HORIZON

The Berenberg Capital Market Outlook · Wealth and Asset Management

UPWARDS

Economic and profit growth remain high – even though positive surprises and annual growth rates are slowing.

U-TURN

As inflation remains the defining issue, central banks are likely to announce their reversal towards the end of the third quarter – markets will play this earlier and bond yields are likely to rise.

BACK AND FORTH

The frequent changing of favourites is likely to persist for the time being, with limited upside potential for equities. However, high liquidity, positioning and growth make strong setbacks unlikely.

Q3 | 2021

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FOREWORD

Prof Dr Bernd Meyer
Chief Investment Strategist

Dear reader,
In the second quarter, economic and market recovery continued with continued positive growth and earnings surprises. Oil, industrial metals and equities gained and have been extending their lead over bonds since the beginning of the year. The markets focused on the Eurozone reawakening from the pandemic lockdown. The euro appreciated, bond yields rose, especially in the Eurozone, European equities were ahead and have even been leading since the beginning of the year. Investor sentiment has fluctuated between growth disappointments, reflation hopes and inflation fears at already high market valuations. The result was not only a more volatile market development with less growth, but also a constant back and forth between investment styles. Ultimately, however, more cyclical and less highly valued assets also led in Q2. Our strategies benefited from an overweight in equities and cyclical commodities as well as a more balanced positioning of growth stocks and cyclicals.

The back and forth of investment styles is likely to continue for the time being. The strong economic recovery continues, and business investment is also picking up. Economic and profit growth remain high, even if growth rates are slowing in comparison to the previous year. Ad hoc releases suggest that the Q2 reporting season should once again be very good. However, positive economic and earnings surprises are likely to diminish. With further high inflation figures, inflation is likely to be the dominant theme. But to what extent is this temporary and when will the central banks initiate their reversal? We expect more clarity towards the end of the third quarter at the latest – but the markets will play this earlier. Bond yields should therefore continue to rise, especially real yields. Cyclical and less highly valued assets could therefore remain in focus for now, but their out-performance could weaken during the third quarter. Defensive investments and profitable growth stocks could then become more interesting again. The path for the markets over the summer therefore appears full of potholes – it could become bumpier, especially as the tax discussion is also likely to pick up speed in the US and political risks are likely to come back into focus. However, equities remain supported by high investment demand, earnings growth and the low positioning of systematic investment strategies. Setbacks of more than 5-10% seem unlikely and would offer buying opportunities from today's perspective. When the base effect-induced inflation wave subsides somewhat, there is more clarity about the behaviour of central banks and a continuation of the economic recovery in 2022 becomes apparent, we expect further potential for equities. Therefore, it would be wrong to be too pessimistic: however, we have positioned ourselves less aggressively for the summer.

In the Insights interview, our fund selector Tobias Schäfer shares with us what his job entails, how and where we use active funds and ETFs in our strategies, and how we select them. I hope you enjoy reading this issue of Horizon.

CONTENTS

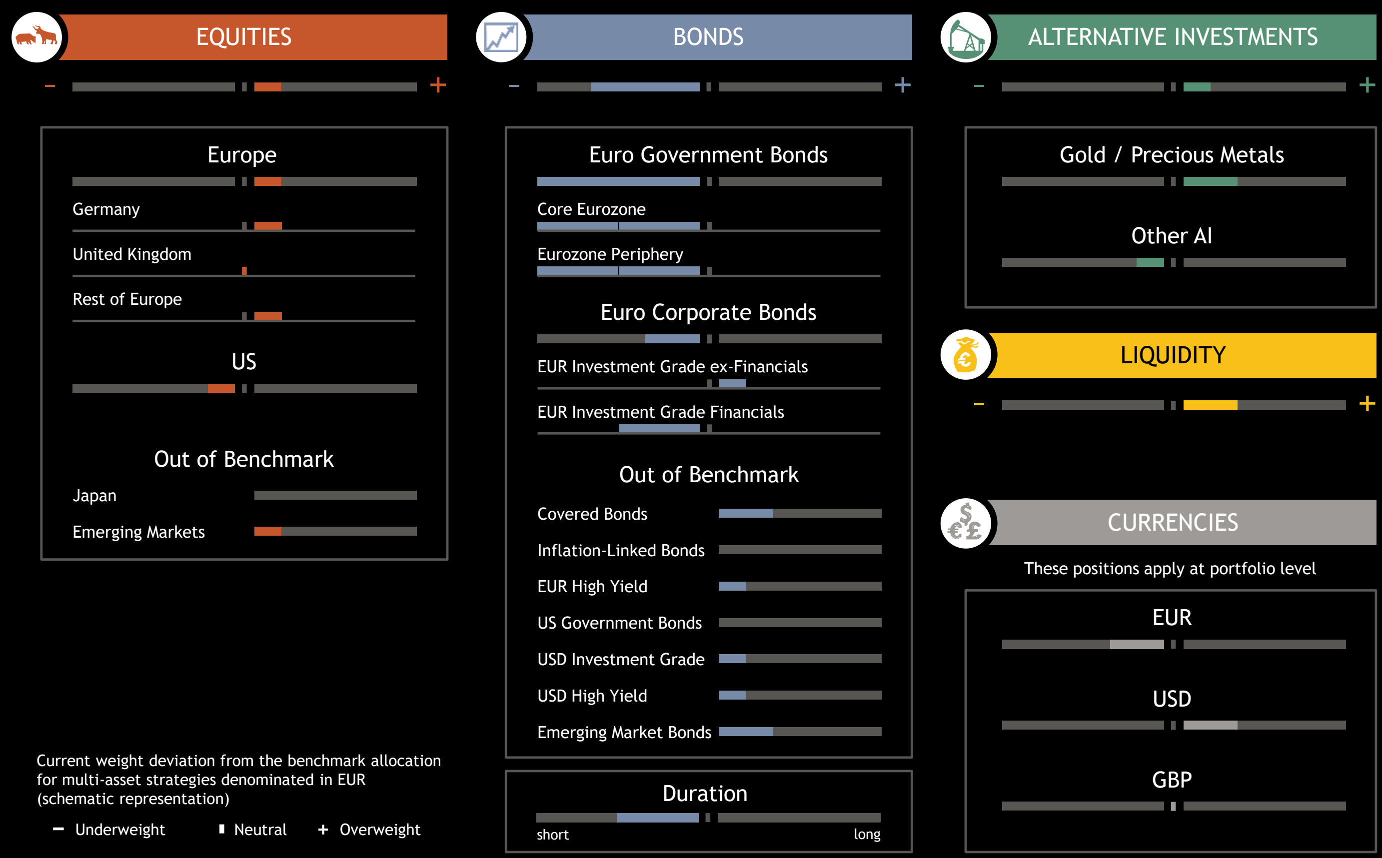
BUMPY BUT DECISIVE SUMMER WITH OPPORTUNITIES

IN A NUTSHELL

- The economy is recovering dynamically, but positive surprises are likely to fade and year-on-year comparisons will become more difficult. Inflation remains high.
- Discussion about curbing expansive monetary policy is becoming central. (Real) Yields are likely to rise.
- Equities, supported by positioning and growth, are likely to fluctuate sideways over the summer. However, setbacks of more than 5-10% seem unlikely.
- Few clear trends in the summer. Towards mid-cycle, the cyclical outperformance is likely to weaken. Defensive and profitable growth stocks will then become more interesting.

Portfolio positioning at a glance

By the second quarter, we had already halved the high equity overweight from the beginning of the year. After the continued strong performance of the equity market in April, we continued on course by reducing the equity quota to only a slight overweight, as the summer is likely to be bumpier. Until there is more clarity on central bank behaviour and markets set their sights on the continuation of the economic recovery in 2022, we feel comfortable with reduced risk. Our liquidity position allows us to seize opportunities should there be more significant setbacks. Otherwise, the portfolio structure has changed very little. We are continuing to tactically complement our strategic focus on structural growth with cyclical and value-heavy elements (small caps, Latin America, UK, commodities). Defensive investments are likely to have a more difficult time initially. We prefer corporate and emerging market bonds to government bonds, even though a further narrowing of spreads is less likely as companies focus increasingly on shareholder value. Gold benefits from rising demand and higher inflation and remains an important portfolio component for diversification, even if bond yields continue to rise.



Current weight deviation from the benchmark allocation for multi-asset strategies denominated in EUR (schematic representation)

Looking back on the second quarter — Europe moves into focus

The main trends from the first quarter continued in the second quarter, but with significant changes beneath the surface. Oil, industrial metals and equities continued to rise, while bonds tended to continue to lose. While the economic opening in the US was in the foreground in the first quarter, the opening in the Eurozone moved into the market's focus in the second quarter because of the progress made with COVID-19 vaccinations. US Treasury yields paused and eased somewhat after the sharp rise in the first quarter as the rise in yields in the Eurozone continued. European equities have now been ahead of American equities since the beginning of the year. The US dollar largely lost its Q1 profits, while gold made up for its Q1 losses. Emerging market equities lagged somewhat as China's positive surprises did not continue and the declining credit impulse there reflects the already less expansionary monetary and fiscal policy. In contrast, equities from Latin America and Eastern Europe rose significantly, not least due to the further increase in commodity prices. With the reduced US yield increase, investment styles showed fewer clear trends. Growth and value were constantly changing leadership – but overall, value and more cyclical areas were still ahead in the second quarter.

Declining growth momentum, increasing inflation

Our economists' outlook remains almost unchanged. The Eurozone is following the example of China and the US with a strong economic recovery. Positive economic surprises have dominated globally since the second quarter of 2020. In contrast to Europe, Great Britain and Japan, economic data from the US has recently failed to produce any positive surprises, and China was even disappointing. During the third quarter, positive surprises in the economy and earnings are likely to diminish. Higher expectations and more difficult year-on-year comparisons might have a negative impact. Growth rates are passing the peak, but it should not be misunderstood that growth rates are likely to remain very high thanks to high consumer and investment spending and that the recovery is continuing dynamically (top figure page 5). Markets are becoming less concerned about how strong the recovery will be and more concerned about how long it will last. Consumer price inflation is likely to continue to rise for the time being, and will be the central issue on capital markets and generate volatility.

What part of the inflation increase will ultimately be temporary and how the central banks react to the higher inflation rates is likely to become clearer towards the end of the summer at the earliest. While we also expect inflation to fall back somewhat after a significant increase, we also believe that disinflationary trends such as globalisation or demographic change have turned around in recent decades and will ensure higher inflation in the medium term than before the pandemic. With regard to Fed policy, the central bank conference in Jackson Hole at the end of August could, as so often before, point the way ahead. The Fed is expected to announce a reduction in bond purchases in late summer. As the COVID-19 crisis subsides, markets are likely to return their focus more on political risks (China-US, Russia, elections in Germany).

Oil and equities continued to rise more slowly in Q2 - Europe ahead, gold and EUR/USD make up Q1 losses, bonds continued to lose ground

Total return	YTD and Q2 21 (in %, in EUR)		12-month periods of the last 5 years (in %, EUR)					CAGR*	Std. dev.*
	YTD (31/12/20-15/06/21)	Q2 21 (31/03/21-15/06/21)	15/06/20 15/06/21	15/06/19 15/06/20	15/06/18 15/06/19	15/06/17 15/06/18	15/06/16 15/06/17	15/06/16 15/06/21	15/06/16 15/06/21
Brent	47.4	14.9	67.6	-36.0	-9.2	55.3	-14.6	5.3	37.6
Stoxx Europe 50	16.7	8.3	25.3	-4.2	4.7	0.5	21.3	8.9	15.9
S&P 500	14.8	3.9	30.9	7.6	9.7	11.9	20.9	15.9	19.9
DAX	14.7	4.8	32.1	-1.5	-7.0	2.5	32.1	10.4	19.1
MSCI EM	8.4	1.9	35.5	-3.1	-3.2	9.0	28.1	12.2	15.7
USDEUR	0.7	-3.3	-6.6	-1.0	3.6	-4.0	1.0	-1.5	6.8
Eonia	-0.2	-0.1	-0.5	-0.4	-0.4	-0.4	-0.4	-0.4	0.0
EM Sovereigns	-0.3	0.6	0.7	0.9	13.8	-7.1	9.9	3.4	8.0
EUR Corporates	-0.4	0.3	3.7	0.3	3.7	0.7	2.1	2.1	2.4
US Sovereigns	-0.7	0.0	-8.2	6.9	9.9	-5.3	0.2	0.5	6.3
EUR Sovereigns	-1.0	-0.2	0.8	1.0	3.1	-0.1	0.3	1.0	2.1
Gold	-1.4	5.3	0.6	27.3	8.6	-2.1	-1.9	6.0	12.4

Time period: 15/06/2016-15/06/2021
Source: Bloomberg * CAGR = Annualised return (in %, in EUR); Std. dev. = Annualised standard deviation (in %, in EUR).

Rising corporate investment

While the first phase of the recovery was and will be strongly driven by consumer spending, growth in the coming quarters should be increasingly supported by business investment spending (middle figure). The profit recovery, high corporate liquidity, capacity constraints, supply chain restructuring, rising labour costs and expansionary monetary and fiscal policies all point to a pronounced investment cycle and more corporate takeovers – with the latter already being observed. If balance sheet repair takes a back seat, this should herald the end of spread tightening in corporate bonds. However, the hunt for yield and continued high central bank purchases with limited issuance activity are likely to prevent a significant widening of risk premiums. In contrast, an accelerating capex cycle supports commodities and more cyclical sectors, especially as government investments in infrastructure and climate protection are added to the mix.

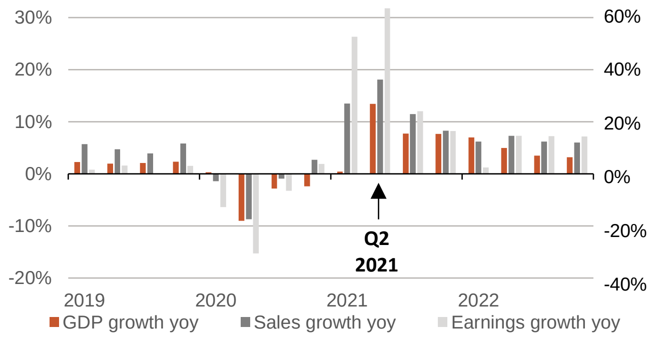
High investment pressure continues to support markets

Investment pressure from investors remains high. Since the beginning of the year, global funds of all asset classes have recorded inflows (lower figure). Equity funds saw the strongest inflows with historic record volumes. According to Bank of America, the more than USD700bn in net inflows since November is already significantly more than in the entire previous 12 years. However, there was no rotation out of money market funds or bond funds. After renewed inflows, there is USD4.6trn in US money market funds again, almost as much as at the peak of the COVID-19 crisis. With rising inflation, the pressure to invest is getting higher because purchasing power cannot be maintained with cash, money market funds and government bonds. Therefore, investors are likely to use setbacks in markets as purchasing opportunities in the coming months. Global equities have not seen a setback greater than 5% since November last year. Setbacks greater than 10% have not been seen since the COVID-19 bear market. Moreover, systematic investment strategies are not highly positioned in equities due to the still heightened volatility in equities and bonds and their increasingly positive correlation. Therefore, we consider major setbacks unlikely even over a bumpy summer. Setbacks, on the other hand, offer buying opportunities if expectations remain unchanged. Financial repression, ie an environment in which central banks keep yield levels below inflation rates, continues to favour real investments such as commodities and equities in the medium term.

Prof Dr Bernd Meyer, Chief Investment Strategist

Continued very high growth rates, despite peak in Q2 2021

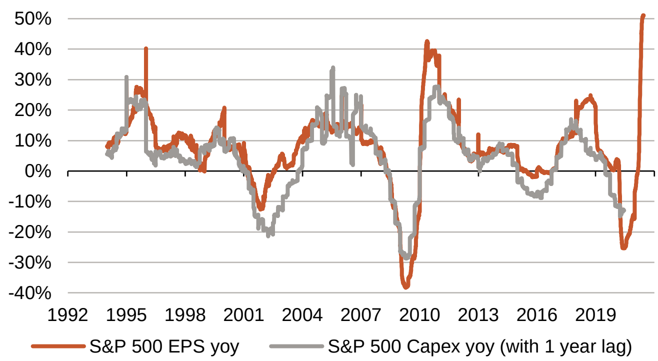
In the second quarter, the annual growth rates in the US economy, sales and profits are expected to exceed their peak



Time period: 01/01/2019–31/12/2022
Source: Refinitiv, Bloomberg, Berenberg

Investment expected to increasingly drive economic growth

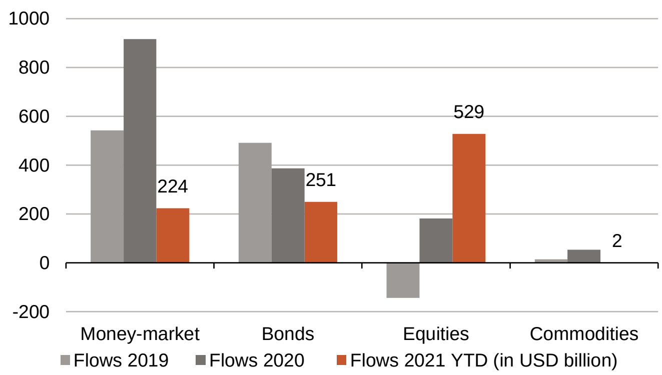
Development of the growth of realised profits determines future corporate investments



Time period: 01/01/1993–15/06/2021
Source: Bloomberg, own calculations

Investment demand supports all asset classes, particularly equities

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



Time period: 01/01/2019–09/06/2021
Source: Bank of America, own calculations

POWERFUL RECOVERY

IN A NUTSHELL

- Global economy: strong recovery as COVID-19 pandemic subsides. US initially ahead of Europe.
- Special effects drive inflation in 2021 – but the longer-term inflation trend remains subdued.
- Monetary and fiscal policy support the economy more than ever before. Central banks are preparing the turning point – but slowly.

The pandemic is subsiding

The worst seems to be over. On both sides of the Atlantic, the winter wave of the pandemic has largely subsided. In the US, the number of new infections has fallen to the lowest level since the end of March 2020; in the Eurozone, things are also moving in this direction albeit with a slight delay. The rapid progress of vaccinations and the warmer and brighter weather have had a positive effect.

Nevertheless, there are still risks. In some emerging markets, the pandemic continues to rage almost uncontrollably. Case numbers are rising again in the UK. In addition to the gradual return to a largely normal life, the Delta variant also seems to be contributing to this. However, as the UK is ahead in vaccinations among the major countries of the world (with almost 100 vaccine doses administered per 100 inhabitants compared to about 65 in the Eurozone), the odds are good that there will not be a dramatic increase in severe cases that would lead to a new nationwide lockdown.

The recovery gains momentum

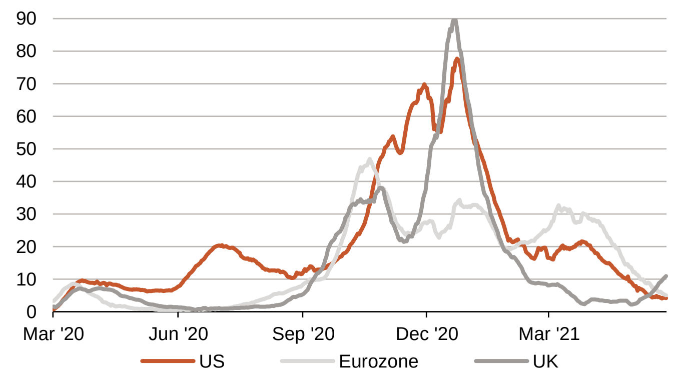
After the temporary setback in Europe and – to a lesser extent – in the US during the winter wave of the pandemic, the economic traffic lights turned green in the second quarter. The gradual easing of restrictions should lead to a rapid rebound in economic output. Even after the sharp slump in March and April in spring 2020, the economy recovered surprisingly quickly from May onwards.

Business sentiment has improved considerably in recent months. In the export-oriented manufacturing sector in the Eurozone, purchasing managers currently assess the situation as better than ever before, even though supply bottlenecks are likely to mean that there will be a delay in processing some of the flood of orders. The situation in the services sector has also improved considerably. After the long period of tougher lockdowns, Europe's services sector is now starting to catch up with the US.

Apart from foreign trade, the major driving force of the recovery initially will be private consumption. In 2020 and early 2021, households spent less money than usual as a result of the lockdowns. At the same time, government programmes ensured that their disposable incomes either remained almost constant (Europe) or even increased (US) during the pandemic. If households now gradually reduce their savings rate, this will lead to a strong increase in consumption over several years. Consumers want to get back to enjoying life.

COVID-19: the pandemic subsides

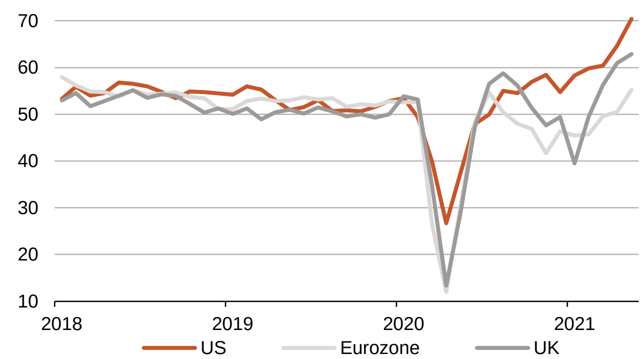
Daily confirmed new cases per 100,000 inhabitants



Seven-day averages. Time period: 01/03/2020-15/06/2021
Source: Johns Hopkins University

Things are looking up

Purchasing Managers' Index Services US, Eurozone and UK



50 = neutral, above 50 = growth. Time period: 01/01/2018-31/05/2021
Source: Markit

A broad-based recovery

In addition to consumer spending, the other components of macroeconomic demand will also support the recovery. Since March of last year, companies almost throughout the Western world have produced fewer goods than they have sold to customers. They will now have to replenish their stocks accordingly. And as the economy improves, they will want to expand their investments. Moreover, additional government spending, especially for investments in infrastructure and climate protection, will continue to boost the economy in 2021 and 2022. While the virus will not disappear, vaccination progress will presumably mean that a seasonal increase in the risk of infection in autumn 2021 will not trigger new lockdowns.

All components of demand are contributing to the recovery.

The second issue of the year: inflation

The prospect of a strong recovery is increasingly highlighting the issue of inflation. Currently, a number of one-off factors are causing a sharp rise in inflation rates. In addition to the expiry of the German VAT rate reduction and the increased tax on CO_2 emissions, the high transport costs and supply bottlenecks for goods are currently impacting inflation rates as well as the base effect of the extraordinarily low oil prices from March to autumn 2020. And in view of high demand, many service providers will raise their prices when pubs, restaurants and hotels reopen; therefore, the inflation rate in the Eurozone is likely to soar to around 2.5% in the summer. In the US, the rate is likely to exceed even 3% until late autumn.

However, the strong year-on-year rise in inflation is not expected to last. Base effects will naturally expire again. The shortage of containers, which contributes to the high transport costs, will be solved by autumn at the latest. Given the ongoing higher levels of unemployment, permanent drivers of inflation such as wage pressures will remain rather subdued until 2023, with inflationary risks more pronounced in the US than in the Eurozone given the particularly strong fiscal stimulus there.

Central banks are slow to backtrack

After years of very low inflation, central banks will initially take a cautious approach to the temporary rise in inflation. They will only take their foot off the accelerator when they are sure that inflation, without one-off factors, will return to their target of around 2% on a permanent basis. We expect the Fed to present a timetable for scaling back its bond purchases in the course of the third quarter. The European Central Bank (ECB) is also likely to reduce the pace of its bond purchases somewhat as the year progresses. While the Fed will probably raise its key interest rates at the end of 2022 and at the latest by the beginning of 2023 and the Bank of England will probably act as early as autumn 2022, the ECB is likely to follow suit only in autumn 2023 in view of lower inflation risks in the Eurozone.

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	7.1	6.6	4.6	4.1	1.2	1.3	3.7	3.4	3.3	2.5
Eurozone	-6.7	-6.8	4.7	4.3	4.6	4.2	0.3	0.3	1.9	1.8	1.5	1.4
Germany	-5.1	-5.3	3.8	3.4	4.4	4.2	0.4	0.5	2.7	2.5	1.7	1.5
France	-8.0	-8.3	5.9	5.8	4.4	4.0	0.5	0.5	1.5	1.5	1.5	1.2
Italy	-8.9	-8.9	5.2	4.6	4.6	4.0	-0.1	-0.1	1.1	1.3	1.2	0.9
Spain	-10.8	-11.4	6.2	5.9	6.5	5.6	-0.3	-0.3	1.9	1.6	1.8	1.2
UK	-9.8	-9.9	7.0	6.4	5.4	5.5	0.9	0.9	1.7	1.6	2.2	2.0
Japan	-4.7	-4.8	3.3	2.6	2.2	2.4	0.0	0.0	-0.1	0.1	0.6	0.6
China	2.0	2.3	8.9	8.5	5.3	5.5	2.5	2.5	1.4	1.5	2.2	2.3
World*	-3.3	-	4.7	-	3.5	-	-	2.2	-	3.3	-	3.0

* 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 15/06/2021

LESS POTENTIAL, OPPORTUNITIES IN ASIA

IN A NUTSHELL

- Reopening of the economy leads to widespread positive earnings revisions. However, earnings estimates for next year are subject to greater uncertainty.
- Equities remain expensive compared to their history – especially in the US. However, there is no attractive alternative.
- Equity markets are unlikely to have much upside potential at the index level in the third quarter; as for Asia, we see opportunities in the second half of the year.

Cyclicals mostly outperformed in the second quarter

Robust economic data and positive earnings revisions led to mostly rising equity prices in the second quarter. Europe, which tends to be a cyclical equity region, was out in front. Improved investor sentiment due to the COVID-19 vaccination progress and the reopening of the economy also helped. The continued strength of the euro and the weakness of the US dollar are also likely to have influenced international investors. US equities rose slightly, with a lot of movement below the surface. While technology companies underperformed, commodity-linked equities and financials in particular gained. Asia clearly underperformed in the second quarter as it has done since the beginning of the year. The fight against COVID-19 is only making slow progress there; for instance, there have been further lockdowns in Japan and India. China suffered from a slowdown in economic momentum and an increase in regulatory uncertainty.

Positive earnings revisions across all regions

Analysts have significantly adjusted their earnings estimates upwards in line with the better economic data – especially for Latin America and the UK. Both regions benefited from the broad commodity rally due to their sector structure. Globally, profits are expected to increase significantly this year. The consensus expectations suggest an increase in profits of 35% – with an enormous spread between the regions. For Switzerland, analysts expect a jump in profits of less than 10%, and for Latin America, a jump of more than 200%. Things are expected to normalise somewhat next year with earnings growth rates between 5-15%. The consensus is constructive for the Eurozone, the US and Asia. Latin America, Eastern Europe and the UK are expected to experience weaker growth next year after massive profit increases this year. How big the earnings growth actually turns out to be is still subject to a great deal of uncertainty. The further inflation and thus also interest rate path, the development of the COVID-19 pandemic as well as potential fiscal programmes and tax increases are likely to have different effects on the regions and sectors, which cannot yet be foreseen and are therefore hardly taken into account by analysts.

Valuations absolutely expensive, relatively cheap

The still enormous liquidity and low interest rates have meant that equities remain expensive compared with their own history. This is especially true for US equities. The S&P 500 is currently valued at a P/E ratio of 22.5 for earnings estimates over the next 12 months, well above the historical average of 16.8. Nevertheless, there is no way around equities in a cross-asset comparison – the

Many equity regions gained in Q2 - Europe ahead of the US and Asia, since the beginning of the year as well, cyclical stocks extended lead

Total return	YTD and Q2 21 (in %, in EUR)		12-month periods of the last 5 years (in %, EUR)					P/B*	Div.*	P/E*
	YTD (31/12/20-15/06/21)	Q2 21 (31/03/21-15/06/21)	15/06/20 15/06/21	15/06/19 15/06/20	15/06/18 15/06/19	15/06/17 15/06/18	15/06/16 15/06/17	15/06/21	15/06/21	15/06/21
MSCI EM Eastern Europe	20.1	12.5	27.2	-13.5	25.6	9.9	19.8	1.1	6.3	8.8
MSCI USA Small Caps	19.7	2.1	50.8	-5.2	-1.3	15.1	22.0	2.4	1.1	27.1
Stoxx Europe Cyclicals	18.3	6.8	43.5	-7.8	-6.5	5.8	32.3			
Euro Stoxx 50	18.3	6.9	35.1	-5.6	-1.0	2.1	27.9	2.2	2.6	19.1
MSCI UK	18.0	6.7	26.7	-16.2	-1.2	6.4	17.1	1.8	3.9	13.5
Stoxx Europe Small 200	17.0	8.5	42.8	-2.6	-4.7	9.7	23.9	1.9	2.3	26.3
Stoxx Europe 50	16.7	8.3	25.3	-4.2	4.7	0.5	21.3	2.5	3.1	17.4
S&P 500	14.8	3.9	30.9	7.6	9.7	11.9	20.9	4.3	1.4	22.5
DAX	14.7	4.8	32.1	-1.5	-7.0	2.5	32.1	1.8	2.7	15.7
Stoxx Europe Defensives	12.4	7.3	15.3	0.5	6.2	1.8	13.3			
MSCI EM Asia	6.6	0.3	36.4	4.6	-8.4	13.0	30.8	2.0	2.0	16.2
Topix	5.1	-1.5	19.5	2.1	-6.6	10.9	22.4	1.3	2.0	16.1

Time period: 15/06/2016-15/06/2021
Source: Bloomberg * PBV = Price/book value ratio; Div. = Dividend yield (%); PER = Price/earnings ratio. Values based on estimates for the next 12 months.

difference between equity dividends and government bond yields is between 100-200bp higher than the historical average, depending on the region. Most investors simply lack attractive alternatives should they sell equities.

Style volatility likely to remain high, Asia with opportunities in H2

For the time being, we are sticking to our barbell strategy of quality growth companies that benefit from megatrends such as digitalisation, as well as tactical value investments in selected regions such as the UK and Latin America. Many value sectors have recently benefited from significantly positive earnings revisions. In our opinion, US bond yields are likely to rise slightly again, reflecting the broad economic recovery worldwide. Central banks are moving closer to curbing their bond purchases. However, US mega-caps have also become relatively more attractive lately, especially as equity buyback programmes were expanded recently. The ups and downs between value and growth are therefore expected to continue for the time being. The upside potential at index level should be limited in the third quarter after the very strong first half of the year. We anticipate greater opportunities in Asia for the rest of the year, after the strong underperformance since the beginning of the year and given that the negative consequences of the COVID-19 pandemic should also ease there due to the progress made with the vaccinations. No distinct positioning or euphoric sentiment also speak for Asia.

Ulrich Urbahn, Head of Multi Asset Strategy & Research

WHAT'S ON THE MIND OF COMPANIES?

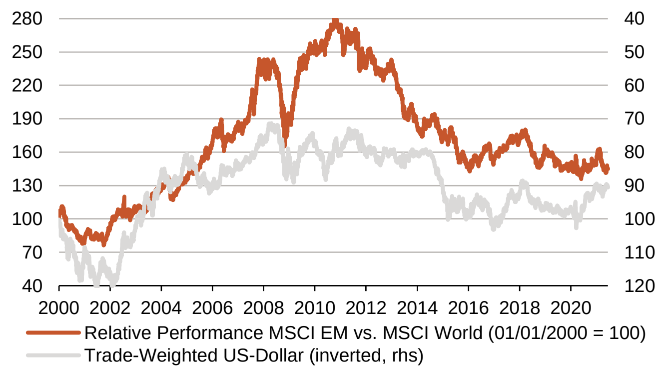
The post-COVID-19 era

With the COVID-19 vaccination campaign finally gaining momentum in Europe in the second quarter and many countries in the midst of the much anticipated reopening, companies increasingly allowed themselves to look into the more distant future and the post-COVID-19 era. As a result, companies in the health industry are increasingly starting to see a return to normality. The number of COVID-19 tests performed daily seems to have seen its peak, the use of intensive care beds is returning to the long-term mean and elective surgeries are gradually returning to pre-pandemic levels. And the pandemic seems to have been almost forgotten in many parts of the consumer goods industry. The exceptionally strong demand from China, especially for luxury goods, is contributing to this. Inflation and supply chain bottlenecks are two issues that have come up more and more in our recent conversations. And since we are mainly in contact with companies that tend to be able to pass on rising costs, we have heard rather relaxed voices in this regard. Many were more concerned about the supply bottlenecks. Access to computer chips in particular is likely to remain difficult for the time being.

Matthias Born, Head of Portfolio Management Equities

USD weakness should support emerging markets

Relative performance MSCI EM versus MSCI World (01/01/2000 = 100) and trade-weighted US Dollar (DXY Index)



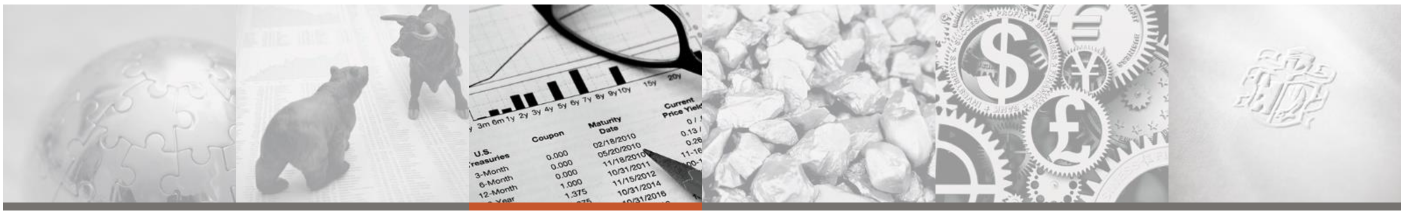
Time period: 01/01/2000-15/06/2021
Source: Bloomberg, own calculations

Forecast summary: upside potential limited

Index forecasts	Currently 15/06/2021	31/12/2021	30/06/2022	∅* in 12 months
S&P 500	4,247	4,250	4,400	4,696
DAX	15,730	15,800	16,300	17,754
Euro Stoxx 50	4,144	4,150	4,300	4,491
MSCI UK	2,016	2,050	2,200	2,217

Index potential (in %)				
S&P 500	-	0.1	3.6	10.6
DAX	-	0.4	3.6	12.9
Euro Stoxx 50	-	0.2	3.8	8.4
MSCI UK	-	1.7	9.1	9.9

* Average, consensus as of 15/06/2021
Source: Bloomberg, FactSet, Berenberg



NAVIGATING OBSTACLES BY MAKING THE RIGHT CHOICES

IN A NUTSHELL

- Safe government bonds continue to move in difficult waters – caution remains advisable.
- EUR corporates: avoid duration risks, current yields at the short end are more attractive.
- In emerging markets, we favour high-yield government bonds and the local currency segment.

Bond markets continue to offer yield opportunities

Falling COVID-19 infection rates and mounting progress in vaccinations coupled with economic traffic lights that are green worldwide and rising inflation – in this environment, the bond markets have already experienced noticeable movements in the course of the year so far. Nevertheless, the months ahead will also bring opportunities and risks, and generating positive returns with bonds is still possible. The right focus with a duration that is not too long is crucial for this.

Government bond yields have only a temporary respite

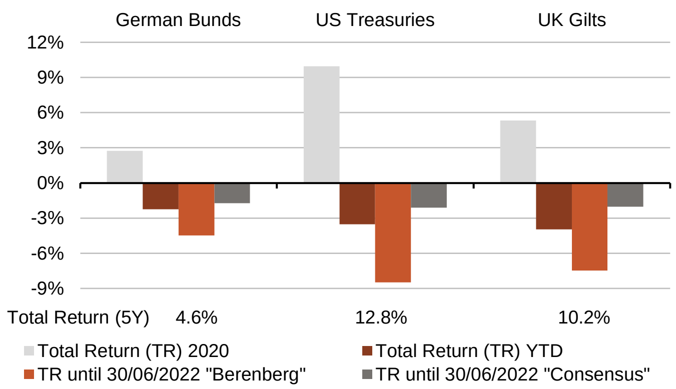
In the second quarter, the yield of 10-year German Bunds rose more slowly than in the first, while in the Anglo-Saxon region the yield of British and US government bonds stabilised or even fell slightly. Similarly, the rise in inflation expectations has recently lost momentum. Nevertheless, it would be wrong to sound the all-clear in the market for safe government bonds, as the economic outlook suggests a difficult environment for this asset class for the rest of the year – which means that yields are likely to rise further. This applies all the more if it should turn out in the course of the summer that the rise in inflation could not only be temporary, but also structural in character, at least in part. And although the ECB will not reduce its demand activities for government bonds in the coming quarter like the Bank of England, but will continue its purchase programme unchanged, we are continuing to advise caution with government bonds with high credit ratings.

Corporate bonds: boringly good

We reiterate our positive view on corporate bonds and expect continued outperformance versus European government bonds in the coming months. This continues to be underpinned by a sustained economic recovery and healthy corporate balance sheets. Even temporary waves of new issues have so far only led to marginal increases in spreads – the hunt for positive returns in the persistent negative interest rate environment is too strong in the medium term. Although limited in extent, there should still be moderate potential for spreads to narrow due to the rise in yields in recent months. However, the historically high valuations remain a bitter pill. Looking at the figure on the left of page 11, it is also clear that the curves for yield premiums in euros are comparatively flat – the additional yield does not currently compensate for the risk associated with longer (spread) duration. Contrary to our expectations, it would take significant declines in yields to achieve significantly better performance with longer-dated corporate bonds. This view is reinforced by the fact that the short-dated segment in particular has recently been supported by positive capital inflows.

There is no all-clear for safe government bonds

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



Time period: 15/06/2016-15/06/2021
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 end of 2021 and mid-year 2022

	15/06/2021	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	1.49	2.50	1.88	2.75	2.02
Eurozone					
Base interest rate	0.00	0.00	0.00	0.00	0.00
10Y Bund yield	-0.23	0.10	-0.02	0.30	0.01
UK					
Base interest rate	0.10	0.10	0.10	0.10	0.15
10Y Gilt yield	0.76	1.50	0.99	1.70	1.10

* Average, consensus as of 15/06/2021
Source: Bloomberg

Accordingly, our belief remains: attractive current interest at the short end. For the next few months, we prefer maturities of less than seven years, the BBB segment as well as subordinated and high-yield bonds.

Emerging markets: high-yield government bonds with potential

In the second quarter, stabilising US government bond yields in particular led to a more relaxed mood among investors in emerging market bonds compared to the first three months of the year. This applied to both hard and local currency securities. Nevertheless, a certain amount of caution is called for. Bonds with better credit ratings in particular show a high sensitivity to US yields and, after their long catch-up phase, have hardly any narrowing potential in terms of risk premiums. But this is precisely what would be needed to counteract further increases in yields. In absolute terms, we still consider the current yield levels for both government and corporate bonds to be attractive, but must clearly distinguish between the individual sub-segments. Compared to its investment grade counterpart, the high yield segment is expected to outperform, although government bonds in particular have not yet been able to regain their spread level from the time before the COVID-19 crisis. Coupled with a much lower sensitivity to US interest rate movements, high-yield government securities promise to outperform those with higher credit ratings over the summer. We also rate local currency securities as worthwhile due to their cyclical nature as well as their low interest rate sensitivity. In many emerging markets, local yields have already risen again, which makes an entry in the coming weeks and months appear significantly more attractive, also from the perspective of current yields.

Conclusion: it all comes down to choice

Rising yields will generally not make it easy for bond investors in the further course of the year, making it all the more important to focus investments on segments that have earnings potential beyond yield movements. Safe government bonds are not one of them: their current interest rate does not provide sufficient compensation for price losses. Corporate bonds should do better, as although they still have only a narrow margin for falling spreads, they generate comparatively attractive returns at the short end without being too sensitive to interest rates. In emerging markets, high-yield government bonds in particular can even benefit from falling risk premiums. Local currency bonds also offer interesting entry opportunities at higher yield levels.

Martin Mayer, Senior Portfolio Manager Multi-Asset
Christian Bettinger, Head of Fixed Income Euro Flexible
Robert Reichle, Head of Fixed Income Global & EM

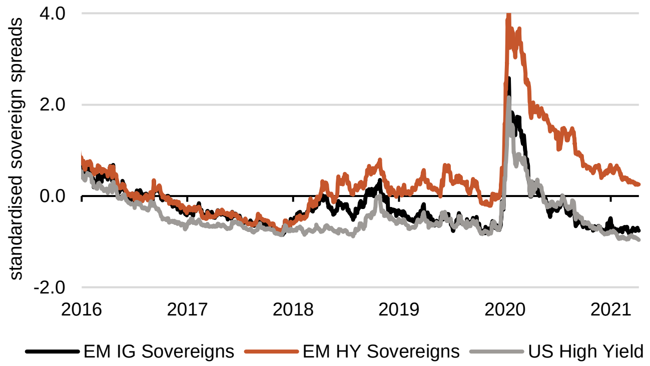
Corporate bonds: duration does not pay off

A duration risk beyond seven years is currently not sufficiently compensated by correspondingly attractive yield premiums

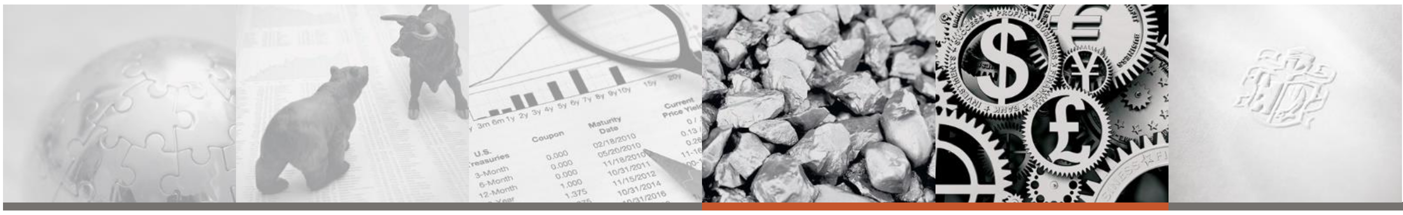
Time period: 15/06/2016–15/06/2021, Source: Bloomberg, ICE, own calculations
Presentation: Option Adjusted Spreads (OAS) versus Libor

Emerging markets: high-yield government bonds are favoured

High-yield government bonds (sub-IG) offer significantly more attractive yield premiums than the investment grade segment (IG) and than US sub-IG securities



Time period: 14/06/2006–14/06/2021, Source: Bloomberg
Presentation: historical Z-score, observation period 15 years



COMMODITIES SHIFT DOWN A GEAR

Supply response to demand recovery determines oil prices

COVID-19 remained the number one price driver for oil in the second quarter. Market participants alternated between concerns about demand in Asia due to rising infections and hopes for demand in the West thanks to the onset of vaccination successes. Overall, oil moved volatilely upwards. In the coming months, the focus is likely to shift more towards supply. The strong catch-up effects of demand and positive seasonality are contrasted by stagnating production on the part of the US shale oil industry. This gives OPEC+ more leeway for its own supply increases without endangering the oil price. At the same time, the latter, together with the return of Iran, should also limit the potential, with the risks still outweighing the opportunities for the time being. Upward surprises in the oil price cannot be ruled out.

Catch-up effects of gold demand meet rising interest rates

Despite positive investor sentiment and the associated continued rotation into cyclical assets, gold was still able to make gains in the second quarter – there are many reasons for this; on the one hand, the precious metal experienced tailwinds from falling real interest rates, a weaker US dollar and rising inflation. This, coupled with the crossing of the 200-day line and the crash of major cryptocurrencies, caused investors to again strongly increase their gold holdings. On the other hand, the increased demand from central banks and the jewellery industry also supported the gold price. While demand catch-up effects should continue to limit downside risks in the coming months, upside potential also remains limited. Rising interest rates, ergo opportunity costs, are likely to weigh on gold. In combination with rising inflation, this suggests a (volatile) sideways movement in the coming months.

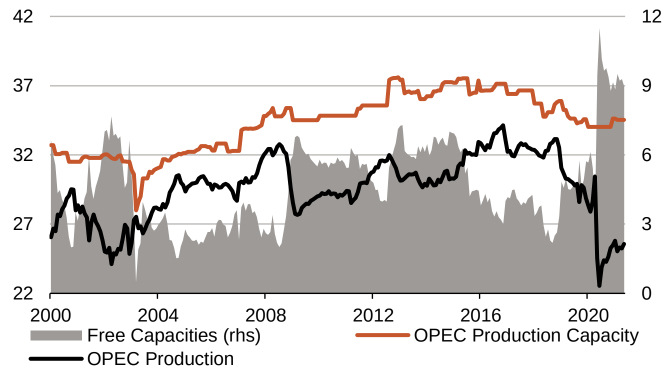
Industrial metals slow themselves down

Prices for industrial metals continued their upward trend in Q2 thanks to high demand from manufacturing. Many metals climbed to multi-year or even new all-time highs; however, this strong and very rapid price increase is now making itself felt in manufacturing. And if higher commodity costs are passed on to consumers, this is likely to slow down the long-term upward trend we expect in the short term. Meanwhile, China's ability to control metal prices is likely to have diminished, as the commodity markets have become less dependent on the Middle Kingdom with the return of the West's hunger for raw materials. The downward potential from this side therefore remains limited.

Ludwig Kemper, Analyst Multi-Asset Strategy & Research

High spare capacity gives OPEC room to manoeuvre

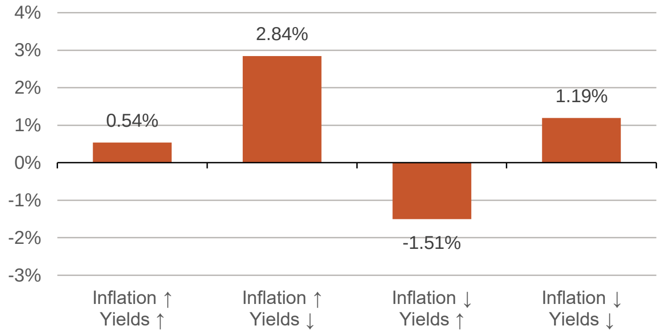
Current OPEC oil production versus actual capacity in millions of barrels per day



Time period: 01/01/2000–31/05/2021
Source: Bloomberg, own calculations

Current yield and inflation environment curbs gold's potential

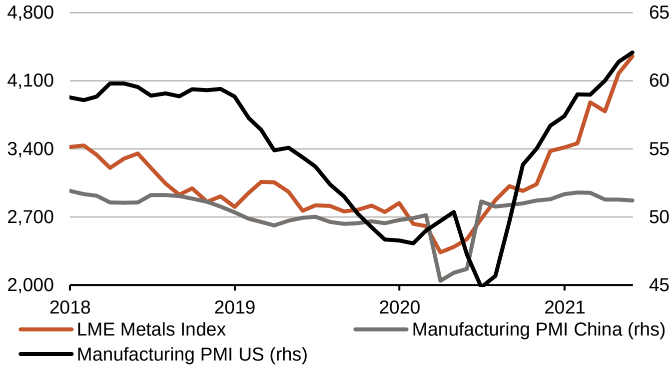
Average rolling 3-month gold price development depending on the change in US CPI yoy and 10Y US Treasury yields



Time period: 01/01/1980–31/05/2021
Source: Bloomberg, own calculations

Western manufacturing drives metal prices (and not China)

Development of the LME index against the manufacturing purchasing managers' indices (rolling three-month average) of China and the US



Time period: 01/01/2018–31/05/2021
Source: Bloomberg, ISM, China Federation of Logistics and Purchasing

POSITIVE ENVIRONMENT FOR THE EURO

Positive economic outlook boosts the euro

The first quarter of 2020 had a few surprises in store. Above all, the impressive vaccination progress in the US and the UK provided a boost for the US dollar and the British pound, because, at the same time, the countries of the Eurozone were only making very slow progress with vaccinations. In the second quarter, the situation on the foreign exchange market returned to normal. Although the two countries continue to lead in vaccination rates, overall declining infection figures are creating a positive mood everywhere. The focus is no longer so much on the vaccination lead of the US and the UK; instead, the focus is on the economic outlook, which is now also very positive for Europe and promises a strong economic recovery.

EUR/USD: between debt, interest and inflation

The economic situation is complex, especially on the other side of the Atlantic. On the positive side: improved political sentiment after the first successes of the new President Joe Biden, rapid job growth in the labour market, the very positive economic outlook and the interest rate advantage over the Eurozone. But good economic prospects come at a price. Reviving the economy costs money, money that Americans themselves do not have: the US budget deficit will be around 15% in 2020 and 2021. The Fed has to pursue an aggressively expansionary monetary policy to keep government borrowing costs low, while the expansionary spending policy is driving up inflation rates (May: +5 % versus the same month last year). This contrasts with a less dynamic economic recovery in the Eurozone, which, however, appears more sustainable: the Eurozone will come through the crisis in 2020 and 2021 with deficits of "only" around 7% each and the inflation rate is currently not even half as high as in the US. Financial markets currently seem to have more confidence in the European model again. The euro exchange rate rose again to well over USD1.20 per euro, but was unable to clear the hurdle of USD1.23 for the time being. For the second half of the year, we still see some upside potential and see the euro at USD1.25 per euro by the end of the year.

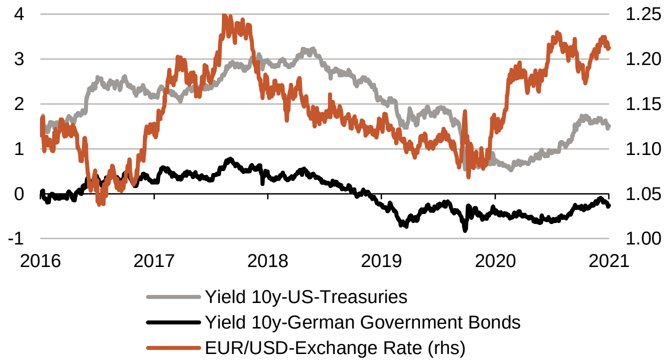
Pound cannot continue the first quarter's highs

The pound has settled at GBP0.86 per euro and is likely to continue to fluctuate at that level. The Bank of England remains one to watch. It could tighten its monetary policy faster than the ECB. This could bring upside potential for the pound.

Dr Jörn Quitzau, Senior Economist

EUR/USD: green light for euro economy – the euro benefits

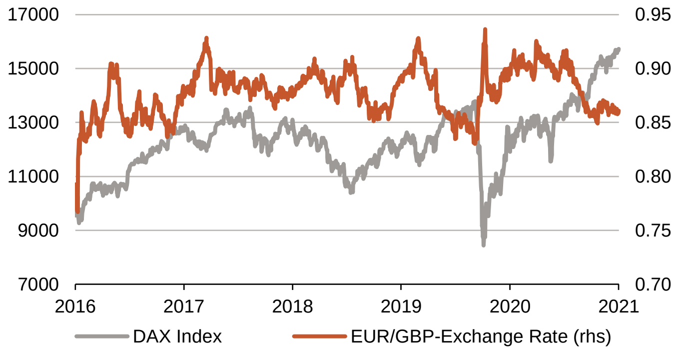
The euro is overcoming the lethargy of the pandemic and benefiting from the fact that US economic policy poses long-term risks



Time period: 15/06/2016–15/06/2021
Exchange rate in US dollars; federal bond and US government bond in %. Source: Macrobond

EUR/GBP: pound swings into sideways movement

After the brilliant first quarter, the pound cannot make further gains. The euro benefits from positive economic and stock market prospects



Time period: 15/06/2016–15/06/2021
Exchange rate in GBP, DAX Index in points. Source: Macrobond

Exchange rate forecasts

Euro sees slight upward potential against the US dollar

	15/06/2021	31/12/2021		30/06/2022	
Exchange rate forecast	Currently		∅*		∅*
EUR/USD	1.21	1.25	1.22	1.28	1.24
EUR/GBP	0.86	0.85	0.85	0.85	0.85
EUR/CHF	1.09	1.10	1.12	1.10	1.13
EUR/JPY	133	133	133	135	134
Change against the euro in %					
USD	-	-3.0	-0.6	-5.3	-2.2
GBP	-	1.3	1.3	1.3	1.3
CHF	-	-1.0	-2.7	-1.0	-3.6
JPY	-	0.4	0.4	-1.1	-0.4

* Average, consensus as of 15/06/2021
Source: Bloomberg

INTERVIEW WITH TOBIAS SCHÄFER

Mr Schäfer, you are responsible for fund selection in Asset Management at Berenberg. What does your position entail?

In addition to fund and ETF selection for the entire Asset Management, my area of responsibility includes the management of the Berenberg fund strategies. This requires regular exchanges in order to know the up-to-date list of our fund investments and to find out which topics are of concern to market participants. Of course, I am always on the lookout for new fund concepts that add value to our portfolios. To do this, I use personal contacts and draw on a network of over 350 product suppliers. In addition, it is important to continuously scrutinise and further develop the existing processes; currently, for example, the integration of sustainability requirements into the fund and ETF selection is a major project.

What exactly does your day-to-day work look like? And how is the COVID-19 pandemic affecting you?

In my day-to-day work, I meet with potentially interesting managers while preparing for and following up on appointments. Prior to the COVID-19 pandemic, I was attending over 300 meetings a year, either on site or at conferences, but now the exchanges take place exclusively online. On the one hand, this increases efficiency, as it is easy to talk to managers all over the world, even from home. On the other hand, with virtual meetings, you lose the interpersonal perception, making it particularly difficult to map digitally the entire selection process for new managers.

When should funds be preferred to individual securities?

From our vantage point, there are four situations. Firstly, funds give us access to other attractive markets in which we do not have our own expertise. Secondly, fund investments allow us to invest in a diversified way even with a small investment volume, instead of, for example, exclusively using bonds, which are often only placed in a denomination of EUR100,000 per bond. Thirdly, fund investments can significantly reduce the administrative burden for investors. Transactions within the funds do not result in any entries on the client account. Last but not least, tax deferral benefits can be used, as the profits generated are only taxable when the fund is sold.

How do you go about selecting funds and what special features arise when selecting active fund managers? Do you have the expertise to stay up to date with all of the topics?

Our search always starts with an investment idea – for example, Chinese equities. We start by searching databases for funds that best reflect this idea. We analyse various key figures over various time horizons with the aim of finding a small number of particularly promising funds. After this look into the past, we talk to the most promising managers to take a look into the future. We always conduct these interviews together with at least one of our portfolio managers who has the relevant asset class expertise in order to go into greater detail. Alongside the personal impression, it is important for us to find out whether what the manager says is consistent with our analysis results. We need to understand the drivers of investment success and the extent to which they can be replicated in the future.

When should you rely on ETFs and when on active funds?

Active funds offer significant added value in inefficient markets, which are also often covered by only a few analysts. This is where managers can best exploit the advantages of experience, market access and their own research. Examples of this include small-cap investments and Chinese equities.

ETFs are suitable for quota management, as trading over an exchange offers a high degree of flexibility for adjustments. In addition, ETFs are a good choice for tactical ideas: while many active managers focus on high-quality companies, sudden increases in the index are often driven by broad optimism, which particularly benefits companies of lesser quality that usually only play a stronger role in ETFs. Moreover, ETFs make sense especially in large, very efficient markets such as US large caps, where hardly any manager is able to deliver added value over the long term.

What else should be taken into account with ETFs apart from the costs?

Instead of looking only at the total expense ratio, TER for short, it is worth looking at the composition of the index and how it can be tracked. In relation to the S&P500, there are performance differences between ETFs of 0.30% per year depending on the type of tracking, meaning that the cheapest ETF does not always perform best. In addition, attention must be paid to how well an index is being tracked, the volume of the products and the trading costs. Finally, there are also optimisation opportunities in trading, such as considering trading periods for cost-effective settlement. Especially in the case of ETFs, it becomes apparent that despite the simple structure at first glance, the devil is in the details.

How do you take ESG criteria into account when selecting funds?

In contrast to a classic ESG rating, we not only assess the securities contained in the portfolio with the help of a systematic approach, but also examine the product provider's focus on sustainability, examine the entire investment process and check the quality of sustainability reporting. In addition to making a positive environmental and social contribution, we also aim to identify and eliminate ESG risks at the investment level at an early stage.

How has the fund landscape changed over the last few years? Which trends are likely to continue in the future?

As strategies have become increasingly comparable, the environment has become much more competitive. Funds are distributed among a few very good managers, whereby investors do not tolerate persistent underperformance – in line with the principle: "the winner takes it all". The ongoing consolidation of ETF providers leads to economies of scale, which further increase the cost pressure for active and also passive products. The trend towards ETFs is also continuing. However, this leaves its mark on the behaviour of the market as a whole and on individual securities. Passive investments are one of the drivers of the continuously changing market structure.

On the other hand, there is a new interest in sustainable investments. However, the approaches here are very heterogeneous, making it difficult to compare them at present. However, it is to be expected that uniform standards will be defined in the future to simplify this. Looking ahead, it can be assumed that, due to the negative return on liquidity, very conservative solutions with equity exposure will be a first step in the capital market for many investors.

To what extent do you use in-house funds?

In our selection process, we consider both external and internal fund solutions as potential investments and assess them according to the same criteria. Therefore, Berenberg funds must be competitive in order to be used in our multi-asset strategies. Fortunately, most Berenberg funds do exceptionally well in a competitive comparison. If in-house funds are used, we benefit not only from the internal exchange of information but also from low costs. For almost all Berenberg funds, special tranches without management fees are issued for use in asset management. Every competitor must first offset this cost advantage with better performance.

BRIEF BIOGRAPHY

Tobias Schäfer is responsible for fund and ETF selection as well as fund-based asset management strategies in Wealth and Asset Management at Berenberg. Before joining Berenberg in July 2018, he worked as a portfolio manager in institutional multi-asset portfolio management at Union Investment and has experience in the financial sector since 2012. He has a Master of Finance from the Frankfurt School of Finance & Management.

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IMPORTANT NOTICES

Date: 17 June 2021

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