HORIZON

The Berenberg Capital Market Outlook · Wealth and Asset Management

REALITY CHECK

Hopes for a strong economic recovery must now be backed up by real growth. For markets to remain stable, this growth should neither be too weak nor too strong.

INFLATION WORRIES

Inflation, bond yields and central bank reaction will dominate markets into the summer. Real interest rates are likely to rise further.

SLOWING PACE

If markets fear that central banks will take their foot off the gas, investors will do so, too. We remain constructive in the medium term but expect further volatility into the summer.

Q2 | 2021

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FOREWORD

Prof Dr Bernd Meyer
Chief Investment Strategist

Dear reader,
Energy commodities, industrial metals and equities had a good start to the year, propelled by the tailwinds of negative real interest rates, expansionary monetary and fiscal policy, high liquidity, rising profits, vaccination progress and declining numbers of COVID-19 cases. The reallocation to equities continued at a record pace. In February, however, bond yields began to rise in a more pronounced manner. Not only inflation expectations, but also real bond yields rose sharply, triggering volatility, weakness across all asset classes, and a clear change of favourites. Safe havens like gold and government bonds, as well as defensive stocks and highly valued growth stocks, were especially affected. Although not unexpected, this development was surprisingly fast and strong, providing further proof of a changed market environment with increasingly abrupt movements.

After living on hope for so long, markets now need to confront the realities of growth in the coming months. As observed already in the first quarter, this could ultimately cause more uncertainty. On the one hand, high expectations for economic and profit growth could be disappointed and the outlook could be dimmed by rising bankruptcies. On the other hand, overly strong growth could lead to faster inflation, rising interest rates and a policy reversal by the central banks.

Although bond yields have already risen markedly, they are likely to rise further. Real yields appear too low for the expected strong growth. The higher inflation numbers will probably stoke speculation as to when central banks will initiate a policy reversal despite their current efforts to calm markets. The impact on equity markets will be limited as long as rising yields are a reflection of strong growth. However, if rising yields are a reflection of more restrictive, growth-inhibiting monetary policy in future, the impact on equity markets will be much more problematic.

We expect market sentiment to swing between growth disappointments, reflation hopes and inflation fears through the summer. This would lead to market volatility, only limited upside potential, further reflation surges with rising yields, and a rotation towards more cyclical and less highly valued assets. We believe equities will have more upside potential later in the year if the base effect-driven inflation wave subsides somewhat, investors have more clarity on central bank behaviour, and the economic upturn looks likely to continue into 2022. Our outlook for risky assets remains positive. Into the summer, however, investors should not be positioned too aggressively.

In the Insights Interview, our fund manager Martin Hermann offers an insight into his approach, his everyday work, and what is important for successfully managing global equity portfolios.
I hope you enjoy this issue.

CONTENTS

BETWEEN REFLATION HOPES AND INFLATON FEARS

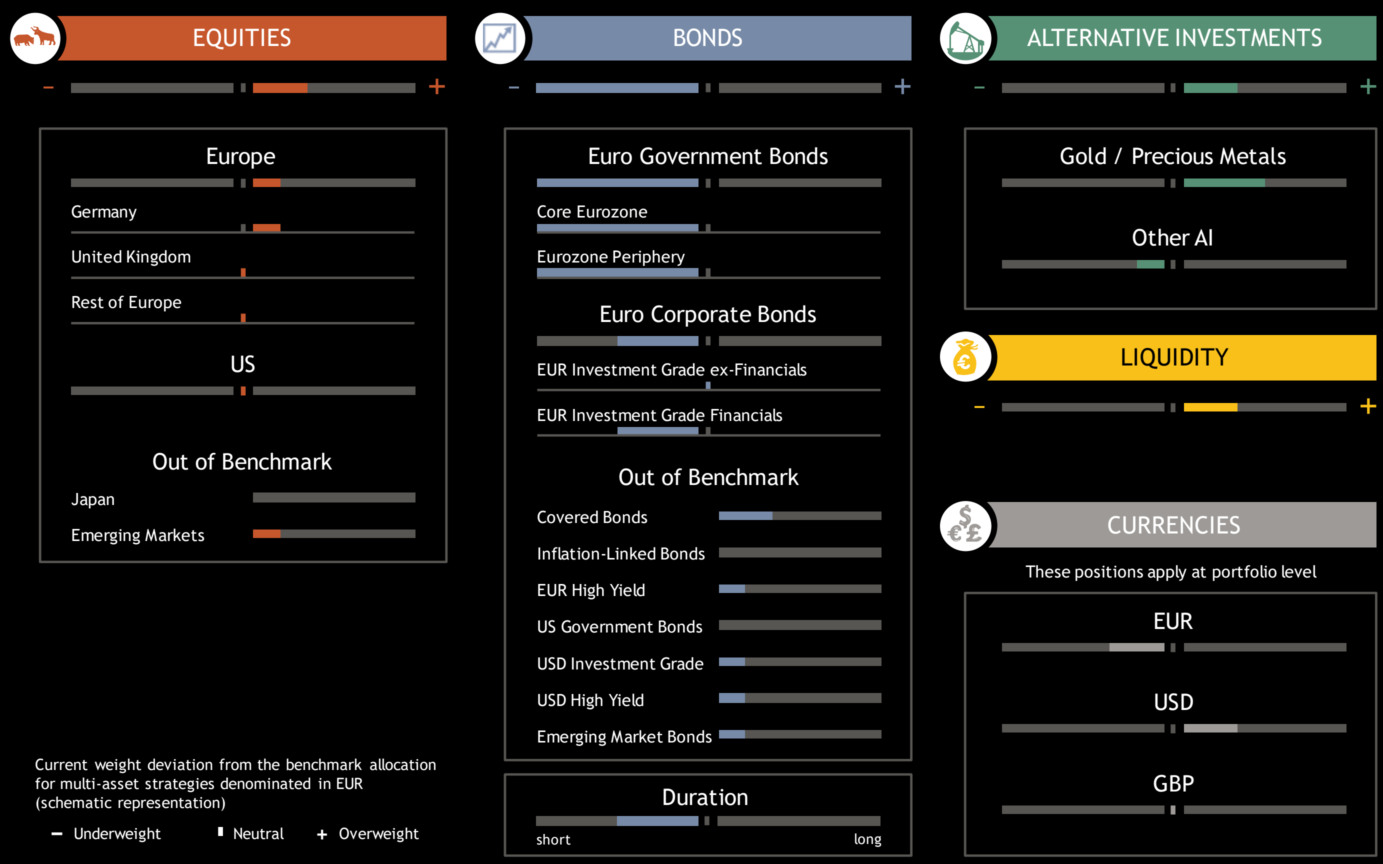
IN A NUTSHELL

- The economic recovery will probably accelerate, and inflation will rise at a faster rate in the second quarter.
- The growth will also cause real bond yields to rise, putting pressure on all assets, especially those with higher valuations.
- Inflation, bond yields and central banks will remain key topics throughout the summer, causing volatility and limiting the upside potential of equities.
- Investor sentiment and positioning are optimistic. However, systematic strategies and individual investors still have potential for increasing their equity positions. While our medium-term outlook is still positive, we have tactically reduced our portfolio risk.

Portfolio positioning at a glance

Although equity markets had already priced in a substantial economic recovery at the start of the year, we saw further potential based on investor sentiment and positioning, as well as the expected news flow. We benefitted from our strong overweight in equities, small caps and emerging markets, as well as the closure of our underweight in the UK, our broadly diversified exposure to commodities, our short duration positioning and our preference for corporate and emerging-market bonds over government bonds.

Our portfolio structure will remain virtually unchanged into the second quarter. We have reduced risk overall by slightly reducing small caps and halving our overweight in equities, for example. Safe government bond yields will probably rise further. We favour a positioning in cyclical segments (small caps, emerging markets, commodities) coupled with a focus on structural growth. Defensive sectors will probably continue to struggle. We therefore prefer corporate and emerging-market bonds over government bonds, although even in the former categories rising yields can no longer be completely offset by further spread tightening. Despite the current headwinds, gold is still an important element in our portfolio for diversification purposes.



Looking back on Q1: economic recovery drives rotation

Equity markets and cyclical commodities had a good start to the year. Falling numbers of new COVID-19 cases, vaccination progress, positive economic surprises, accelerating economic activity and much better-than-expected corporate profits in the fourth quarter coincided with high levels of liquidity for investors and cautiously positioned systematic investment strategies. Other positive factors were the massive new US fiscal stimulus and efforts by central banks to prevent market participants' emerging inflation worries from morphing into fears of more restrictive monetary policy. The rotation to equities continued unabated in the first quarter. However, the positive economic surprises also shifted the focus to inflation concerns and rising bond yields. By mid-March, yields on 10-year US Treasuries had risen by more than 0.7ppt. Moreover, not only inflation expectations, but predominantly real bond yields have also been rising.

The change of favourites in the markets gathered steam. Since the beginning of the year, energy commodities and industrial metals have led the field, followed by equities from emerging markets and industrialised countries. Against the backdrop of strong economic data from the US, the slow pace of vaccinations in the Eurozone, the widening yield difference and the unilateral positioning of speculative investors, the US dollar stabilised against the euro and did not depreciate further. Corporate bonds outperformed government bonds due to the continued tightening of credit spreads. Government bonds and gold have been the real losers of rising yields since the start of the year.

Reality check ahead

Hopes for a strong economic recovery must be followed by growth in the coming months. This phase could become problematic for markets because the realisation of growth is likely to push up not only inflation expectations, but real yields as well. Moreover, the realised growth should be neither too weak nor too strong for markets to remain stable. There are risks on the one hand of high expectations being disappointed, and on the other hand of strong inflation, rising interest rates and a possible policy reversal by central banks.

Inflation, bond yields, and central bank reactions are key

Our economists anticipate a powerful economic recovery beginning in the spring given that the support afforded by monetary and fiscal policy has never been greater. Consequently, inflation, bond yields and central bank reactions are likely to be dominant issues for markets even into the summer. Inflation numbers have only recently begun to surprise to the upside (see the top graph on page 5). Many market participants who believe the rising inflation trend to be temporary could well be disappointed. While we share the view that inflation will slow somewhat after a substantial rise, we also believe that the disinflationary trends of the last few decades, such as globalisation and demographic changes, have since reversed, meaning that inflation will be higher in the medium term than it was before the pandemic.

Therefore, markets face two crucial questions: how fast yields will rise, and whether not only inflation expectations, but also real bond yields ultimately have much greater potential to rise from

A perfect start to the year for oil, industrial metals and equities; gold and government bonds under pressure

Total return	YTD and in 2020 (in %, EUR): YTD (31/12/20-16/03/21)	YTD and in 2020 (in %, EUR): 2020 (31/12/19-31/12/20)	12-month periods of the last 5 years (in %, in EUR): 16/03/20 16/03/21	16/03/19 16/03/20	16/03/18 16/03/19	16/03/17 16/03/18	16/03/16 16/03/17	CAGR* 16/03/16 16/03/21	Std. dev.* 16/03/16 16/03/21
Brent	36.5	-37.1	74.4	-46.0	14.3	12.2	14.5	6.7	37.7
S&P 500	8.7	8.8	58.4	-12.5	13.6	2.8	24.1	15.0	19.9
MSCI EM	7.5	8.7	55.1	-18.0	-3.0	12.3	28.9	12.3	15.8
Stoxx Europe 50	6.5	-6.3	40.2	-20.2	6.8	-0.9	14.3	6.3	16.2
DAX	6.1	3.5	66.5	-25.2	-5.7	2.5	21.0	7.8	19.4
USDEUR	2.6	-8.2	-6.1	1.3	8.5	-12.4	4.3	-1.2	6.9
Eonia	-0.1	-0.5	-0.5	-0.4	-0.4	-0.4	-0.3	-0.4	0.0
EUR Corporates	-0.6	2.7	5.9	-0.1	1.6	2.2	2.7	2.4	2.4
EUR Sovereigns	-0.7	2.1	2.7	0.8	1.4	1.6	-0.7	1.2	2.1
US Sovereigns	-0.7	-2.8	-8.3	11.0	12.3	-12.8	3.0	0.5	6.5
EM Sovereigns	-1.5	-2.7	5.8	-1.1	11.7	-9.4	13.6	3.8	8.1
Gold	-6.4	14.9	7.4	17.7	7.5	-6.1	1.3	5.3	12.5

Time period: 16/03/2016–16/03/2021.
Source: Bloomberg. * CAGR = Annualised return (in %, in EUR); Std. dev. = Annualised standard deviation (in %, in EUR).

current low levels (middle and bottom graphs). Real yields have indeed risen since the start of the year. For example, 10-year US Treasuries have risen by more than 0.4ppt, considerably more than the increase in 10-year breakeven inflation.

Rising real yields increase opportunity costs, put pressure on all asset classes and stoke volatility in the markets and beneath the surface of the major equity indices. What is crucial is what exactly is pushing real yields higher. If they are rising as a result of solid economic growth accompanied by still expansive monetary policy, the adverse impact on equities will remain limited. In this case, the pressure on valuations would be countered by strong revenue and profit growth and inflation expectations could be expected to rise further. If, however, the trend of rising bond yields is being driven by the expectation of more restrictive monetary policy or by the fact that US government debt is swelling further such that higher supply can be expected for a longer period, then the adverse impact on equity markets will be greater. In this case, economic growth would be weighed down, bond yields would not rise as much, and inflation expectations could even come down. Our economists expect that, as early as the late summer or the autumn of this year, the US Federal Reserve will announce a plan to reduce bond purchases as from 2022. However, it will try not to surprise the market as it did 2013, when real interest rates rose quickly after just such an announcement, in an event that became known as the “taper tantrum” (middle graph). Therefore, a more gradual increase in real yields would probably be in the Fed’s interest.

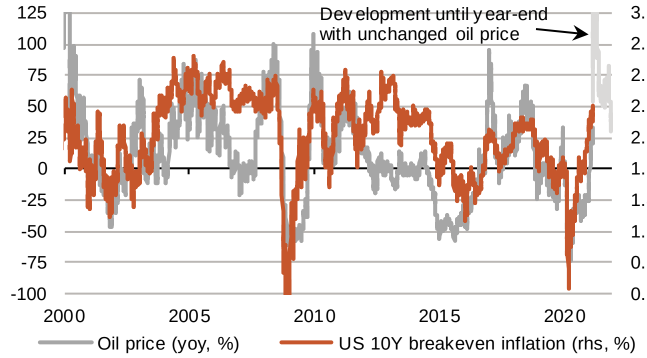
Déjà-vu: another lacklustre summer

Markets are likely to remain volatile into the summer due to wide swings in market sentiment coupled with more limited overall potential for equity markets. The market has already priced in a substantial economic recovery, the sentiment of market participants is optimistic, and many investors are positioned accordingly. However, the still heightened level of implicit volatilities means that the market is not completely unprepared. Cyclical companies and companies with pricing power, somewhat higher debt and overall lower valuations should do better in a climate of improving economic activity and inflation. In such an environment, real assets such as commodities and less highly valued equities should still be preferred over nominal bonds.

Prof Dr Bernd Meyer, Chief Investment Strategist

Base effects alone speak for even higher inflation (expectations)

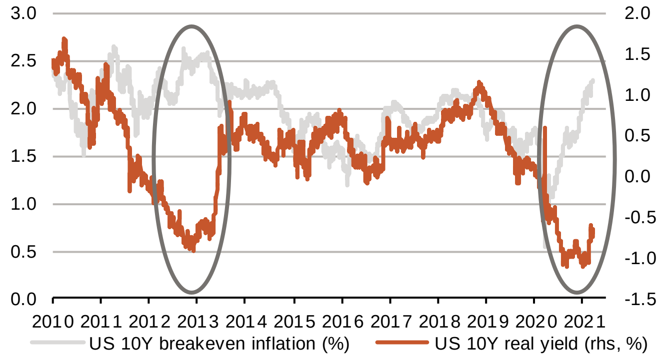
The inflation expectations priced in by the market for the next 10 years are astoundingly synchronised with the trend of oil prices last year.



Time period: 01/01/2000-31/12/2021, as of: 16/03/2021.
Source: Bloomberg, own calculations.

From rising inflation expectations to rising real yields

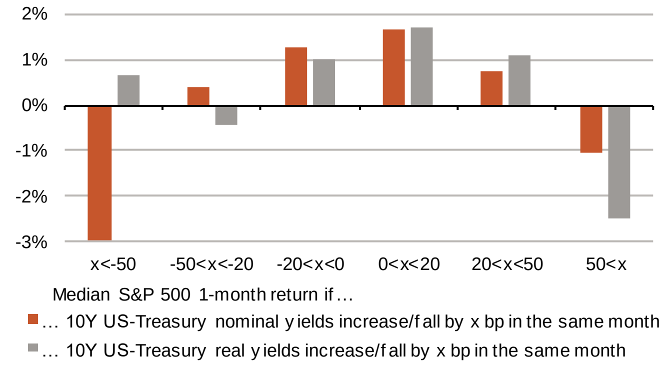
In the last nine months, rising inflation expectations have driven the rise in bond yields as real yields remained negative.



Time period: 01/01/2010-16/03/2021.
Source: Bloomberg, own calculations.

Fast-rising (real) bond yields usually weigh on equities

Equities have historically performed best in an environment of relatively stable bond yields. Sharp yield movements tend to weigh on equities.



Time period: 01/01/1987-16/03/2021, real yields only as of 01/01/1997.
Source: Bloomberg, own calculations.

POWERFUL RECOVERY BEGINNING IN THE SPRING

IN A NUTSHELL

- Global economy: powerful recovery as soon as the pandemic subsides; US first, then Europe.
- Inflation is being driven by one-off effects in 2021, but the underlying inflation trend remains subdued.
- Also in 2021, the economy will be supported by monetary and fiscal policy more than ever before. China will likewise continue to stimulate.

Fresh impetus for the economy in the spring

Even 15 months after the first serious outbreak in China, economic activity is still influenced more by the pandemic and the measures imposed to curb the virus than by any other factor. Although new and more contagious variants of the virus are spreading, there are signs that the pandemic will recede as vaccinations progress. In the northern hemisphere, the return of sunnier and warmer weather should allow for lockdowns to be gradually eased. Despite the current setback in Europe and – to a lesser extent– in the US, the global economy should pick up again in the course of the spring. Thanks to rapid vaccinations, the US and the UK are ahead of the European continent. However, the recovery could be powerful nearly everywhere in the western world. Even in the spring of 2020, the economy recovered surprisingly quickly in May after the sharp declines in March and April.

Consumer spending will probably be the main driver of the recovery. As a result of the lockdowns, private households were unable to spend as much as usual in 2020. Moreover, thanks to government programmes, consumer income remained nearly constant (Europe) or even increased (US). Even if households do not immediately spend their additional savings, but instead only gradually reduce their savings rates in 2021 und 2022 back to pre-pandemic levels, this will lead to a powerful increase in consumer spending.

Broad-based recovery

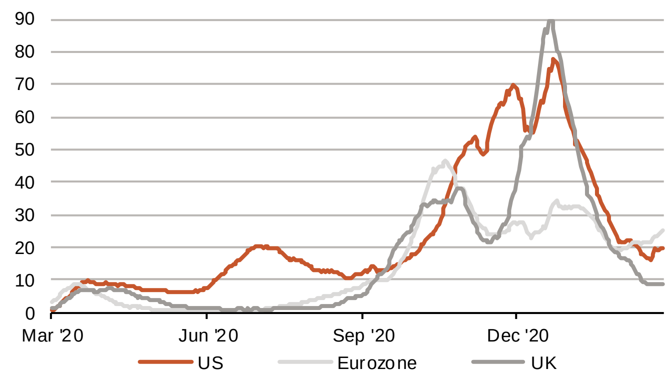
In addition to consumer spending, the other components of macroeconomic demand will also support the recovery. Businesses in nearly all countries of the western world have produced fewer goods overall than they sold to customers since March of last year. Retail sales have recovered more quickly than production and cross-border trading in goods. Businesses will therefore need to restock their inventories. And as the economy improves, they will also want to increase business investments. In fact, many companies will actually want to invest more than usual to make their supply chains more crisis-resistant. Moreover, additional government spending, especially on infrastructure and climate protection, will provide substantial support to the economy in 2021 as well. Although the virus will not disappear, medical progress and vaccination campaigns presumably mean that a seasonal increase in the infection risk in the autumn of 2021 will no longer necessarily entail serious economic damage.

Big differences between countries

Thanks to an especially large fiscal stimulus, the US will be able to maintain a lead over the Eurozone in 2021. We expect that the US economic output will return to the levels it had reached at the end

New COVID-19 cases: US, UK and Eurozone

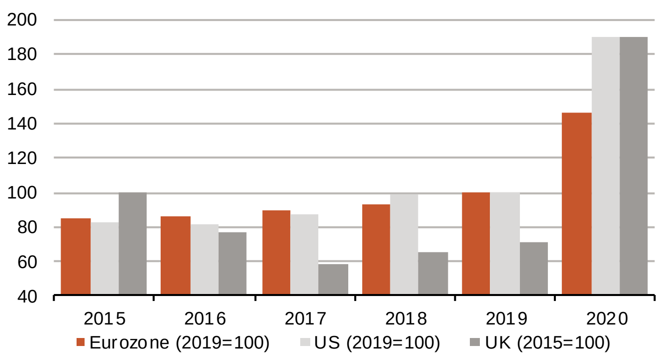
Daily confirmed new cases per 100,000 inhabitants.



Seven-day averages. Time period: 01/03/2020–16/03/2021.
Source: Johns Hopkins University.

Additional savings of private households

US, Eurozone indexed with 2019=100, UK with 2015=100.



The data for the UK are indexed differently in order to account for the decrease in savings after the Brexit referendum in 2016. Estimate for the Eurozone and UK. Time period: 2015-2020. Source: BEA, Deutsche Bundesbank, ONS, BoE, INSEE, Berenberg.

of 2019, i.e. pre-pandemic, as soon as Q2 2021. Germany can achieve this milestone at the end of this year, followed by France (early 2022) and the Eurozone overall and the UK (both Q2 2022). China looks to be on track to generate strong growth of over 9% in 2021, supported as usual by an expansive credit policy. Solid demand growth in the US, Europe and China will also create a positive environment for many emerging-market countries.

Solid demand growth in the US and Europe is also positive for emerging markets

New issue this year: inflation

The prospect of a powerful upswing is increasingly highlighting the issue of inflation. A number of one-off factors will trigger an initially strong rise in inflation rates this year. Other factors contributing to higher inflation, besides the expiry of the German VAT rate reduction and the broadened tax on CO2 emissions, are the currently high costs of transporting goods and the base effect of extraordinarily low oil prices in the period from March to the autumn of 2020. And if many service providers are able to increase their prices in the face of strong demand, as can be expected when bars, restaurants and theatres reopen, Eurozone inflation could even soar to 2.5% in the summer. In the US, the inflation rate could exceed 3% at times. Those who postulate inflation risks will interpret this as a vindication of their worries.

However, the strong rise in inflation is likely to be temporary. By definition, base effects do not last. The scarcity of containers, which has contributed to the high level of transport costs, will be rectified in the autumn at the latest. Given the still tense situation in labour markets, permanent inflation drivers such as wage pressure, for example, will remain rather subdued until 2023. After an appreciable drop in inflation in 2022, structural factors such as the demographically-driven scarcity of skilled workers will gradually lift inflation rates back to around 2.0% (Eurozone) or 2.5% (US), levels that were considered normal 20 years ago.

Central banks to stick with expansionary monetary policy

After years of very low inflation, central banks will not initially react to the rise in inflation. They will only take their foot off the gas pedal when they are sure that inflation will permanently remain around their target of roughly 2% in the absence of exceptional factors. We therefore expect that the Fed and the ECB will slowly reduce their bond purchases starting in 2022. Base interest rates will remain stable into 2023. Central banks will permit a certain rise in yields that reflects the improved growth outlook. However, they will intervene if excessively high yields endanger the recovery.

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	6.5	5.6	4.5	3.9	1.2	1.3	2.5	2.4	2.6	2.2
Eurozone	-6.8	-6.8	4.4	4.2	4.3	4.1	0.3	0.3	1.9	1.5	1.5	1.2
Germany	-5.3	-5.3	4.0	3.5	4.0	4.0	0.4	0.5	2.4	2.0	1.6	1.4
France	-8.2	-8.3	6.4	5.7	4.0	4.0	0.5	0.5	1.5	1.2	1.4	1.1
Italy	-8.9	-8.9	4.9	4.7	4.0	4.0	-0.1	-0.1	1.8	0.9	1.4	0.9
Spain	-11.0	-11.4	6.2	5.8	5.7	5.6	-0.3	-0.3	1.0	1.0	1.2	1.1
UK	-9.9	-9.9	6.2	4.7	5.7	5.7	0.9	0.9	1.6	1.6	2.2	1.9
Japan	-4.9	-5.1	4.8	2.8	2.0	2.1	0.0	0.0	0.3	0.0	0.6	0.5
China	2.0	2.3	9.5	8.4	5.3	5.5	2.5	2.5	1.6	1.6	2.2	2.3
World*	-3.3	-	4.7	-	3.4	-	-	2.2	-	2.8	-	2.9

* 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 16/03/2021.

STICK WITH THE BARBELL STRATEGY

IN A NUTSHELL

- Earnings estimates were revised upwards in the first quarter, especially for economically sensitive regions.
- Valuations declined as a result but remain elevated compared with their own history.
- We continue to favour a combination of “quality growth” companies and small-cap, UK and emerging-market equities.

Strong rotation in the first quarter

The first quarter was marked by great volatility. Whereas both cyclicals and especially growth stocks initially made gains, the situation started to change in February. The strong and rapid rise in bond yields triggered a pronounced rotation in equity markets. The relative winners were cyclical stocks and value sectors like financials and energy, while defensive sectors like utilities and highly valued growth stocks suffered. Beneficiaries of this development were UK equities, which made above-average gains in euro terms. Financials and commodity sectors, which exhibit a positive performance year-to-date, are strongly represented in the UK benchmark index. Consequently, the closure of our underweight position in UK equities towards the end of last year yielded positive results. Defensive European stocks have been among the big losers since the start of the year.

Brightened profit outlook

In the last three months, analysts have revised their profit expectations for the next 12 months markedly upwards across all regions. As we expected, consensus tends to struggle with inflection points and was therefore overly conservative. Earnings expectations were raised primarily for emerging markets, Japan and the UK. Within emerging markets, Eastern Europe and Latin America have benefitted from higher commodity prices. Analysts now anticipate global profit growth of 27% this year and 14% next. Within Europe, the UK is still expected to record the strongest profit growth (43% over the previous year). We consider this expectation to be justified for a variety of reasons. First, the UK stands to benefit from a positive base effect after the disastrous corporate profits in 2020. Second, the index structure, which includes numerous financials and commodity names, is advantageous in this year of strong economic growth. The UK is also benefitting from the faster vaccination of its population. Finally, UK companies now enjoy more planning certainty after the Brexit deal with the EU.

Valuations are now declining

Equity valuations have risen in the past few years as a result of falling interest rates and the greater role of price-insensitive investors (e.g. momentum strategies, passive/thematic investing). At the end of 2020, the price/earnings ratio for the S&P 500 reached similar levels as during the tech bubble – partly because the market looked beyond the COVID-19 crisis and anticipated the recovery of corporate profits. Recently, however, rising earnings estimates

Wide gap between different equity market segments in Q1: cyclicals in the lead, defensive stocks in the rear

Total return	YTD and in 2020 (in %, EUR): YTD (31/12/20-16/03/21)	2020 (31/12/19-31/12/20)	12-month periods of the last 5 years (in %, EUR): 16/03/20 16/03/21	16/03/19 16/03/20	16/03/18 16/03/19	16/03/17 16/03/18	16/03/16 16/03/17	P/B* 16/03/21	Div.* 16/03/21	P/E* 16/03/21
MSCI USA Small Caps	19,5	8,7	105.4	-30.5	10.3	0.7	30.9	2.4	2.0	29.5
MSCI UK	11,1	-17,9	46.1	-24.2	7.7	7.6	31.7	0.9	6.9	8.7
MSCI EM Eastern Europe	10,5	-19,1	71.4	-25.1	0.1	9.9	13.9	1.6	2.4	25.1
Stoxx Europe Cyclicals	9,6	-0,3	57.9	-12.1	-3.7	15.6	27.3	2.1	1.8	17.6
S&P 500	8,7	8,8	37.4	-30.6	9.0	-1.7	13.2	1.7	3.9	14.4
Euro Stoxx 50	8,7	-3,2	49.6	-15.6	-2.6	5.0	22.6	1.4	1.8	21.8
Stoxx Europe Small 200	8,2	4,8	67.1	-28.7	-4.0	6.9	21.8			
MSCI EM Asia	7,8	17,9	40.2	-20.2	6.8	-0.9	14.3	2.3	3.3	17.2
Topix	7,4	3,3	66.5	-25.2	-5.7	2.5	21.0	1.7	2.7	16.1
Stoxx Europe 50	6,5	-6,3	54.6	-25.7	1.2	2.4	15.7	1.9	2.8	18.8
DAX	6,1	3,5	50.5	-12.5	13.6	2.8	24.1	4.0	1.5	22.9
Stoxx Europe Defensives	4,1	-6,3	27.0	-19.3	14.2	-1.9	6.8			

Time period: 16/03/2016–16/03/2021.
Source: Bloomberg. * PBV = Price/book value ratio; Div. = Dividend yield (%); PER = Price/earnings ratio. Values based on estimates for the next 12 months.

and falling share prices have brought about a swift adjustment of valuations. US equities are now over 20% less expensive than at the end of 2020. Nevertheless, equities are still trading well above their historical P/E ratio averages, especially US equities. Therefore, the valuation adjustment could proceed further if bond yields continue to rise sharply and quickly. However, it should also not be forgotten that equities are still valued favourably compared with bonds.

Barbell strategy still makes sense

We are sticking with our strategy of supplementing our long-term exposure to "quality growth" companies with cyclical elements such as emerging-market and UK equities. While the former still enjoy long-term support from megatrends such as digitalisation and an ageing population, the latter stand to benefit from the reopening of the economy, as reflected in the highly positive earnings revisions. By contrast, we tend to avoid more defensive equity regions. For that reason, we are currently not invested in the Stoxx Europe 50, which is heavily weighted towards Swiss "bond proxies". As for US equities, we took profits on small caps after their strong outperformance. The US equity market will probably become more attractive during the rest of the year, barring a further sharp rise in bond yields. Finally, the US economy is likely to be one of the best performers to emerge from the pandemic.

Ulrich Urbahn, Head of Multi-Asset Strategy & Research

WHAT'S ON THE MIND OF COMPANIES?

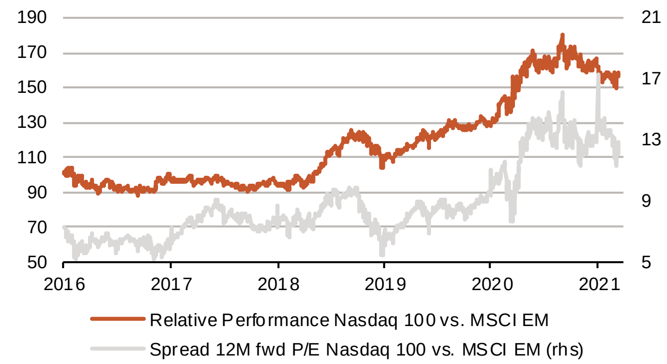
Light at the end of the tunnel

The second wave of COVID-19 infections has delayed the long-awaited economic recovery. Consumer-driven industries in particular are chafing under the protracted lockdown. Nevertheless, many companies have recently told us they can see light at the end of the tunnel. The especially hard-hit tourism sector is a prime example. Though still deep in the crisis, travel and aviation companies note huge increases in bookings for the summer. Assuming a sustained reopening, many industries can expect a significant recovery in the second half of the year. This optimism has also been confirmed by what we are hearing from digital advertising giants in the US, which are encountering massive demand. However, this also proves that the digitalisation trend that was accelerated by the pandemic is irreversible. The online shop is the new shopping centre. Compared with consumer goods, the recovery of manufacturing is far more advanced. Buoyed by strong demand from China, the automobile industry, for example, is already in relatively good shape.

Matthias Born, CIO Equities

US tech stocks undergo valuation adjustment, EM stocks stronger

P/E ratio valuation on the basis of earnings estimates for the next 12 months for NASDAQ-100 and MSCI EM, and relative performance (01/01/2016 = 100)

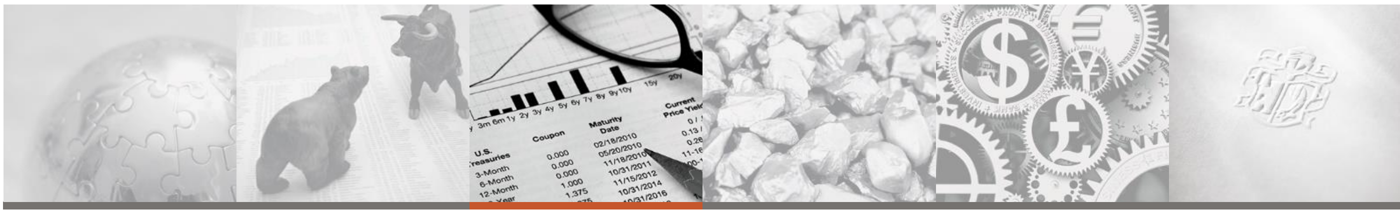


Time period: 01/01/2016-16/03/2021.
Source: Bloomberg, Berenberg.

Forecast summary: further upside potential for equities

	Currently			∅*
Index forecasts	16/03/2021	31/12/2021	30/06/2022	in 12 months
S&P500	3,963	4,050	4,300	4,379
Dax	14,558	14,900	15,800	16,023
EuroStoxx 50	3,851	3,900	4,100	4,158
MSCI UK	1,905	2,050	2,200	2160
Index potential (in %)				
S&P500	-	2.2	8.5	10.5
Dax	-	2.4	8.5	10.1
EuroStoxx 50	-	1.3	6.5	8.0
MSCI UK	-	7.6	15.5	13.4

* Average, consensus as of 16/03/2021.
Source: Bloomberg, FactSet, Berenberg.



RISING YIELDS STILL POSE A CHALLENGE

IN A NUTSHELL

- Government bonds: inflation expectations and bond yields are rising, investment opportunities are still unattractive.
- Euro-denominated corporate bonds exhibit resilience and potential for further moderate spread tightening.
- High-yield emerging-market bonds denominated in local currencies are promising, duration should be kept short.

Rediscovery of inflation is moving the bond markets

Even though the economic recovery has been delayed by the second wave of infections and vaccination delays in many places, it is sure to come sooner or later. And bond markets have anticipated this scenario, particularly in the form of rising nominal yields, which are themselves a reflection of universally higher inflation expectations. Although all segments of the bond market are equally preoccupied with this trend and the uncertainty about real interest rate developments, we do have some clear preferences.

Government bonds are faltering, yields are rising

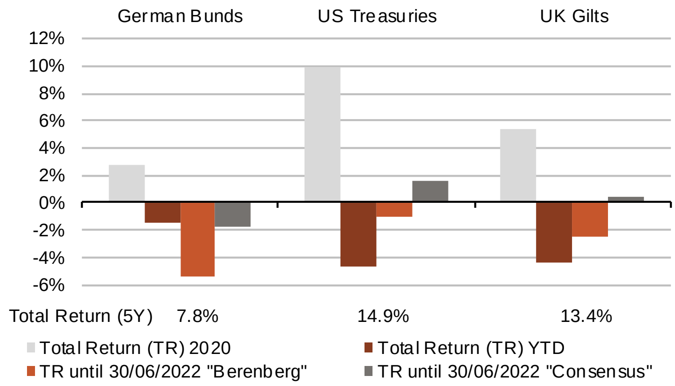
The trend of rising yields that has already been in effect for US Treasuries since last autumn has continued this year, and since January it has dominated European markets too. This trend is driven by rising inflation expectations, economic growth and rising government debt, as reflected by yield curve steepening on both sides of the Atlantic. In the US, the Eurozone and the UK, the yields of longer-dated bonds have risen faster than those at the short end since the beginning of this year. Given the pronounced rise in yields, we would not be surprised by temporary counter movements. Nevertheless, we anticipate further rising yields in the medium term. With this in mind, we are fundamentally cautious towards government bonds. In the best case, US Treasuries could become attractive for a short while if their yields temporarily overshoot.

Corporate bonds are still resisting the rise in yields

As expected, the risk spreads of European corporate bonds in the investment-grade and high-yield segments have tightened as of the end of February (by -3bp and -29bp, respectively). Nevertheless, the performance of many maturities is still negative in absolute terms. The safety cushion of risk premiums, especially in the higher-rated categories, was too small to absorb the strong upward movement of risk-free interest rates. Looking forward, many questions remain. Can investors be placated by continuing ECB purchases? Will higher absolute yields whet fresh buying interest or will investors shed their exposures to corporate bonds due to their negative performance, thereby causing spreads to widen? According to J.P. Morgan, the latter scenario is not yet supported by capital flows: European investment-grade funds have suffered only marginal outflows of around 0.1% of assets under management since the beginning of the year. The left-hand graph on page 11 illustrates the dilemma in the investment-grade segment: although risk premiums were once lower than today, the nominal yield was never lower than at the start of 2021 due to negative interest rates. The current yield surge can provide some relief in this respect and

Safe havens exhibit losses in the wake of 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: 16/03/2016-16/03/2021.
Source: Bloomberg, own calculations, iBoxx Government Bond Indices (7-10 years, TR).

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

Comparison of Berenberg and consensus forecasts, values at the middle and end of 2021

	16/03/2021	31/12/2021		30/06/2022	
	Currently		∅*		∅*
USA					
Base interest rate	0.00-0.25	0.00-0,25	0.25	0.00-0.25	0.30
10Y US yield	1.62	2.00	1.67	2.15	1.85
Eurozone					
Base interest rate	0.00	0.00	0.00	0.00	0.00
10Y Bund yield	-0.34	0.10	-0.18	0.30	-0.08
UK					
Base interest rate	0.10	0.10	0.10	0.10	0.15
10Y Gilt yield	0.78	1.10	0.81	1.25	0.92

* Average, consensus as of 16/03/2021.
Source: Bloomberg.

offers the potential for further moderate spread tightening, assuming that the extent and speed of interest rate movements remain within manageable limits. At the moment, the technical factors still appear to be intact: the regular monthly ECB purchases, only moderate new issuance activity thus far, and fund inflows should continue to favour surplus demand for corporate bonds. We still take a positive view of this asset class, preferring shorter duration and lower ratings (BBB), together with allocations in higher-risk premium segments such as subordinated financials as a safety cushion.

Emerging markets: high-yield, local-currency bonds preferred

Compared with the end of 2020, developments in the first quarter were completely different for bonds in both hard and local currencies. Whereas the influence of the COVID-19 crisis has receded somewhat, the faster-than-expected rise in US interest rates has been the main driver of anxiety in this asset class. However, this trend is countered by rising commodity prices, particularly at the level of local-currency bonds, prompting fast-rising capital inflows into this segment especially in January and February. Whereas a rise in US government bond yields had been expected by most market participants, many were surprised by the speed of this movement. That being said, this has changed nothing about the positive fundamental outlook. For the rest of the year, however, one should focus on more cyclical segments with an adequate spread component, which can better offset any further interest rate increases. Moreover, preference should be given to bonds with lower interest rate sensitivity. We consider the current level of yields to be attractive for both government and corporate bonds. Nevertheless, we are setting clear priorities given that we expect high-yield bonds to outperform investment-grade ones. In addition, we believe that local-currency bonds are promising, due to their cyclical character and low interest rate sensitivity. In the hard-currency segment, corporate bonds generate an attractive current yield despite their relatively high credit quality and are therefore more attractive than government bonds, not least because of their shorter duration.

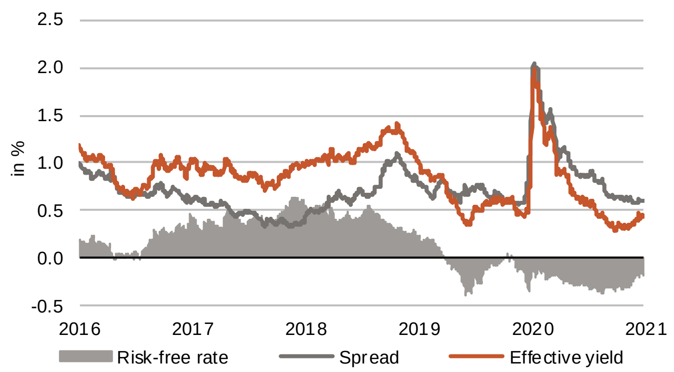
Conclusion: spreads are indispensable

While the rise in yields was expected, there is still no end in sight: The trend should continue – albeit at a slower rate – and safe government bonds are therefore unattractive. By contrast, the risk spreads of European corporate bonds in the lower investment-grade segment may tighten (moderately) further, and for that reason this segment has something to offer against rising interest rates, as do emerging-market bonds, especially in the high-yield and corporate segments. The latter are our first choice in the current market environment.

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

Corporate bonds: tightening spreads and rising yields

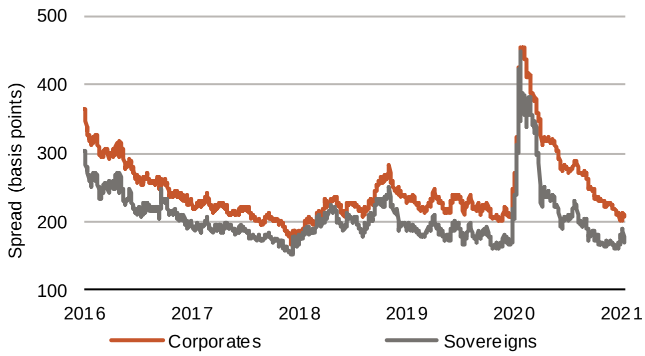
Even though nominal yields reached a historic low at the beginning of 2021, risk spreads still have further tightening potential.



Time period: 16/03/2016–16/03/2021.
Source: Bloomberg, own calculation.

Emerging markets: corporates offer more than governments

Compared with the yield of US Treasuries, hard-currency corporate bonds in the BBB rating segment offer higher premiums than government bonds.



Time period: 16/03/2016–16/03/2021.
Source: Bloomberg, own calculations.

COMMODITIES SEEM UNSTOPPABLE

OPEC+ is doing a good job of controlling the oil market

Energy commodities have been the best asset class since the start of the year. Crude oil gained more than 30% in the first quarter thanks to the OPEC+ in particular. Month after month, the cartel has surprised the market with its remarkably strict production discipline, leading to a pronounced supply deficit and fast-falling inventories. OPEC+ will continue to set the tone in the coming months as production increases by the US shale oil industry are likely to be restrained. Thanks to the economic recovery, even rising production volumes would not necessarily be negative for oil prices, although in that case the rally could be expected to considerably lose momentum.

Gold poised to break out of its downward spiral

Gold had the worst first quarter of the last 30 years. Rising real interest rates and the growing popularity of Bitcoin as an alternative prompted substantial investment outflows from gold. Future investment demand will depend on growth and inflation risks. If the economic recovery meets high expectations and inflation worries are kept at bay in the coming months, gold will probably remain low on the list of investors' favourites. However, looking at the already highly positive sentiment and the move in interest rates, the gold correction has probably run its course for the most part. Moreover, last year's headwinds are likely to reverse, providing support in the future. The "wealth effect" will probably give a powerful boost to jewellery demand. At the same time, high commodity prices will enable the central banks of emerging-market countries to continue to "dedollarise" their reserves. Nevertheless, upside potential remains limited if real interest rates rise further.

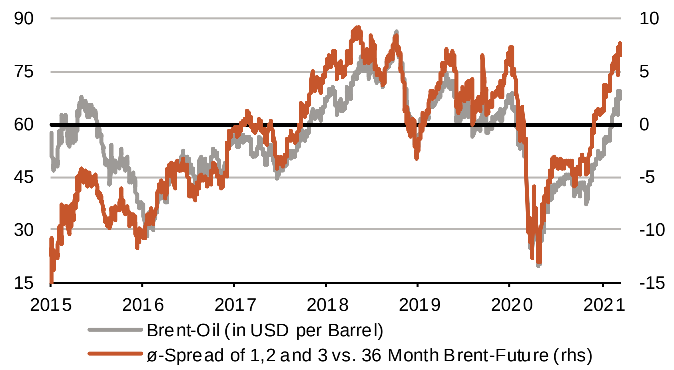
Industrial metals enjoy cyclical and structural support

In the first quarter, industrial metals picked up where they left off last year. Many metals are at multi-year highs. Manufacturing is booming. Moreover, metals such as copper, aluminium and nickel play a crucial role in the decarbonisation of the economy. Mine operators are faced with the difficult task of satisfying this demand after years of austerity and non-investment in the exploration of new mineral reserves. Supply deficits are probably in the offing and that will push prices higher. That being said, the rally of the last few months has in no small part been driven by speculative investors. Temporary pullbacks triggered by sentiment reversals should not be ruled out.

Ludwig Kemper, Analyst Multi-Asset Strategy & Research

Strict production discipline of OPEC+ ensures rising prices

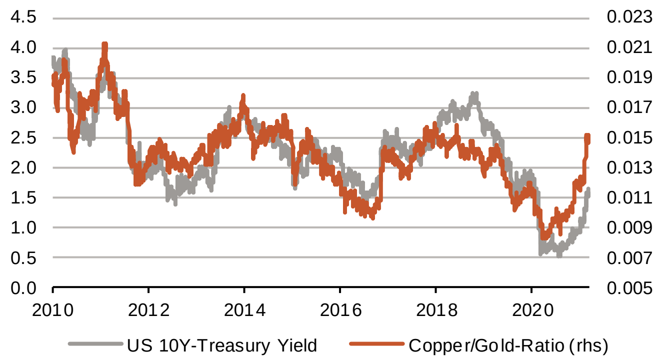
The supply deficit signalled by higher prices at the short end of the futures curve is driving up oil prices.



Time period: 01/01/2015-16/03/2021.
Source: Bloomberg, own calculations.

Interest rate-driven gold correction has probably run its course

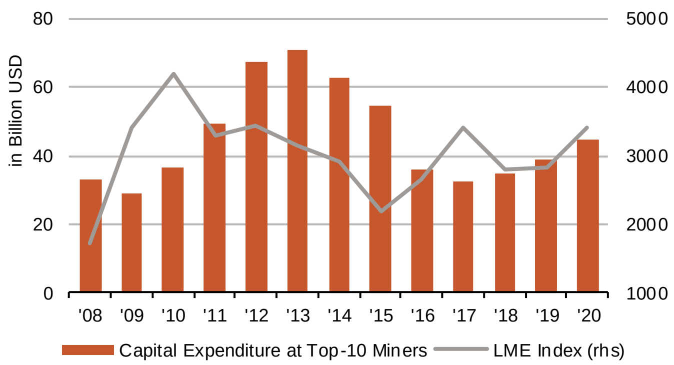
In a cross-asset comparison, the gold price appears to have already discounted rising interest rates.



Time period: 01/01/2010-16/03/2021.
Source: Bloomberg, World Gold Council, own calculations.

Lack of investment is likely to result in supply deficits

After years of restraint, mine operators will have to make big investments before they can meet surging demand in the future.



Time period: 01/01/2008-31/12/2020.
Source: Bloomberg, own calculations.

COMEBACK FOR THE US DOLLAR AND STERLING

Small surprises in the currency market

The euro got off to a strong start to the year, rising above USD1.23 per euro. Later in the first quarter, however, sentiment shifted surprisingly in favour of the US dollar. The tailwinds supporting sterling at the end of 2020 carried over into the new year, driving a rally in the first quarter. By contrast, the chronically overvalued Swiss franc has recently come under pressure, falling to its lowest level against the euro in about one and a half years. Thanks to the positive economic outlook, demand for the Swiss franc as a safe haven has diminished while technical factors have probably also played a role.

US dollar boosted by short-term outlook

The US dollar's exchange rate against the euro is benefitting from a comparatively strong economy and faster vaccination progress in the US, holding out the prospect of a quicker return to economic normality. The extremely expansive fiscal policy, evinced by the recently enacted fiscal package, is supporting economic optimism, which is temporarily having a positive effect on the dollar's exchange rate. In addition, higher interest rates make investments in dollar-denominated securities seem more attractive. In the longer term, however, the higher government debt resulting from this fiscal policy is likely to weaken the dollar.

By contrast, the Eurozone is suffering from the slow pace of vaccinations. It also had to contend with the government crisis in Italy; however, this issue has since been resolved now that Mario Draghi has been appointed Prime Minister. The Eurozone will probably bring the pandemic under control with the advent of the "outdoor season" and increasing vaccinations. We therefore expect sentiment to turn in favour of the euro again over the course of this year.

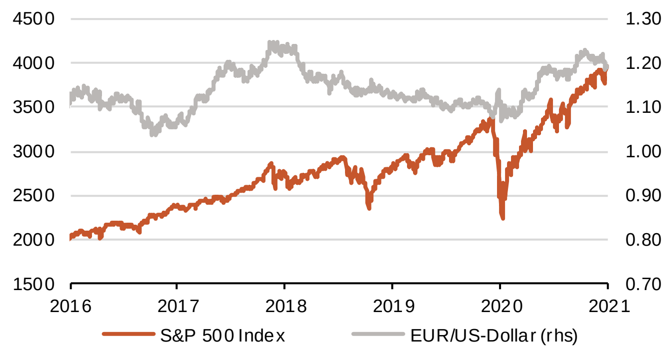
Sterling on the rise

The conclusion of a Brexit follow-up agreement between the EU and the UK shortly before the end of 2020 cleared the way for further exchange rate gains for the pound. The UK currency's recovery in the first quarter of 2021 was quite dynamic. It was aided by the rapid progress of vaccinations: almost 40 vaccine doses have been administered for every 100 persons in the UK, compared with just over ten in Germany and many other Eurozone countries. However, any further upside potential is probably limited.

Dr Jörn Quitzau, Senior Economist

EUR/USD: US dollar enjoying temporary strength

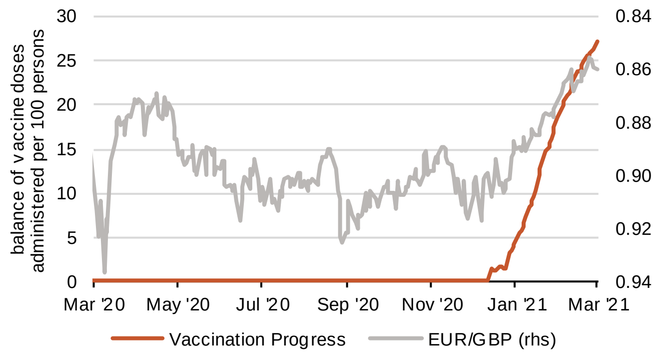
US currency bolstered by vaccination progress and positive economic outlook.



Time period: 16/03/2016–16/03/2021.
Exchange rate in US dollars; S&P Index in points. Source: Macrobond.

EUR/GBP: the pound is also benefitting from vaccination progress

After the Brexit follow-up agreement, vaccination progress is also paying off.



Time period: 15/03/2020–15/03/2021.
Exchange rate in GBP; right-hand scale inverted. Vaccination lead UK vs. Germany, administered vaccine doses per 100 persons. Source: Macrobond, Our World in Data.

Exchange rate forecasts

US dollar weakness is likely to persist.

	16/03/2021	31/12/2021		30/06/2022	
Exchange rate forecast	**Currently**		∅*		∅*
EUR/USD	1.19	1.28	1.23	1.29	-
EUR/GBP	0.86	0.85	0.87	0.85	-
EUR/CHF	1.10	1.10	1.11	1.10	-
EUR/JPY	130	129	129	129	-
Change against the euro in %					
USD	-	-7.0	-3.2	-7.7	-
GBP	-	0.8	-1.5	0.8	-
CHF	-	0.1	-0.8	0.1	-
JPY	-	0.6	0.6	0.6	-

* Average, consensus as of 16/03/2021.
Source: Bloomberg.

INTERVIEW WITH MARTIN HERMANN

Mr Hermann, you manage a global equity fund and the corresponding asset management strategy at Berenberg. What tasks does your job entail?

My tasks are very diverse. The main focus is to find stocks that can appreciate significantly over a horizon of three to five years. We also strive to discover subsectors that stand to benefit from long-term growth trends. We then look for long-term winners within these industries. The challenge is to identify the long-term winners from an extremely large population of thousands of companies. Having collected all the data, we need to analyse it, which means combining all relevant information to establish a basis for decision-making.

That sounds exciting! What does your normal working day look like? And how is the COVID-19 pandemic affecting your work?

Basically, our job is to buy and hold equities that we believe in. I spend 90% of my normal working day collecting relevant information and then combining it into logical investment propositions. Therefore, I spend a lot of time reading and talking on the phone. My sources are diverse, ranging from annual reports of companies and conversations with senior management to industry data and conversations with industry experts. The pandemic has changed very little about my work aside from not being able to visit companies in person. All internal and external meetings are now conducted virtually by video.

What motivated you to become a portfolio manager? What makes your profession so exciting, do you think?

Most of all, I have always been attracted to the variety and the opportunity to learn new things. Like a treasure hunt, there is always something new and valuable to discover. And like a puzzle, you need to assemble different bits of relevant information to arrive at a meaningful picture. And in this work, you always have your finger on the pulse of the times, dealing with exciting technological, socio-economic and geopolitical trends in addition to company analysis.

Why have you decided to focus on equities outside Europe? What makes other equity regions different from Europe? And how can investors benefit from these differences?

An international orientation allows for a broader investment universe and stricter stock selection criteria. In addition, there are certain business models such as those of global internet companies, for example, that are only represented in the US and China. The advantages are high-alpha opportunities and good diversification. For example, China was hit by the COVID-19 crisis earlier than and not as hard as the rest of the world.

What are the challenges for German portfolio managers who invest in companies across the globe?

Information procurement is more demanding and language barriers are sometimes a problem. For that reason, we do not invest in certain markets such as frontier markets, for example. Apart from that, we get on very well with the help of our broad network of company contacts and access to experts.

How would you describe your investment philosophy? Do you have a role model?

We invest in companies with strong market positions that stand to benefit from long-term growth trends and are led by outstanding owners. There are many investors whom I admire. My investment style has been influenced the most by Philip Fisher, one of the best-known investors focused on growth stocks and quality stocks. His book “Common Stocks and Uncommon Profits” details many fascinating ideas and investment approaches.

What role does ESG play in your investment approach?

Although businesses are only now paying more attention to ESG issues, they have always been an important part of our investment analysis. We focus primarily on a company's business practices and culture. How popular is the company as an employer, how much genuine value-added is created for customers, how does the company treat other stakeholders and the environment? If you have a multi-year investment horizon, the company must be strong on all these points. Major disparities in these factors point to a potentially high level of business risk. Naturally, the ability to exercise shareholder rights in the annual general meeting and hold direct discussions with senior management on ESG topics are also important points for us.

By what criteria do you select stocks, specifically?

The four main criteria are the competitive advantages of the business model, the long-term growth prospects, the quality of the management, and the company's valuation. Companies with strong competitive advantages and numerous growth options have a high potential for appreciation. The combination of growth and competitive advantage determines the valuation. Of course, the trick is to buy outstanding companies when they are not currently in vogue. That requires creativity, patience and also speed, in addition to conventional analysis. We must act quickly when an opportunity arises as in the spring of 2020, for example, when some top companies were trading at fire-sale prices, but only for a few weeks. In the long term the quality of management is one of the most important factors.

Why is management especially important for you and how do you assess its quality?

A company does not operate in a vacuum: it is defined by the skill and actions of top executives, both directly by their own actions and indirectly by the persons they hire and promote. Like attracts like. We prefer owner-managed companies because they are usually focused on longer-term growth instead of short-term share price gains. Such companies are also more goal- and mission-focused, enabling them to better seize opportunities and avoid risks. In the context of Germany, I could point to HelloFresh. A few years ago, hundreds of meal kit services entered the market, but Dominik Richter and his team built their company into the global market leader on the strength of a strong data model, quick local execution and brand-building. Being able to foresee this successful development requires an analysis of past management decisions and above all conversations with employees, competitors and industry experts.

What special aspects need to be considered in the corresponding asset management mandates compared with your mutual fund? And how is your "Berenberg Global Focus Fund" different from the "Berenberg Aktien Global Plus" fund?

The Berenberg Global Focus Fund and the Aktien Global asset management mandates are managed similarly, with an overlap of around 90%. We manage the Global Focus Fund more aggressively in terms of the allocation to fast-growing names. Berenberg Aktien Global Plus is a hybrid fund in which we hold not only the equities from the Global Focus Fund, but also other asset classes such as gold and higher levels of cash at times.

How satisfied are you with the performance of your strategy?

From its inception a little more than two years ago until the end of 2020, the Berenberg Global Focus Fund has generated a performance of more than 77%, corresponding to an outperformance of the broad stock market of more than 31%. That is a very good result not only in absolute terms, but also compared with our competitors.

BRIEF BIOGRAPHY

Martin Hermann is a senior portfolio manager and responsible for the Global Focus Fund and the Aktien Global asset management strategy. He began his career in 2010 as an investment trainee on the graduate programme at Allianz Global Investors. Before coming to Berenberg in October 2017, he was portfolio manager and vice president on the award-winning Europe Equity Growth Team. Among other roles, he was the deputy fund manager of the International Equity Growth Fund. Martin is a CFA Charterholder and holds a master's degree in investment analysis and corporate finance from the University of Vienna.

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IMPORTANT NOTICES

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