HORIZON

The Berenberg Capital Market Outlook · Wealth and Asset Management

NORMALISATION

The past year of Covid-19, restrictions and recession should be followed by a year of vaccines, re-opening and economic recovery.

TAILWINDS

Equities are supported by negative real interest rates, loose monetary and fiscal policy, high levels of liquidity, rising profits, and their relative valuations. But as soon as all investors have repositioned themselves, overall market conditions are likely to become more difficult.

ROTATION POTENTIAL

An even more pronounced change of market favourites looms if inflation expectations rise further or should real interest rates begin to rise.

Q1 | 2021

BERENBERG

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FOREWORD

Prof Dr Bernd Meyer
Chief Investment Strategist

Dear reader,
Markets increasingly priced-in a global economic recovery in the fourth quarter. Global equities broke out of the sideways channel that they have been stuck in since early June and climbed higher. The main beneficiaries were more cyclical and value-orientated investments such as commodities, small caps and emerging-market equities and bonds.

Despite the renewed lockdowns, we had anticipated this market development and consider it to be justified. Besides giving us reason to hope for substantial investments in (green) infrastructure, new US President Biden is also likely to pursue a much more diplomatic foreign policy – and the fact that vaccines should soon be widely available is a major step in the battle against the pandemic. Everything should gradually normalise in 2021. The year of COVID-19, restrictions and recession should be followed by a year of vaccination, re-opening and economic recovery. Our economists are convinced that the economy is poised for growth. They anticipate a globally synchronised recovery accompanied by initially low inflation and further supported by favourable fiscal and monetary policy. For instance, the funds of the EU Recovery Fund should only flow over the next few years. Moreover, a normalisation of extremely loose monetary policy is not to be expected anytime soon.

Does that mean that capital markets are also poised for a continued upturn in 2021? We are in the early phase of a global economic recovery that should last for several years. Corporate profits will rise significantly, and the money supply is growing at a rapid pace. That is a very good starting point for equities. However, capital markets have already priced-in much of these developments in the rally since March 2020. Investor sentiment has brightened. While it is not yet euphoric, scepticism has given way to growing optimism. Nevertheless, equity markets still have potential given that volatility remains high and equity valuations are still attractive compared to bonds. Diminishing volatility could entice more systematic investment strategies. An overshoot of equity markets is certainly possible. However, I am sticking to my view that when a vaccine becomes widely available, it will not mark the starting point of a positive trend in equity markets. It may rather prompt a temporary high point. Success in the battle against the pandemic is currently priced in. When all investors have positioned themselves and euphoria takes hold, it will be time to become more cautious. This should be kept in mind, especially if inflation expectations and bond yields start rising more quickly than anticipated in the course of the economic recovery.

In the Insights Interview, Nico Baum, Head of Innovation & Data, and I discuss the role that big data and artificial intelligence (AI) are already playing in the markets and in our investment process. I wish you all the best in 2021.

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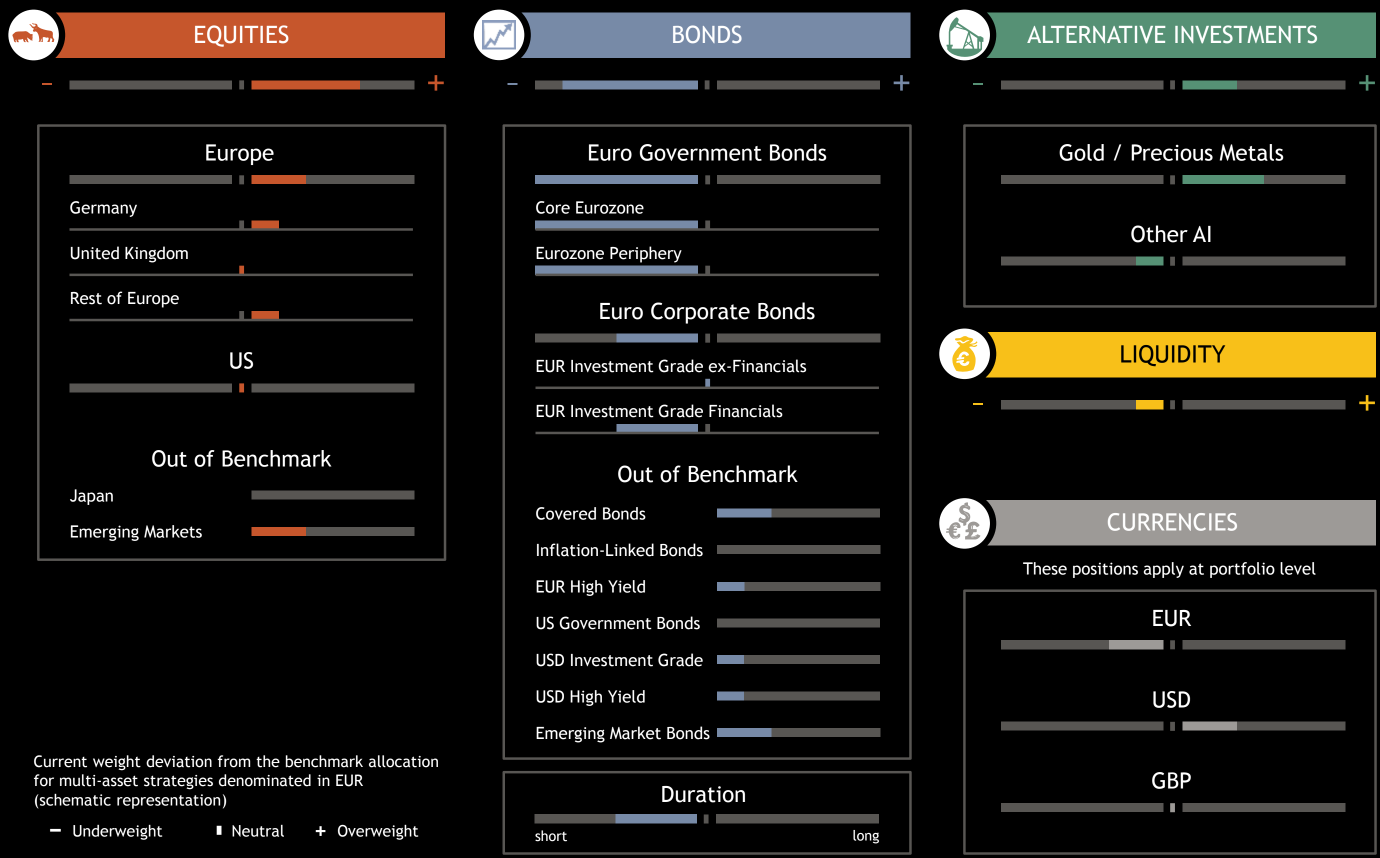
MARKETS EYE A GLOBAL ECONOMIC RECOVERY

IN A NUTSHELL

- The fading of political risks and the prospect of COVID-19 vaccines clear the path for a cyclical recovery with globally synchronised growth.
- Capital markets have left COVID-19 behind and are looking into the future. Investor sentiment has brightened, but it is not yet euphoric. The reallocation from cash to equities still has great potential.
- Systematic investment strategies should increasingly invest in equities again as volatility decreases.
- A more aggressive positioning with cyclical elements remains appropriate into 2021.

Portfolio positioning at a glance

Since September, we have increased our equity allocation further and added cyclical stocks to our portfolios. We consider a clear overweight position in equities to be appropriate also into 2021. We expect volatility to decrease further and equities are likely to outperform other asset classes. Emerging markets and Europe in particular should benefit from a recovery of global growth. Moreover, emerging-market currencies are likely to rise further. Especially in Europe, but also in the US, we are investing more in small caps. Within Europe, we have substantially scaled back the strong underweight of UK equities. Once the Brexit uncertainties are resolved, UK equities could become the surprise winners of 2021. They are relatively cheap and considerably underweighted by investors. We expect the yields of safe government bonds to rise gradually during the recovery. We remain underweight in this segment. Corporate and especially emerging-market bonds still offer yield, but the potential for tightening yield spreads is limited after the pronounced development of the last few months. The US dollar should weaken further. Gold remains supported due to negative real interest rates and rising government debt. Nevertheless, cyclical commodities seem to be more attractive in the short term.



Looking back on 2020: conciliating conclusion in the fourth quarter

2020 has been a year to remember. The measures imposed to curb the COVID-19 pandemic triggered the worst collapse of the global economy in peacetime, which central banks and national governments counteracted with unprecedented fiscal and monetary policy action. The global economy quickly began to recover. Although the recovery faltered somewhat as a result of the renewed restrictions in Q4 in Europe and elsewhere, the prospect of widespread vaccination fuelled hopes for a further normalisation. The capital markets exhibited a no less spectacular development, earning many superlatives such asthe fastest and shortest bear market, the fastest return to a bull market, and countless extreme market swings. All this is further proof of the changed market structure that we have repeatedly addressed in the last few years, one that demands more opportunistic investor behaviour.

In the fourth quarter, the capital markets increasingly priced-in the ever more probable recovery of the global economy in 2021 (see the graph at the top of p5). Equities recovered further after the sluggish summer months and largely turned positive for the year to date. Few would have thought that was possible in the spring. Emerging-market countries and Europe in particular benefited from the upturn in Q4. The oil price made big gains, but oil is still the biggest loser since the beginning of the year. Gold gave up some of its strong year-to-date performance in the risk-on environment of the fourth quarter.

Green light for the global economy in 2021

Barring residual COVID-19 risks such as vaccination failures due to low efficacy, a low level of willingness to be vaccinated, vaccine side-effects or virus mutation, the global economy can be expected to expand dramatically in 2021. Savings rates in the US and Europe have risen considerably – catch-up effects in spending should provide support. Growth should also be driven by government investment spending and business investment. Many parts of the world are in the early phase of a strong, multi-year upswing. Inflation is low and additional support is being provided by monetary and fiscal policy. This is a good starting point. For years, market participants have constantly feared a recession because the upswing had lasted so long already and the US-China trade war had put increased pressure on markets. These issues are behind us now.

Business investment as growth driver

Various uncertainties (Brexit, the trade war, the US election, the COVID-19 crisis) along with collapsing corporate profits caused businesses to curtail their investment spending sharply in recent years (see the centre graph on p5). Deferred business investment will need to be made up in the future. Clarity regarding Brexit, less noise in the trade war, and a substantial rise in corporate profits should prompt a substantial increase in business investment in 2021 and beyond. After corporate profits fell by 17% and 5% in the industrialised nations and emerging-market countries respectively in 2020, consensus expectations call for profit growth of 26% and 33% respectively in 2021 and further growth in 2022.

The end of Brexit uncertainties will unleash investment spending

Strong performance of oil and equities (expecially EM) in Q4; Gold has performed best in 2020 despite Q4 losses; USD declines further

Total return	YTD and in Q4 (in %, EUR)		12-month periods of the last 5 years (in %, in EUR)					CAGR*	Std. dev.*
	YTD (31/12/19-14/12/20)	Q4 (30/09/20-14/12/20)	14/12/19 14/12/20	14/12/18 14/12/19	14/12/17 14/12/18	14/12/16 14/12/17	14/12/15 14/12/16	14/12/15 14/12/20	14/12/15 14/12/20
Gold	11.2	-6.5	13.4	21.2	3.0	-1.9	12.5	9.3	12.6
S&P 500	6.1	4.9	7.2	26.4	4.3	8.5	17.8	12.6	20.2
MSCI EM	5.6	11.6	7.5	16.7	-7.4	18.7	19.7	10.6	16.3
EUR Corporates	2.9	2.2	2.7	6.6	-1.9	3.4	4.1	3.0	2.5
EUR Sovereigns	2.3	0.8	2.0	3.8	-0.4	1.0	1.7	1.6	2.1
DAX	-0.2	3.6	-0.4	22.2	-16.9	16.2	10.9	5.5	20.0
Eonia	-0.4	-0.1	-0.5	-0.4	-0.4	-0.4	-0.3	-0.4	0.0
US Sovereigns	-2.3	-3.8	-3.3	8.3	4.6	-8.0	3.8	0.9	6.9
EM Sovereigns	-3.1	0.8	-3.4	15.4	-0.2	-0.9	13.9	4.7	8.4
Stoxx Europe 50	-7.3	6.1	-6.2	22.2	-7.7	11.0	3.7	4.0	17.0
USDEUR	-7.7	-3.5	-8.4	1.7	4.2	-10.5	4.4	-2.0	7.0
Brent	-38.7	11.7	-37.6	19.6	6.3	0.6	21.0	-0.7	39.7

Time period: 08/12/2015–14/12/2020.
Source: Bloomberg * CAGR = annualised return (in %, in EUR); Std. dev. = Annualised standard deviation (in %, in EUR).

as companies will finally know how to restructure their Europe-wide supply chains. With more planning certainty once the pandemic is overcome and with Joe Biden as president of the US, companies will be willing to invest again. They are likely to rethink their supply chains and focus on more security, stability and ecological as well as social consequences. Companies operating in the fields of automation, robotics, digitalisation, AI and semiconductors are likely to benefit from this trend, along with industrial metals.

As they increase investment, companies will also shift their focus from balance sheet repair and bondholder value back to shareholder value. In this environment, one can well imagine that both equities and commodities will perform better than corporate bonds in 2021, especially considering that yield spreads are now below their long-term averages again, corporate bond funds have already had substantial inflows, and a wave of insolvencies can still be expected in the future. However, spreads are likely to narrow further initially due to the hunt for yield and the ongoing high level of central bank purchases, coupled with limited issuance activity.

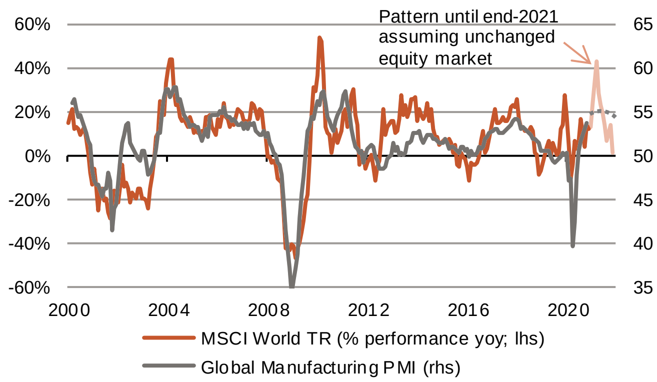
Interest rates and yields pose the greatest risk for markets

However, the economic recovery could also push markets to unjustifiably high levels that would then necessitate a painful correction. For this reason, it would be imprudent to expect constantly calm market conditions throughout the year. Besides the residual risks of the pandemic and the still unresolved political risks, we think the development of interest rates will pose the greatest risk. We do not expect that actual inflation will accelerate on a sustained basis in 2021. But what if oil prices rise to USD 60-70/bbl in the wake of the economic recovery? The input and output price indices of the US Purchasing Managers Index have already risen to the highest level in the last 10 years and the US inflation surprises index has risen to a 12-year high. Inflation expectations are likely to increase and yield curves to steepen further (see the graph at bottom). The worst-case scenario would be an increase in real interest rates because that would put pressure on the valuations of all asset classes. Investors must at least be prepared for volatility in bond yields. Equity markets would not be immune to this volatility, especially considering that the interest rate sensitivity of equity markets has increased substantially. There is a risk that positive reflation hopes could give way to negative inflation fears over the course of 2021.

Prof. Dr. Bernd Meyer, Chief Investment Strategist

Equity markets are pricing-in a global economic recovery

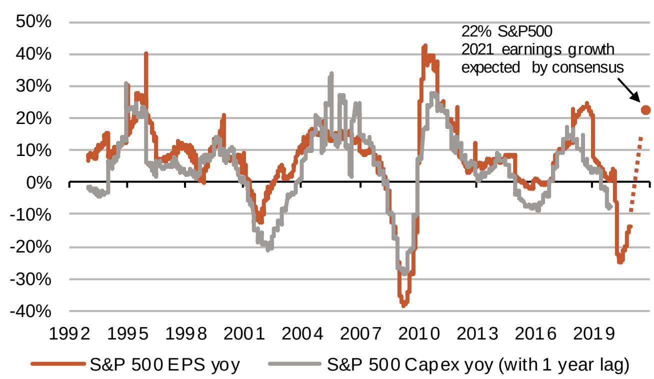
Performance of global equities year over year compared with the global Manufacturing Purchasing Managers Index (PMI). PMI close to 55 through 2021?



Time period: 01/01/2000–31/12/2021.
Source: Bloomberg, own calculations.

Rising profits should lead to increased business investment

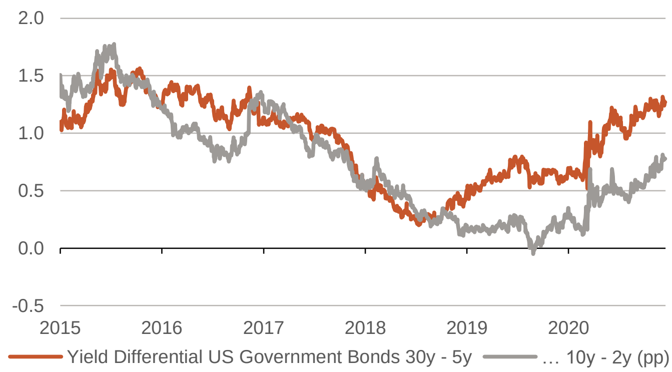
The growth of realised profits should drive subsequent business investment



Time period: 01/01/1993–14/12/2020.
Source: Bloomberg, own calculations.

Rising inflation expectations, steepening yield curves

If yield curves continue to steepen, central banks would need to buy up more longer-dated bonds or tighten monetary policy



Time period: 01/01/2015–14/12/2020.
Source: Bloomberg, own calculations.

POWERFUL UPSWING IN SIGHT

IN A NUTSHELL

- Global economy: Powerful upswing as soon as the second wave of the pandemic subsides.
- Biden effect: Calmer US trade policy can revive global trade. Good for Europe.
- Monetary and fiscal policy will continue to support the economy more than ever before. China will likewise continue to stimulate.

The end of two nightmares

Two severe shocks have rattled the global economy over the last two years. In 2019, US President Donald Trump dealt a heavy blow to global trade with his trade war against China and his threats against the EU. A general sense of unease damaged the economy even more than the tariffs. As a result, the economic growth rate of the Eurozone as the world champion of exports fell from slightly more than 2% at the start of 2019 to less than 1% at the end of 2019. After the "Phase 1" deal between China and the US cleared the way for renewed economic growth at the start of 2020, the COVID-19 pandemic plunged the global economy into the deepest recession in 90 years in March.

These two extraordinary shocks are set to fade in 2021. Although new US President Joe Biden is no free trader, he does want to work closely with allies like the EU, Canada and Japan instead of intimidating them with threats. Although many points of contention between Europe and the US remain unresolved, the two sides are likely to discuss them calmly and also strive for a unified stance on China. Therefore, the risk of a trade war between the world's two biggest economic zones, the US and the EU, is probably off the table. This is the best news for global trade in more than four years.

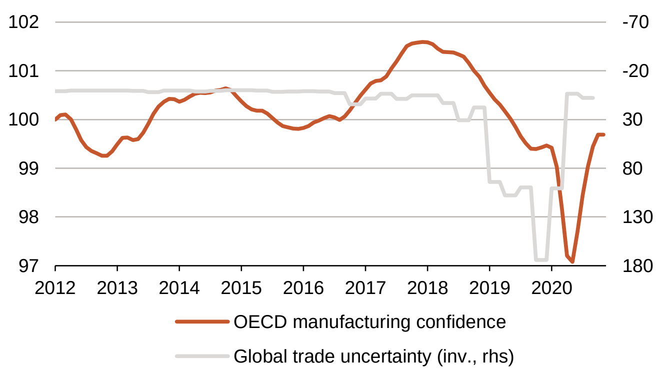
After the second wave of the pandemic

After a strong recovery in the months from May to October, the European economy was slammed again by the second wave of the pandemic in the late autumn of 2020. However, as the restrictions were significantly more targeted than in March and April, and as manufacturing was not crippled by disrupted supply chains with China, economic activity declined only moderately in Europe and presumably not at all in the US. Declining numbers of new infections in Europe, a stabilisation in the US and the concrete prospect of effective vaccines give reason to hope that the second wave of the pandemic will soon recede.

Countries in the Northern Hemisphere will probably be able to largely lift the restrictions on public life at the latest at the start of the brighter and warmer spring season. Although the virus will not disappear, medical advances and vaccine campaigns will probably mean that a seasonal rise of infection risk in the autumn of 2021 will not necessarily have serious economic consequences. In the pause between the two waves of the pandemic in 2020, the Eurozone made up almost the entire loss from Q2 in Q3. This

Outlook for 2021: Powerful recovery after two nightmares

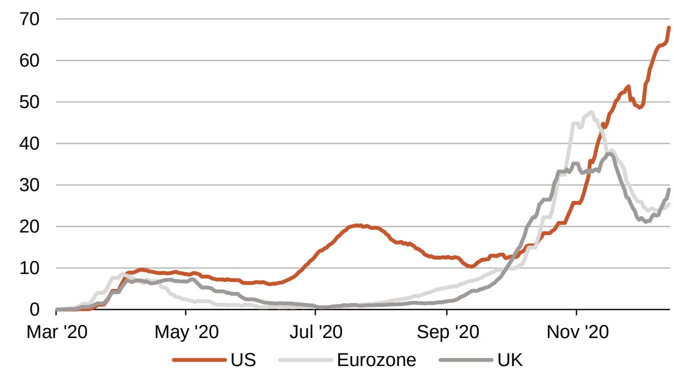
Economic climate vs. trade uncertainty



Time period: 01/01/2012–30/11/2020.
Source: OECD, PolicyUncertainty.com.

Progress on the COVID-19 front

Confirmed daily new infections per 100,000 inhabitants, 7-day average



Time period: 01/03/2020–14/12/2020.
Source: Johns Hopkins University.

suggests that the economy could fire up quickly again after the second wave recedes.

"The economy could fire up quickly again after the second wave recedes"

We anticipate that the economies of the US and Germany will have returned to their pre-pandemic levels by the end of 2021. The Eurozone will probably only regain this level in the middle of 2022, as the structurally weak Italy weighs down the average Eurozone country GDP. Due to Brexit, the UK will not be able to make up its economic losses until the start of 2023. China could even post modest economic growth already in 2020 since it was able to prevent a second wave of the pandemic. Signs are pointing to solid growth in 2021, supported as usual by expansive credit policy.

Monetary and fiscal policy are more expansive than ever before

In response to the mega-recession caused by COVID-19, finance ministers and central banks almost everywhere in the world opened the monetary flood gates wider than ever before in 2020. By this means, they supported household incomes, saved many companies from bankruptcy, and prevented a financial crisis or sharp deflation with long-lasting mass unemployment.

Monetary and fiscal policy will continue to support the economy more than ever before. After the European Central Bank loosened its monetary policy powerfully again in December 2020, the Fed and the ECB will probably leave their current strategy largely unchanged in 2021. Even though inflation is likely to hit a trough soon and slowly rise in the further course of 2021, central banks will welcome this initially as a move in the right direction. A genuine reversal of interest rates is likely to occur at the end of 2022 at the earliest. Following the deep recession, central banks will be more careful than before to ensure that the recovery reaches especially hard hit labour market groups such as recent graduates and workers in low-wage sectors before they slowly tighten monetary policy.

Even though government budget deficits will shrink appreciably amid the powerful economic upswing in 2021 as households and businesses need less emergency aid, the fiscal impulse will be even more powerful in 2021 than in 2020 in many countries thanks to increased public-sector investment and hiring, including in healthcare. This prospect also supports the expectation of a robust recovery next year. Solid demand increases in the US, Europe and China and continued low interest rates will also create a positive environment for many emerging-market countries.

Dr Holger Schmieding, Chief Economist

Growth and inflation forecasts

	GDP Growth (in %)						Inflation (in %)					
	2020		2021		2022		2020		2021		2022	
		∅**		∅**		∅**		∅**		∅**		∅**
USA	-3.5	-3.5	3.9	3.9	2.5	3.1	1.2	1.2	1.9	2.0	2.0	2.1
Eurozone	-7.5	-7.4	5.0	4.6	3.6	3.7	0.2	0.3	0.8	0.9	1.3	1.2
Germany	-5.8	-5.6	4.4	4.0	3.4	3.3	0.4	0.4	1.3	1.3	1.2	1.4
France	-9.3	-9.3	7.0	6.1	3.9	3.8	0.5	0.5	0.9	0.8	1.3	1.2
Italy	-9.5	-9.0	5.8	5.4	3.3	3.1	-0.1	-0.2	0.6	0.4	1.3	0.9
Spain	-12	-11.6	7.1	5.9	6.2	4.8	-0.4	-0.3	0.7	0.6	1.3	1.1
UK	-11.7	-11.2	8.0	5.4	4.3	4.5	0.9	0.9	1.2	1.5	2.0	1.9
Japan	-5.3	-5.3	3.4	2.6	1.9	1.8	0.1	0.0	0.2	0.1	0.5	0.5
China	2.7	2.0	9.0	8.2	4.8	5.5	2.5	2.7	1.4	1.7	2.2	2.4
World*	-3.3	-3.8	4.1	5.2	2.7	3.7		2.2		2.7		2.9

* Berenberg data on actual exchange rates as opposed to purchasing power parities (PPPs). KKPs give more weight to fast-growing emerging-market countries.
** Average, Bloomberg consensus as of 14/12/2020.

RISING EARNINGS, DECLINING VALUATIONS

IN A NUTSHELL

- All equity regions and especially COVID-19-ravaged sectors and regions gained in Q4.
- We expect corporate earnings to rise substantially next year, more than offsetting a decline in valuations. Equities on the whole can also be expected to rise.
- We have a tactical preference for US small caps and UK equities and, for the full-year 2021 especially, European and emerging-market equities.

Equities on fire in Q4 thanks to diminishing uncertainty

Joe Biden's election victory combined with positive COVID-19 vaccine news let stock markets skyrocket in November. All prominent stock barometers throughout the world, particularly regional indices that were especially hard hit by COVID-19 restrictions, made substantial gains in the fourth quarter. For instance, US small caps and eastern European equities are up 20% and 17% respectively in euro terms. US large caps, which had experienced a strong run-up already before the fourth quarter, were among the relative losers due to the below-average performance of tech stocks. On a year-to-date basis, however, the situation is different: eastern European and UK equities are clearly down on the year, while Asian and US equities are well up on the year and have reached all-time highs in some cases.

Substantial increase in corporate earnings in 2021

After corporate earnings fell sharply in 2020, especially in sectors hit hard by COVID-19 such as energy, finance and leisure, the consensus expectation calls for a strong recovery in 2021. Analysts expect the strongest profit growth next year to come in Latin America and eastern Europe, regions that can be expected to benefit especially from a recovery of commodity prices. Profit growth of 22% is expected for the US and 34% for Europe. We think that the optimistic estimates are justified. For one thing, the baseline is lower after the profit decline in 2020. Expansive central bank policy all over the world and the planned fiscal stimulus measures in many regions will continue to support equity markets. A more diplomatic approach to trade and foreign policy under Joe Biden combined with higher business investment spending should also be conducive to corporate profit growth. Therefore, the historically often too optimistic earnings forecasts of analysts could prove to be correct or even too conservative. Analysts often have trouble with estimates after inflection points because they are overly reliant on past trends.

Valuations are likely to come down

Equity valuations increased considerably in 2020 for two reasons. Lower interest rates, especially in the US, led to lower discount factors being applied to future profits. Moreover, the market looked past the COVID-19 crisis in the justified hope that vaccines would be available soon. Considering that bond yields will probably rise at least modestly next year, and with the market also

Broad recovery of equity markets in Q4, especially among YTD underperformers

Total return	YTD and in Q4 (in %, EUR): YTD (31/12/19-14/12/20)	QTD (30/09/20-14/12/20)	12-month periods of the last 5 years (in %, EUR): 14/12/19 14/12/20	14/12/18 14/12/19	14/12/17 14/12/18	14/12/16 14/12/17	14/12/15 14/12/16	P/B* 14/12/20	Div.* 14/12/20	P/E* 14/12/20
MSCI EM Asia	14.2	10.4	15.8	17.5	-8.9	23.6	15.8	2.0	1.8	19.4
S&P 500	6.1	4.9	7.2	26.4	4.3	8.5	17.8	3.9	1.6	25.8
MSCI US Small Caps	5.8	20.2	7.0	20.9	-0.4	3.3	25.8	2.3	1.2	43.0
Topix	2.7	7.8	1.3	18.1	-7.0	11.2	11.5	1.3	2.0	23.2
Stoxx Europe Small 200	0.6	9.8	1.5	25.5	-9.7	18.9	2.5	1.7	2.2	42.2
DAX	-0.2	3.6	-0.4	22.2	-16.9	16.2	10.9	1.6	2.7	19.3
Stoxx Europa Cyclicals	-2.6	13.2	-2.1	23.8	-14.2	14.9	10.2			
Euro Stoxx 50	-4.5	9.9	-4.2	24.1	-10.7	13.5	5.4	1.8	2.6	22.7
Stoxx Europa Defensives	-7.3	3.7	-6.1	16.9	2.3	7.9	-0.4			
Stoxx Europe 50	-7.3	6.1	-6.2	22.2	-7.7	11.0	3.7	2.2	3.1	20.6
MSCI UK	-18.3	11.5	-17.4	20.2	-6.5	6.2	7.2	1.6	3.5	20.3
MSCI EM Eastern Europe	-19.1	17.0	-17.3	29.1	4.1	5.3	43.9	0.5	4.3	13.7

Time period: 14/12/2015–14/12/2020.
Source: Bloomberg * PBV = Price/book value ratio; Div. = Dividend yield (%); PER = Price/earnings ratio. Values based on estimates for the next 12 months.

already partially pricing in a profit recovery, equity valuations are likely to come down slightly next year because earnings growth can be expected to exceed the rise in prices.

Cyclical stocks preferred

Tactically, we like US small caps and UK equities. The diminishing uncertainty after the final Brexit outcome will probably entice many investors back into the under-invested market, not least systematic investors who can be expected to chase UK equities due to the improving price momentum. Moreover, economic optimism will probably be especially strong at the beginning of the year, which should favour cyclically sensitive sectors that account for an exceptionally large share of UK indices. In addition, the UK economy, which is particularly dependent on the services sector, will benefit especially from the rapid availability of a vaccine. With a view to the full-year 2021, we prefer emerging-market and European equities, which can be expected to benefit most from a synchronised economic recovery next year. Although US equities should also rise next year, their performance should be below-average, at least in the first half of the year. This expectation is supported by the fact that the index is composed of many growth stocks that will probably have only limited upside potential due to their higher valuations as interest rates rise. US equities can be expected to perform better again once the market begins to focus more on 2022.

Ulrich Urbahn, Head of Multi-Asset Strategy & Research

WHAT IS ON COMPANIES' MINDS?

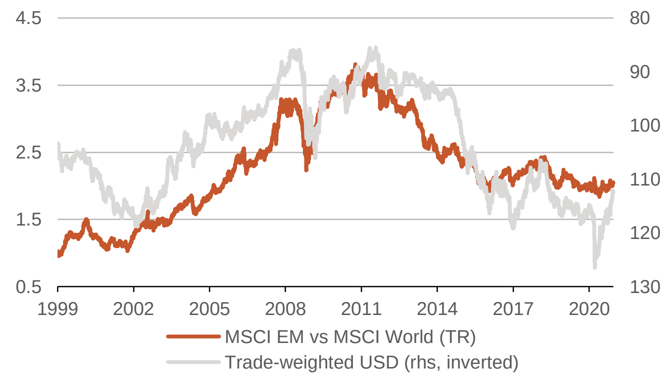
Recovery tendencies continue in Q4

The significantly improving outlook for manufacturing demand that was observed already in the preceding quarter continued in the fourth quarter. Above all, managers in supplier companies in the areas of automation, logistics and mining shared positive outlooks. The current lockdown in Europe is considerably less problematic for manufacturing than the first lockdown. For example, both plant manufacturer Dürr and commercial vehicle manufacturer Traton reported continued sequential improvements in demand. Another constant topic in our discussions with European executive managers is China's continued strength. French spirits maker Pernod Ricard and German athletic apparel manufacturer Puma reported strong positive growth rates in China compared to last year. Furthermore, medical equipment manufacturers have reported that hospitals are managing the renewed increase in COVID-19 patients much better now than in March/April. The second wave should therefore have a much smaller impact on elective procedures. A further recovery is expected in 2021. Therefore, we feel that we are well positioned also for the coming months with our European equity portfolio, which is strongly focused on consumer goods, manufacturing, medical engineering and technology.

Matthias Born, CIO Equities

EM equities are likely to benefit from weakening USD

Relative performance of the MSCI EM compared to the MSCI World on a total return basis, and development of the trade-weighted US dollar (inverted)

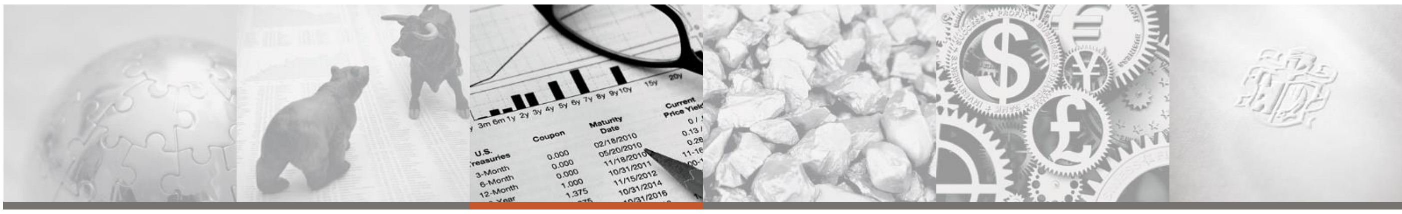


As of 31/12/1998–14/12/2020.
Source: Bloomberg, own calculations.

Forecast summary: Catch-up potential for Europe

	Currently			Ø*
Index forecasts	**14/12/2020**	**30/06/2021**	**31/12/2021**	**in 12 months**
S&P500	3,647	3,800	3,950	3,965
Dax	13,223	14,000	14,600	14,761
EuroStoxx 50	3,504	3,700	3,800	3,782
MSCI UK	1,834	1,950	2,050	2,021
Index potential (in %)				
S&P500	-	4.2	8.3	8.7
Dax	-	5.9	10.4	11.6
EuroStoxx 50	-	5.6	8.4	7.9
MSCI UK	-	6.3	11.8	10.2

* Average, consensus as of 14.12.2020.
Source: Bloomberg, FactSet, Berenberg.



EMERGING-MARKET BONDS ARE STILL FAVOURED

IN A NUTSHELL

- Government bonds: Risk-on sentiment, rising debt and inflation expectations are negative for safe-haven bonds.
- Corporate bonds: Companies with improved balance sheets, persistent excess demand, positive investment outlook.
- Emerging-market bonds: Local-currency bonds to benefit from stronger growth and weaker US dollar.

Political uncertainty diminishes, vaccines give reason for hope

The market-friendly election outcome in the US, which should particularly result in a calmer environment than under the Trump administration, and the likely finalisation of Brexit at the start of the new year will eliminate two key factors of political uncertainty. Also, considering the ongoing progress in the development of COVID-19 vaccines, bond investors should begin the year 2021 in risk-on mode and maintain their appetite for risk premiums against the backdrop of a globally synchronised economic recovery.

Government bonds: vanishing safety bonus

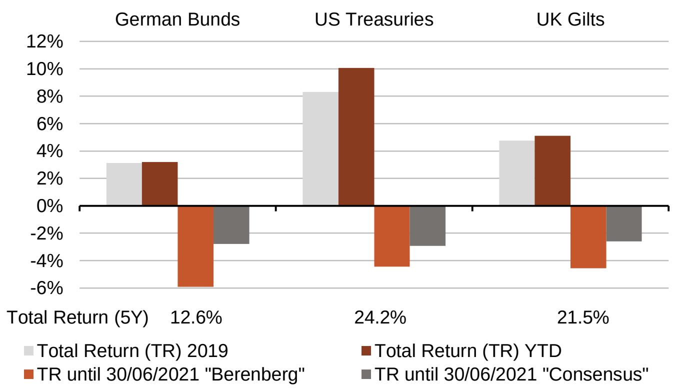
Although 2020 was overall another year of declining government bond yields for nearly all large economies, signs of a trend reversal can already be observed, at least for US government bonds. Besides the factors mentioned above, yields there have been driven by continuously rising inflation expectations since the summer and rising levels of government debt. For similar reasons, we also anticipate rising yields for UK Gilts and German Bunds. The “safe havens” no longer offer the same protection as they did only a few months ago; in fact, they should be treated with caution. Within the Eurozone, the yields of the periphery states compared with those of core nations have narrowed significantly and now hold very little potential as an investment alternative. We are cautiously positioned in the segment of government bonds.

Corporate bonds: technical factors trump weaker balance sheets

Who would have expected technical factors to trump weaker balance sheets after the dramatic price losses in the first quarter of 2020? Corporate bonds in most sub-segments can boast a positive performance at the end of this year. We continue to expect positive conditions in 2021. A significant economic recovery coupled with unprecedented government stimulus should stabilise corporate profits and keep credit losses in check. In Europe, companies will probably continue to focus on balance sheet repair for a little longer than in the US. Cash flow generation, the elimination of unneeded capacities, dividend payments and debt reduction are key measures. Nevertheless, the focus will gradually shift back to shareholders also in Europe over the course of the year. However, various technical factors will probably prove to be even more relevant for credit markets. That is because the ECB is influencing European markets in two ways: directly by means of monthly purchases totalling around EUR8bn, and indirectly by means of the negative interest rate

Safe government bonds suffer losses in the economic recovery

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



Time period: 14/12/2015–14/12/2020.
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 middle and end of 2021

	14/12/2020	30/06/2021		31/12/2021	
	Currently		∅*		∅*
USA					
Base interest rate	0.00-0.25	0.00-0.25	0.25	0.00-0.25	0.25
10Y US yield	0.89	1.25	1.06	1.40	1.23
Eurozone					
Base interest rate	0.00	0.00	0.00	0.00	0.00
10Y Bund yield	-0.62	-0.20	-0.40	0.00	-0.33
UK					
Base interest rate	0.10	0.10	0.10	0.10	0.10
10Y Gilt yield	0.22	0.60	0.34	0.70	0.49

* Average, consensus as of 14/12/2020.
Source: Bloomberg.

environment, which is pushing institutional investors such as insurance companies into the credit segment in their search for positive yield. In this regard, numerous investment banks expect that considerably fewer new issues will come to the market in 2021 after the record issuance activity in the second and third quarters of 2020. This factor will further exacerbate the imbalance between supply and demand. We therefore expect that investors will initially accept the no longer favourable valuations for a lack of alternatives. For this reason, we are retaining our overweight in corporate bonds for now. We anticipate a catch-up in cyclical sectors such as automobiles and capital goods. In addition, we like including subordinated bonds and high-yield bonds into the portfolio because we expect that investors will focus more on these segments in their search for positive income opportunities.

Emerging-markets: local currency bonds offer catch-up potential

The positive performance of emerging-market bonds, including both hard-currency and local-currency bonds, that began in the summer continued in the fourth quarter, albeit at a moderate pace. Rising crude oil prices, a weaker US dollar and fast-rising capital flows into this asset class were the main drivers of its positive performance. In line with our expectation of positive growth, we expect that US government bond yields will gradually rise and basic economic conditions will improve for many emerging-market countries in 2021. We therefore still consider the current yield spreads for government and corporate bonds to be attractive despite the impressive recovery since the first quarter of 2020. In terms of credit ratings, high-yield bonds can be expected to outperform investment-grade bonds. We also consider the local currency segment to be worthwhile. After their poor performance in the last few years, local currencies now have considerable convergence and appreciation potential. In particular, they stand to benefit from international trade activity and a continuation of US dollar weakness.

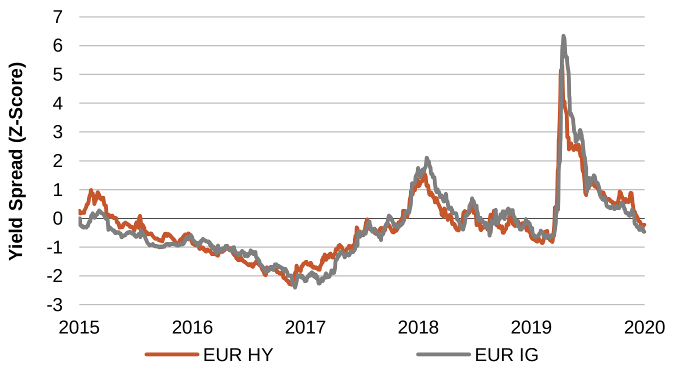
Conclusion: emerging-market and corporate bonds preferred

As we expected, safe government bonds encountered a difficult environment in the fourth quarter. This will not change in the new year. This particular asset class is still unattractive for new investments and could only be in demand in temporary phases of uncertainty. The outlook for European corporate bonds is more promising. Although valuations in this segment are now in line with their historical averages, they should benefit from the expansive monetary environment and low level of new issuance activity. We are most convinced of the prospects for emerging-market bonds. We favour high-yield bonds and local-currency bonds in these markets as international economic growth, trade and a weaker US dollar prevail.

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

Corporate bonds: Yield spreads could narrow further

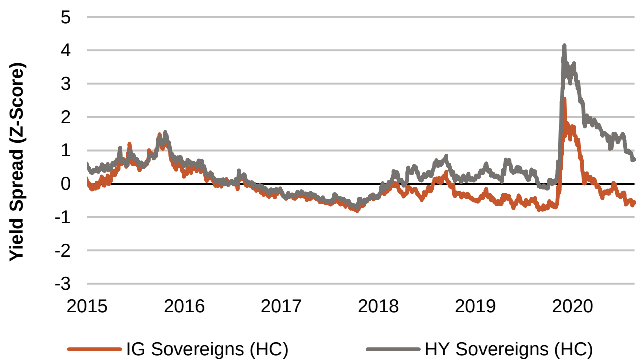
Excess demand will persist despite the no longer favourable valuations of high-yield (HY) and investment-grade (IG) bonds.



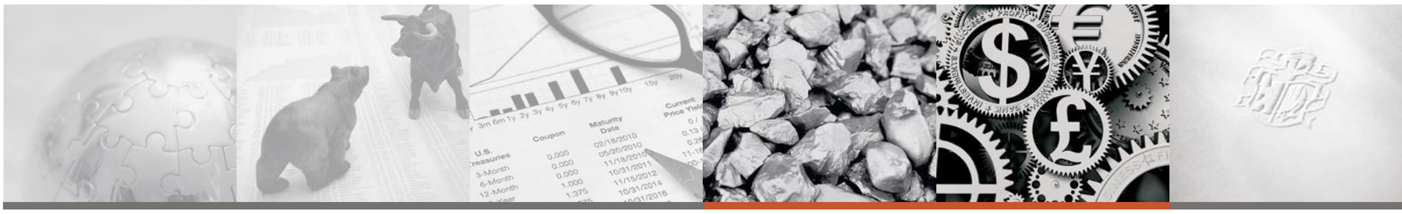
Time period: 14/12/2015–14/12/2020. Source: Bloomberg, ICE, own calculations.
Presentation: Z-Score, moving 5-year average.

EM countries: High-yield bonds are considerably more attractive

Hard-currency (HC) investment-grade (IG) government bonds only offer below-average premiums, whereas high-yield (HY) bonds are historically attractive.



Time period: 14/12/2015–14/12/2020. Source: Bloomberg, own calculations.
Presentation: Z-Score, moving 5-year average.



PLENTIFUL OPPORTUNITIES IN COMMODITY MARKETS

Normalisation of the oil market continues

Despite the sharp rise in daily COVID-19 cases and renewed partial lockdowns, crude oil made strong gains in the past quarter thanks to the positive vaccine news. The short-term potential now seems limited because the COVID-19 situation is likely to remain tense over the winter months, depressing physical demand growth. Later, the economic recovery and particularly the broad availability of a vaccine, which will support the recovery of hard-hit oil-dependent sectors like tourism, should stimulate demand significantly. Meanwhile, downside risk is limited by the OPEC+ and its restrictive policies to keep supply in check. That said, upside potential is limited by the high capacity reserves of its member countries and the still high level of inventories. We therefore anticipate only a moderate rise in prices in the coming year.

Gold can buck the economic recovery

Gold glistened the least this year in the fourth quarter. The rotation into risk assets did not spare the precious metal. When the vaccine successes were announced, gold products suffered the biggest weekly outflow in their history and the price of gold temporarily fell below the USD1,800 per ounce level. Since the beginning of the year, however, it has still been one of the best investments. But aside from the diminishing economic uncertainty, the outlook is still positive. Firstly, the weaker US dollar and the economic recovery, especially in emerging-market countries, should boost jewellery demand – normally the number one source of demand, which has plunged by up to 50% this year – considerably. Secondly, the relative attractiveness of gold as a safe haven remains high compared to government bonds. That is because rising inflation expectations in conjunction with anchored central bank interest rates and massive bond purchasing programmes should keep real interest rates lower for a longer period of time.

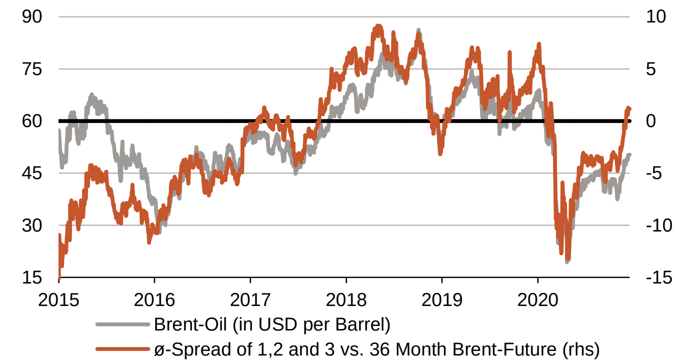
Structural updraft for industrial metals

Industrial metals are increasingly proving to be the big winners of the pandemic. The LME Index is now up by more than 20% since the start of the year. The numerous economic and infrastructure programmes and the investments associated with the increasing focus on sustainability should ensure strong demand in the medium to long term. In the short term, however, caution is advisable because the rise in prices has also been driven substantially by speculative investors. Net investor positioning in copper, for example, is currently at an all-time high. For that reason, the latest rally is prone to pullbacks.

Ludwig Kemper, Analyst Multi-Asset Strategy & Research

OPEC+ supply discipline gives a tailwind to the oil market

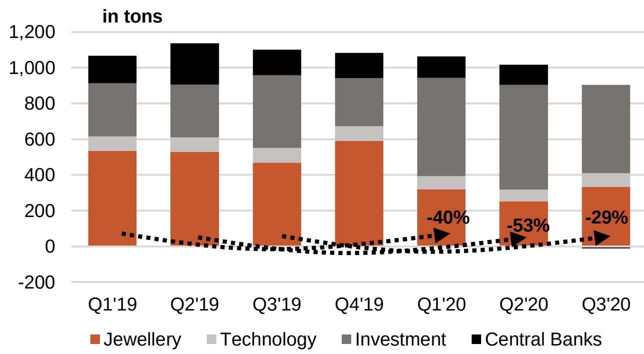
Short-term oil futures are higher than long-term futures for the first time since February, signalling tight supplies.



Time period: 01/01/2015-14/12/2020.
Source: Bloomberg, own calculations.

Demand for gold from the jewellery industry should come back

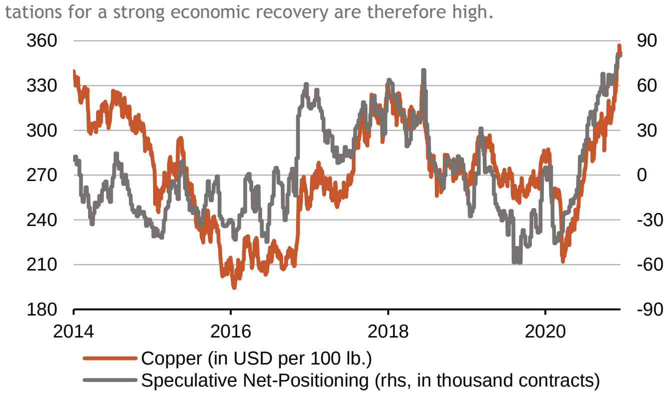
In the wake of the coronavirus crisis, the demand for gold jewellery has fallen by up to 50% from last year. This demand can now be expected to normalise.



Time period: 01/01/2019-30/09/2020.
Source: World Gold Council, own calculations.

Industrial metals are vulnerable in the short term

Speculative net-positioning in copper recently reached an all-time high. Expectations for a strong economic recovery are therefore high.



Time period: 01/01/2014-14/12/2020.
Source: CFTC, Bloomberg.

HEADING FOR NEW SHORES

US dollar weakens: presidential election was only a brief disruption

The EUR/USD exchange rate has continued its upward march, breaking through the mark of 1.20. The temporarily unclear outcome of the US presidential election was only a brief irritant causing wide swings in the exchange rate. Once it became clear that Joe Biden would become the next US president, the dollar slid further and the euro gained. Joe Biden will pursue substantively different policies than Donald Trump in many areas and will also cultivate a different political style. Although Biden is no proponent of free trade and is likely to continue to take a hard stance towards China, his approach will be more reliable and will therefore present fewer uncertainties and risks for financial markets. As a result, the US dollar is less likely to be in demand as a safe haven than if the election outcome had been different. Moreover, the new US administration with the former Fed chairwoman Janet Yellen as treasury secretary is likely to pursue an expansive fiscal policy that will probably lead to higher government debt. Monetary policy will also continue to be very expansive for quite a long time, particularly as a result of the new strategy adopted in August. All things considered, there are many reasons to expect a permanently weaker US dollar.

However, the EUR/USD exchange rate will not only be influenced by the weakening dollar, but also by positive factors affecting the euro. The starting point for the new euro strength was the agreement reached on the "EU Recovery Fund" ("Next-Generation EU") this summer. This joint fund dispelled the fears of a break-up of the Eurozone, which have since been priced-out in the currency market. Although some final details are still the subject of controversy, we assume that the EU countries will ultimately reach an agreement and monies from the fund can be disbursed next year.

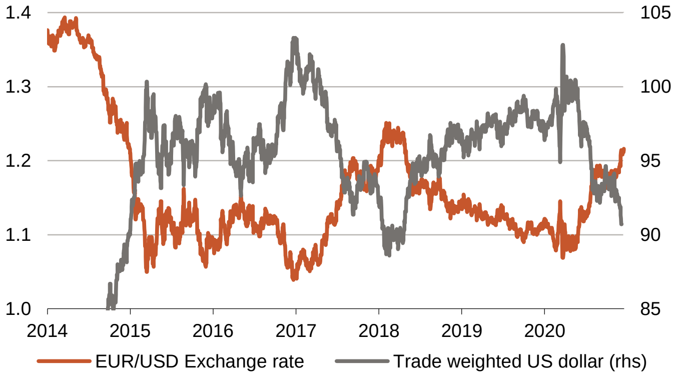
Pound poised to rise further?

The pound has recovered in the last three months in reaction to progress in the negotiations on a Brexit deal. However, markets are still sensitive to negative news, which have caused setbacks for the pound. Nevertheless, we still expect an agreement and see good chances for the pound to rise further in the coming year, with the exchange rate falling to GBP0.85 per EUR.

Dr Jörn Quitzau, Senior Economist

EUR/USD: Euro has picked up momentum again

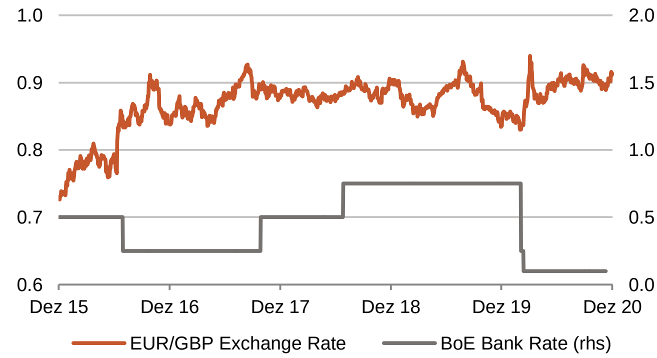
The euro is benefiting from its own strength and the weakness of the US dollar. The level of 1.25 EUR/USD could be reached in the coming year.



Time period: 01/01/2014–14/12/2020.
In US dollars; trade-weighted US dollar in points. Source: Bloomberg.

EUR/GBP: The pound has benefited from Brexit progress

Headwinds for the pound will recede if there is a Brexit deal. Its interest rate advantage could lift the exchange rate up to GBP0.85 per EUR.



Time period: 14/12/2015–14/12/2020.
Exchange rate in GBP, base interest rate in %. Source: Bloomberg.

Exchange rate forecasts

The Euro will rise further once political risks subside.

	14/12/2020	30/06/2021		31/12/2021	
Exchange rate forecast	**Currently**		∅*		∅*
EUR/USD	1.21	1.22	1.22	1.25	1.24
EUR/GBP	0.91	0.86	0.90	0.85	0.90
EUR/CHF	1.08	1.08	1.09	1.11	1.11
EUR/JPY	126	127	125	130	128
Change against the euro in %					
USD	-	-0.5	-0.5	-2.8	-2.1
GBP	-	5.9	1.2	7.2	1.2
CHF	-	-0.3	-1.2	-3.0	-3.0
JPY	-	-0.5	1.1	-2.8	-0.9

* Average, consensus as of 14/12/2020.
Source: Bloomberg.

INTERVIEW ON THE SUBJECT OF ARTIFICAL INTELLIGENCE

Mr Meyer, as the Chief Investment Strategist of Berenberg and Head of Multi-Asset you are well known to our readers. Mr Baum, you are part of the COO team for the Wealth and Asset Management and Head of Innovation & Data at Berenberg. What does your team do? And how did you come to this opportunity?

We founded the Innovation & Data team last year with the goal of attending to the newest technological trends and the growing role of digitalisation in our industry. We want to harness the opportunities arising from the new technologies and the topics of alternative data, big data and machine learning for our asset management. I myself have dealt with these topics and their application in asset management for about five years. As COO and Portfolio Manager, I helped develop an asset manager specialising in big data and AI in 2016.

Mr Meyer, how do you collaborate with the Innovation & Data team? How do you benefit from the expertise it has acquired?

It is always good to apply new technologies and knowledge for the sake of better investment decisions. The goal now is to analyse so far mostly unused data such as texts, videos and real-time news in order to gain an information advantage and use it in making investment decisions. For example, one can attempt to use the news as a way of gauging sentiment towards certain asset classes or financial instruments. The Innovation & Data team is an important source of input for us.

We are talking about big data analytics. Mr Baum, what does that mean and how does it work? Can you give us an example of where this has already been successfully deployed?

The tremendous growth of available data coupled with increasing computing power has created a wealth of new opportunities in the last few years. For example, machine learning, a key technology of AI, makes it possible to analyse large quantities of unstructured data and detect patterns. A machine learns to recognise patterns on its own based on a predefined algorithm and data and then apply what it has learned to new data. This can help to gauge the future and make decisions. These days, AI and machine learning are used across all industries for a number of purposes, including facial recognition, autonomous driving or understanding customers better on the basis of their data. We are now using this technology for financial applications as well.

The inception of more and more AI funds and strategies can be observed in the market. Does this make sense, in your opinion? And where do you see opportunities, but also risks from the use of AI in fund management?

<u>Meyer:</u> First of all, of course not everything with AI on the label actually has AI inside. This can often be a marketing trick. Naturally, we also use machine learning in analysing unstructured data – that can be useful. However, the constant increase in available data and the increasingly more powerful analysis programmes can seduce people into using them hastily without careful reflection. Therefore, analysis must always begin with an economic rationale, otherwise, one can quickly become mired in "data mining". An observed correlation does not necessarily mean a causal relationship. But a causal relationship is crucial if the past is to possibly repeat itself. For this reason, I advise a healthy dose of scepticism regarding investment strategies that rely completely on automatic investment using AI, especially considering that such strategies are usually something of an incomprehensible "black box" for clients.

<u>Baum:</u> Although AI can detect patterns and correlations, it cannot explain causalities. It makes sense to use AI whenever you have large quantities of data that exhibit certain patterns. In the world of finance, this is not necessarily concrete price data, but rather alternative data such as sentiment data, for instance. Despite the above-mentioned scepticism, AI is likely to play a more important role in discretionary investment processes as well: The strength of AI is the ability to process and filter huge quantities of data and make them available on an aggregated basis. The strength of the human being is to recognise causal relationships and any softer factors such as changes in market logic, market structures, or investor behaviour, for example. Therefore, AI will

not replace the active fund manager in the foreseeable future, but will serve as an increasingly more important supporting tool. The way I see it, active management utilising the strengths of AI is a good combination.

Meyer: Exactly, just consider the market development in the midst of the COVID-19 crisis in the spring of 2020. Historically speaking, this development could only be compared with the developments in 1929 and 1987. It is highly improbable that AI models would have had these patterns in their artificial memory and been able to recognise them immediately. Many of these strategies have not been very successful in the past year. On the contrary, in fact. But the track record of such strategies is still too short for a definitive assessment.

Mr Meyer, are there other ways that investors can benefit from the trend towards AI? Are you also investing in AI?

Of course. Just think about the gold rush. In those days, it was better to invest in manufacturers of pickaxes and shovels than in the prospectors themselves. Today, semiconductor manufacturers and cloud providers are benefiting from the trend towards more and more data and AI. We are well positioned in these sectors. Moreover, companies from various other sectors could certainly become more efficient and profitable from the use of AI. As portfolio managers, we need to identify these companies and benefit indirectly from AI by picking the right stocks. As a third point, a discretionary decision maker could also attempt to exploit the still extant deficiencies of systematic investment strategies driven in part by AI and make anti-cyclical investments. We have long argued that investment behaviour is increasingly unidirectional as a result of the growing importance of systematic investment strategies. This has repeatedly led to excesses in both directions, typically followed by abrupt counter movements. And so, one should track the behaviour and positioning of such strategies and apply this knowledge in one's own investment decisions.

Mr Baum, what are currently the biggest hurdles to the further development of AI? What can we expect in the future?

While AI applications have already become established in some industries, in the finance industry AI is still in its infancy. There are many reasons for this, including a frequent lack of expertise in such high-tech fields or also data protection and regulatory issues. Moreover, many firms often lack a strategy for obtaining useful data and effectively analysing it. And clearly, there is a certain scepticism towards this topic, especially in Germany. Therefore, AI-based applications must still prove themselves, not least of all by solid performance results, in order to gain the trust of users and investors. Nevertheless, the exponentially increasing availability of data and continuously increasing processing performance will mean that the use of AI will soon be normal in our industry, in my opinion, although as a symbiotic interaction between man and machine, as I mentioned before. I am thinking about formulating investment proposals for clients depending on their personal goals, improving the client experience by using smart bots, generating additional alpha on the basis of new insights and knowledge gained from alternative data, or creating operational efficiency by automating processes.

Mr Meyer, will AI strategies dominate the future or does the active discretionary fund manager still have a future?

I believe that the active discretionary fund manager definitely has a future. No doubt, everyone dreams of a simple "money printing machine" in the form of a systematic investment strategy that constantly produces outstanding investment results without much effort or continually necessary individual decisions. But that has hardly succeeded in the past and I am not convinced that it will improve as big data becomes more complex and AI more powerful. When it comes to picking individual stocks, just think about the exchanges between the portfolio manager and corporate executives, the importance of personal contact, the assessment of the persons involved. This cannot be replaced by an AI system. Considering the trend towards sustainable investments, such exchanges with companies and the influence exerted by investors, the engagement of investors, is becoming increasingly important. I think Mr Baum summarised it very well before: models and AI can support investment decisions and generate ideas, but the portfolio manager as the final decision-maker is indispensable.

PUBLISHING INFORMATION

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IMPORTANT NOTICES

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