, for example, US competitors with EUR3bn. In addition, our clients of the European small cap strategies can diversify with a complementary investment in the Berenberg International Micro Cap Fund: The correlation is comparatively low at around 0.76.

So it's a completely new concept. How would you describe your investment philosophy?

Our investment philosophy is the same in all small cap funds: We focus on smaller and thus even more inefficient companies that have demonstrated an excellent market position in their structurally growing market niche, which is very well defended thanks to high barriers to entry. This is reflected in an average earnings growth of 20% p.a., a return on capital of 20% and a net cash position.

How do you select your stocks?

In the selection process, we focus on the historical financial ratios, i.e. in particular on the gross margin, which provides information on pricing power, as well as on cash flow generation and returns on capital. We analyse the sustainability of these ratios based on the strength of buyers and suppliers, the intensity of competition in the niche market, the threat of new competitors or substitute products. In addition, the capital structure and incentive structure of the management team provide information on how a company is managed. In our active funds, we make sure that companies have healthy balance sheet ratios and sufficient liquidity reserves. This is often the case with owner-managed companies.

Small-cap and micro-cap companies have not been able to escape the volatile markets, and this is also reflected in the performance of the funds since the year began. What were the reasons for this?

The beginning of the year was characterised by a high level of uncertainty and volatility. Even before the start of the war in Ukraine in February, the expectation of a faster departure from the expansive monetary policy in the US in connection with the rising inflation expectations to date weighed on markets and especially on growth stocks. A substantial rise in interest rates was compounded by a significant economic slowdown. This combination of rising interest rates in a looming recession led to a sharp sell-off.

The absolute and relative performance of our funds is due in particular to market sentiment. Encouragingly, however, the clear majority of our portfolio stocks have outperformed growth expectations over the past reporting season. This confirms our assessment that the fundamental drivers remain intact.

How do you deal with the current market environment?

We use the current market environment to selectively add to equity positions that have fallen particularly sharply without fundamental justification. In the past, this strategy of countercyclical portfolio management has proven to pay off.

I remain convinced that micro and small caps offer a higher risk-adjusted return than blue chips in the medium to long term. This is because the value driver of the higher innovative power of the smaller, more agile and often strategically managed companies remains unchanged. In my opinion, corrections like this year's offer good buying opportunities. For long-term asset accumulation, it is important not to be distracted in such phases, i.e. in case of doubt, sell when the panic on the markets is at its greatest.

BRIEF BIOGRAPHY

Katharina Raatz has been a portfolio manager for Small Cap Equities since 2013. In October 2017, together with Peter Kraus, she launched the Berenberg European Micro Cap Fund and the Berenberg European Small Cap Fund and in November 2021, together with the team, the Berenberg International Micro Cap Fund. From 2013 to 2017, Katharina worked at DWS. She holds a Master of Science and a Bachelor of Science from the University of Mannheim and has been a CFA Charterholder since 2017.

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IMPORTANT NOTICES

Date: 22 September 2022

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