HORIZON

The Berenberg Capital Market Outlook · Wealth and Asset Management

CHANGE OF FOCUS

Once the inflation hump is over, markets are likely to focus on growth. Growth is likely to weaken before improving later in the year. Earnings growth expectations are too high.

BETTER, NOT EASIER

Cheaper valuations, higher interest rates and risk premia, widespread pessimism, low risk positioning and high cash balances promise a better year for investors. Risks are nevertheless high and renewed setbacks likely.

VARIETY OF CHANCES

We see opportunities particularly in commodities, corporate and emerging market bonds as well as equities from Europe and individual emerging markets. A broad, balanced positioning to take advantage of all diversification benefits seems to make more sense than ever.

Q1 | 2023

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FOREWORD

Prof Dr Bernd Meyer
Chief Investment Strategist

Dear reader,
The fourth quarter brought a more conciliatory end to one of the worst years in history for multi-asset investors, with the most aggressive monetary tightening in more than 40 years hitting equity, bond and real estate valuations alike. Commodities offered the only bright spot, not least because of Putin's war and the simmering energy crisis. The recovery went as hoped: US inflation in October surprised lower for the first time, whereupon market expectations of further interest rate hikes fell and the Fed signaled that interest rate steps would probably be smaller from now on. Equities and bonds recovered in parallel – the bottoming we had expected probably took place.

The starting point for 2023 is much better than in 2022, with cheaper valuations, higher interest rates, ongoing widespread pessimism, low risk positions of many investors and high cash balances. Certainly, the global economy will continue to weaken before things start to pick up again. But the threat of recession and a collapse in profits has been talked about for a long time – so surprises should be limited. If inflation falls, interest rate hikes expire, financing conditions stabilise and an economic collapse (hard landing) fails to materialise, as we expect, the lows should be behind us and markets should continue to calm down. Risks to this scenario include systemic credit events ("credit shock"), a severe recession, new geopolitical conflicts or more stubborn inflation that causes central banks to bring the economy to its knees.

Unlike in recent years, we see opportunities in all asset classes. Bonds offer respectable yields again, risk premia have widened, equities are no longer overvalued, especially in Europe and emerging markets, and the super-cycle in industrial metals seems intact. Investors' focus should therefore shift from equities, including tactical quota management, to a broad positioning to exploit the return and diversification opportunities of all asset classes, especially since we do not expect government bonds and equities to quickly find their way back to the negative correlation of the last two decades on a sustained basis. It is not only in this respect that we are witnessing a realignment that challenges many patterns and strategies of the last one to two decades.

COVID-19 restrictions in China, the expectation that a mild recession for the US economy will not come until spring, more stubborn inflation in Europe and too-high earnings expectations all suggest that the way up will not be without renewed setbacks – especially in the first half of the year. We have a balanced position following the recent rally, neutral on equities with a focus on Europe and emerging markets, overweight gold, industrial metals, corporate and emerging market bonds and underweight cash and government bonds.

In the Insights interview starting on p14, Ulrich Urbahn, Head of Multi Asset Strategy & Research, discusses how his team comes up with investment ideas, how his work is changing and what the future might bring. I wish you all the best for 2023!

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2023: BETTER, BUT NOT EASIER

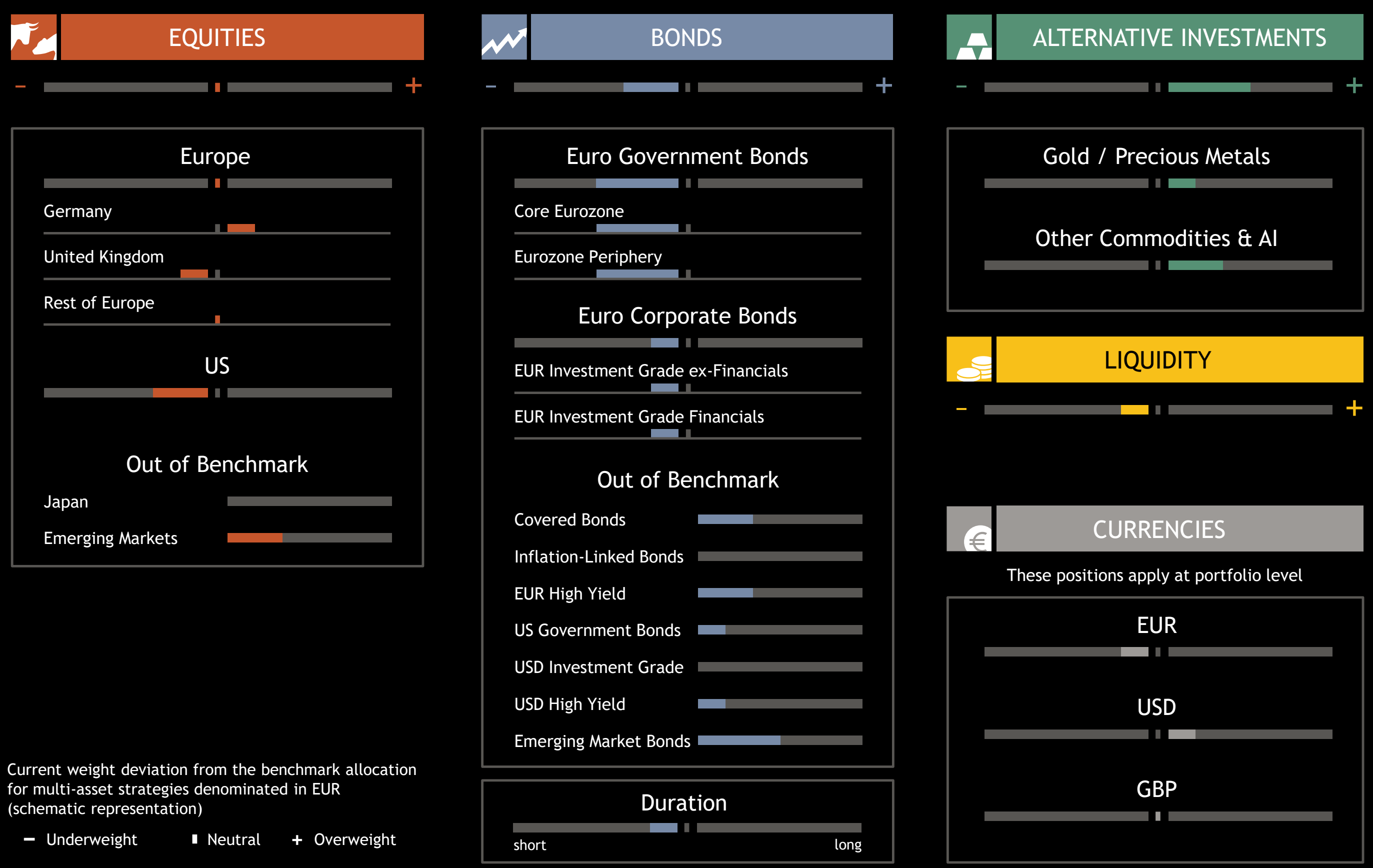
IN A NUTSHELL

- In 2023, growth is likely to move into the focus of the markets. Risks lurk here and growth is likely to weaken further initially. In the event of disappointments, there could be a temporary counter-run in government bonds and equities.
- Investor sentiment and positioning remain pessimistic. This offers potential for a further limited recovery in equities. However, a significant valuation expansion is unlikely and expectations for corporate earnings still seem clearly too high.
- Bonds and commodities offer attractive alternatives, so that too strong a focus on equities does not seem appropriate.

Portfolio positioning at a glance

We were slightly optimistic for the fourth quarter and had closed our moderate underweight in equities after the sell-off in September. However, we did not chase the strong performance in the fourth quarter. On the contrary, we made several small sales to ensure that the equity risk did not become too great due to the positive performance. We reduced our weighting in the US in particular.

In bonds, we increased our overweight outside of safe government bonds in the fourth quarter, at the expense of the cash position and also gold. In addition, we have reduced gold somewhat in favour of industrial metals, but remain significantly overweight. We have also reduced our US dollar exposure. The US dollar has probably passed its high point. A moderate weakening of the US dollar in 2023 would benefit the emerging markets in particular. In terms of equities, we prefer Europe and the emerging markets to the US and have already increased our weighting in small and mid-caps in view of an economic recovery later in 2023. We continue to favour gold and other commodities, especially industrial metals, over government bonds. We are overweight in corporate and emerging market bonds.



Review - bottoming out in the second half of 2022

The fourth quarter brought what the markets had been waiting for for a long time: lower-than-expected inflation in the US. This fuelled hopes that the inflation peak there had already been passed and that the central banks would no longer have to put the brakes on so hard. The US Fed fuelled this hope by discussing a reduced pace of further interest rate steps. With regard to China, the mood alternated between hopes of an opening and new fears of a slowdown. Global equity markets recovered significantly from the lows at the end of September/beginning of October – especially European equities. From mid-October, with somewhat weaker economic data, bond yields also fell from their highs. The environment of positive correlation between equities and bonds thus remained intact. The overvalued US dollar weakened significantly. The upward trend here seems to have been broken. Gold traded almost unchanged in euro terms in the fourth quarter and oil fell, while industrial metals increased significantly.

Economic outlook - change of focus from inflation to growth

Overcoming the inflation summit, an end to interest rate hikes and likely even interest rate cuts in the US in the second half of 2023, a significant recovery of the eurozone economy from recession from spring onwards, only a mild recession in the US, the easing of COVID-19 restrictions in China and possibly also an easing of the situation in Ukraine in the course of the year – the economic environment forecast by our economists does not seem so bad for the financial markets in 2023.

However, the economy is likely to weaken initially before things improve again, and the focus of the markets is likely to switch from inflation to growth. Equities and government bonds could thus temporarily move in opposite directions again and a diversification effect could return. Nevertheless, risks lurk in the growth of the economy as well as in the expected earnings for 2023. We consider profit expectations too optimistic – with increasing pressure on margins, profits are unlikely to rise. And the risks remain manifold, from new geopolitical conflicts to credit events in the face of higher financing costs and weaker growth, to inflation that is too stubborn and/or a much harder landing for the economy after all. Moreover, even after the end of the interest rate hikes, there is still the threat of burdens from the withdrawal of liquidity through quantitative tightening in the US and the eurozone. 2023 is thus likely to be a better year on the financial markets, but not an easy one, and also a very path-dependent one. For example, the answer to the question "Which comes first, the Fed pivot or China's complete opening up from COVID-19 restrictions?" could make a significant difference to markets. But even if the acute problems are overcome, an environment comparable to that of the past decades is by no means to be expected thereafter. There were already increasing signs of this in 2022.

Turn of the times and reorganisation - many things are different in the medium term

Disinflation and deflation fears gave way to high inflation, to levels not seen for more than 40 years. The primary goal of central banks

Equities recovery in Q4, especially in Europe; US dollar in retreat; commodities remain the year's winners, bonds the losers

Total return	YTD and in Q4 2022 (in %, EUR): YTD (31/12/21-13/12/22)	YTD and in Q4 2022 (in %, EUR): Q4 22 (30/09/22-13/12/22)	12-month periods of the last 5 years (in %, in EUR): 13/12/21 13/12/22	13/12/20 13/12/21	13/12/19 13/12/20	13/12/18 13/12/19	13/12/17 13/12/18	CAGR* 13/12/17 13/12/22	Std. dev.* 13/12/17 13/12/22
Brent	42.9	-7.2	48.4	76.1	-37.8	17.9	9.1	15.9	40.3
USDEUR	7.0	-7.8	6.1	7.3	-8.2	2.1	4.1	2.2	7.2
Gold	5.9	0.5	7.6	4.2	14.4	21.4	3.0	9.9	12.8
Stoxx Europe 50	2.3	14.4	5.2	23.8	-6.1	21.5	-7.7	6.5	16.9
Euro Overnight Deposit	-0.3	0.0	-0.4	-0.6	-0.5	-0.4	-0.4	-0.4	0.1
S&P 500	-8.1	3.8	-6.9	38.7	8.0	24.6	5.1	12.8	21.7
EM Sovereigns	-8.7	1.0	-9.5	6.8	-3.1	16.0	-0.8	1.5	8.4
DAX	-8.7	19.7	-7.2	19.1	-1.3	21.6	-16.8	2.0	20.9
US Sovereigns	-8.9	5.3	-9.3	-2.0	7.8	8.9	-0.7	0.7	4.5
EUR Sovereigns	-9.2	1.5	-10.0	-1.0	2.0	3.8	-0.5	-1.3	3.1
EUR Corporates	-12.0	3.8	-12.6	-0.6	2.8	6.7	-2.0	-1.4	3.4
MSCI EM	-13.7	1.9	-14.1	7.2	8.5	15.6	-6.5	1.5	17.2

Time period: 13/12/2017-13/12/2022.
Source: Bloomberg * CAGR = annualised return (in %, in EUR); Std. dev. = Annualised standard deviation (in %, in EUR).

is no longer to support the economy and financial markets but to fight inflation, even if this brings dangers for the economy and markets. The example of the UK has shown that financial markets are critical of massive increases in government debt. The unipolar, US-focused world order is changing with deglobalisation, Russia's war of aggression on Ukraine and the decision of the G7 and the EU to freeze the currency reserves of the Russian central bank into a multipolar world order in which many countries do not want to be closely tied to only one major partner. The development of new supply chains, the infrastructure for mobility and energy supply, and the energy turnaround require strong investments and necessitate a race for scarce raw materials. This distinguishes the current situation from comparable situations in the past, where excesses in the real economy had to be compensated for in a recession. In contrast, we recently experienced an exogenous shock and we have to invest to leave the shock behind. This offers opportunities. However, deglobalisation, the energy transition and the persistent supply bottlenecks in raw materials and labour (demographics) in the medium term are likely to ensure that inflation picks up again quickly with a recovery in growth, which should then again quickly call the central banks into action. The results are shorter, stronger and more erratic inflation and economic cycles and thus increased planning uncertainty. This weighs on valuations, as investors justifiably demand a higher risk premium. Investors should therefore not hope for a rapid, sustained expansion in equity valuations. Even if we see recovery potential for equities in 2023, given low investor positioning and widespread pessimism, the potential remains limited.

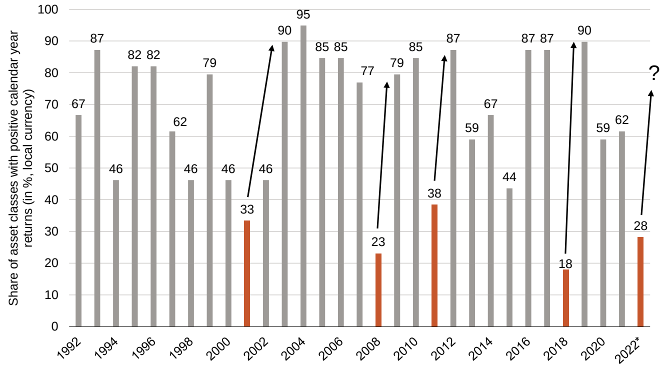
Alternatives in bonds, commodities and emerging markets

For the first time in 14 years, the yields of high-quality corporate bonds clearly exceed the dividend yields of equities (lower figure). Many bond segments, such as subordinated bonds, already offer such a high current yield that they are expected to deliver a positive return in 2023 even if interest rates/spreads rise slightly. Moreover, unlike many government bonds, yields on corporate and emerging market bonds should more than compensate for higher inflation on average in the medium term. Commodities, especially industrial metals, remain clear beneficiaries of the changed environment, and emerging markets such as India, Indonesia and Latin America should also benefit.

Prof Dr Bernd Meyer, Chief Investment Strategist

After bad years for multi-asset portfolios, good ones often follow!

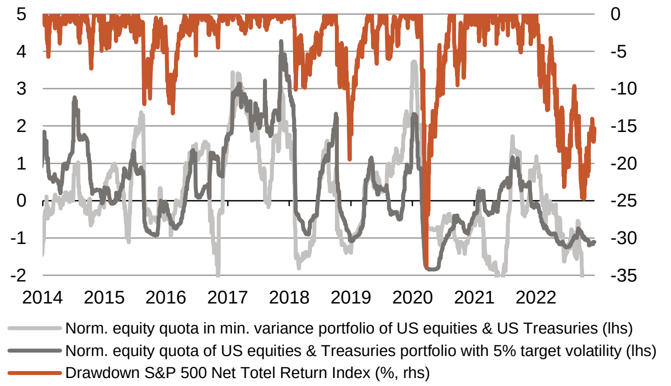
Only a small share of all asset classes (segments, regions...) generated a positive return in 2022. Historically, this usually changed in the following year.



Time period: 01/01/1992–30/11/2022.
Source: Bloomberg.

Still potential through low equity position of systematic Strategies

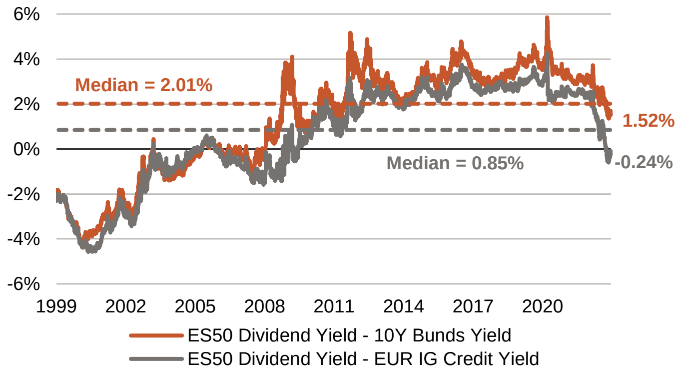
As realised volatility declines, systematic investment strategies (e.g. with target volatility or risk parity) are likely to increase their risk position again.



Time period: 01/01/2014-13/12/2022.
Source: Bloomberg, own calculations.

Bye-bye "TINA" - There are alternatives to equities again

Bonds, especially corporate bonds, are more attractive compared to equities than they have been since the financial market crisis 14 years ago.



Time period: 01/01/1999-13/12/2022.
Source: Bloomberg, own calculations.

FIRST SIGNS OF A CHANGE FOR THE BETTER

IN A NUTSHELL

- Putin's war: Higher energy and food prices hit consumers and businesses.
- Mild recession in the US, harsh winter in Europe.
- But the outlook has brightened somewhat: Europe's gas storage facilities are full, inflationary pressures have peaked in the US and are about to do so in Europe.
- Central banks are stepping on the brakes - but the end of the interest rate cycle is in sight.

The situation is dire …

As 2022 draws to a close, the situation remains difficult. The US economy is losing momentum, Europe is apparently already in recession and China is not getting a grip on its internal problems. Many emerging markets are suffering from higher interest rates, an overvalued US dollar and weakening global trade. Since many central banks tightened their interest rate policies once again in December and the radical monetary policy turnaround of 2022 is only likely to take full effect in the course of next year, the global economy is likely to stutter even more than before in the coming months.

… but the outlook has brightened somewhat

Bad news about the global economy is unlikely to surprise any investor. Instead, the chances are increasing that the setback could be somewhat less severe than it had appeared to be three months ago. There are two main reasons for this:

Firstly, Europe has managed to fill its gas storage almost to the brim at the start of the heating season, even though Russia has closed the most important pipelines. The risk that gas will have to be forcibly rationed this winter has diminished. As Europe is better equipped for the winter than expected, market prices for gas and electricity have also eased since late summer.

Secondly, inflation in the US has apparently peaked. This reduces the risk that the US Federal Reserve will raise its key interest rate to well over 5% next year. The end of the interest rate cycle has not quite been reached yet, but it is clearly closer.

Europe: Recession until spring 2023

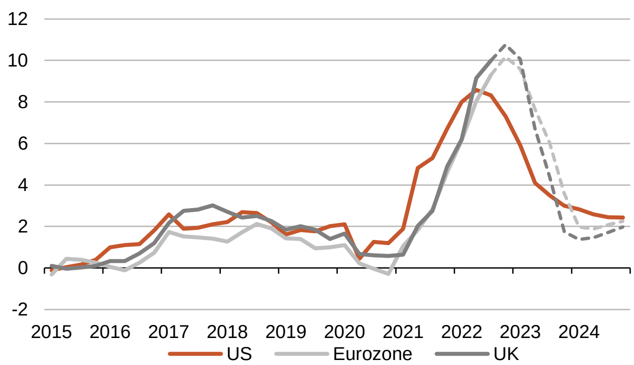
The skyrocketing prices for energy and food have hit the European economy hard. After consumers treated themselves to a good holiday season in the summer after two years of COVID-19, the region appears to have slipped into recession in the fourth quarter, as expected. Given the high cost of energy, consumers are likely to cut back significantly on their spending on other goods and services this winter. In recession, private investment and foreign trade in goods are also likely to decline. However, given the continued high demand for labour, unemployment will rise only slightly.

New upswing in summer 2023

Once the winter is over and the gas market has eased a little further, the euro economy could pick up again in the summer of 2023. From then on, the rise in incomes could also be above the inflation rate again, so that consumers have a little more money in their pockets in real terms. As soon as the presumably mild US recession comes to an end in autumn 2023, exports could also pick up again.

The big inflation hump

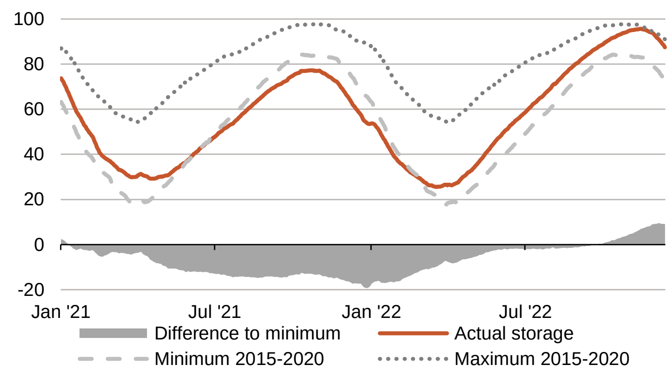
Increase in consumer prices, year-on-year comparison, in %.



01/01/2015-31/12/2024. Dashed: Berenberg forecast. USA: CPI-U, Eurozone: HICP, UK: CPI.
Sources: BLS, Eurostat, ONS, Berenberg.

EU gas storage

Level in %; difference to the minimum in percentage points.



01/01/2021-12/12/2022. EU-27.
Sources: AGSI, Berenberg.

After a decline in economic output of around 0.3% in 2023, we expect growth of 2.0% in 2024. Overall, we expect a roughly V-shaped recovery, as is usual after external shocks. For the UK, we expect a similar course as for the euro area.

Transatlantic Difference

Unlike Europe, the US is suffering primarily from home-grown inflation. With its late but all the more forceful turnaround on interest rates, the Fed is likely to dampen demand in such a way that the US economy stagnates in early 2023 and the US then falls into a mild recession by autumn 2023 – with declining consumption and less investment, especially in residential construction. For China, there are signs that the country will slowly relax its rigid zero-covid policy. At the latest, when the seasonal contagion risks decrease again in spring 2023, its economy could stabilise again.

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

The highest inflation in 40 years

In the US, price pressure has apparently already passed its peak. While wage increases remain high for the time being, somewhat lower prices for petrol and used cars are providing relief for consumers. There are also signs of a turnaround in some services. As the labour market gradually loses momentum, wage pressures may also slowly ease. Unlike in the US, however, many consumers in Europe will have to brace themselves once again for higher electricity and gas prices in January, even if governments will cushion the shock to some extent.

In the coming year, inflation rates on both sides of the Atlantic could decline noticeably. Then the rise in energy prices in 2022 will gradually drop out of the year-on-year comparison. The winter recession in Europe and the emerging dampener for the US economy can contribute significantly over time to largely solving the current supply chain problems. Transport costs are also likely to fall further. This will help to both dampen inflation and reinvigorate buoyancy.

Central banks shift course - interest rate peak in sight

To prevent high inflation from becoming entrenched, the Fed and – somewhat more hesitantly – also the ECB are stepping on the interest rate brakes. In the US, the key interest rate could reach 5.25% at the beginning of 2023. As soon as the Fed sees enough signs that the recession has sufficiently dampened inflationary pressures, it will then lower rates again somewhat, probably starting in H2 2023. However, the Fed will not hold this in prospect for the time being. The ECB could raise its main refinancing rate to 3.5% by March 2023, followed by a recession-related pause for the rest of 2023 and a reduction to 3% by mid-2024.

Dr Holger Schmieding, Chief Economist

Growth and inflation forecasts

	GDP Growth (in %)						Inflation (in %)					
	2022		2023		2024		2022		2023		2024	
		∅**		∅**		∅**		∅**		∅**		∅**
USA	1.9	1.8	-0.1	0.4	1.2	1.4	8.0	8.1	4.1	4.3	2.6	2.6
Eurozone	3.3	3.2	-0.3	-0.1	1.8	1.4	8.4	8.5	6.7	6.0	2.0	2.2
Germany	1.7	1.7	-0.7	-0.6	1.8	1.3	8.8	8.7	7.3	6.5	2.1	2.6
France	2.5	2.5	0.0	0.2	1.8	1.1	5.9	6.0	5.2	5.1	1.9	2.2
Italy	3.7	3.7	-0.6	-0.1	1.3	1.0	8.7	8.6	7.7	6.4	2.0	2.0
Spain	4.5	4.5	0.1	1.0	2.0	1.9	8.4	8.6	2.8	4.5	2.0	2.3
UK	4.3	4.3	-1.1	-1.0	1.8	0.9	9.1	9.1	5.6	7.1	1.6	2.5
Japan	1.2	1.4	1.5	1.3	1.2	1.0	2.5	2.4	2.4	1.8	1.2	1.0
China	2.9	3.0	4.1	4.9	4.1	5.0	2.0	2.1	2.5	2.3	2.3	2.2
World*	2.9	-	1.3	-	2.4	-	-	-	-	-	-	-

* 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 15/12/2022.

VOLATILE, LIMITED UPWARD MOVEMENT

IN A NUTSHELL

- Earnings expectations are likely to be further reduced in line with worsening economic data.
- Valuations have recently risen again, especially for US equities. There is unlikely to be a significant valuation expansion in 2023. Europe and Asia are relatively more attractive.
- Major sell-offs are also likely in 2023. However, the market is likely to focus on 2024 at the end of 2023 and thus there is limited upside potential.

European equities clearly ahead in the fourth quarter

A mild winter so far, robust economic data, and hopes for a significant decline in inflation and accompanying less restrictive central bank policies have boosted equities. European equities in particular benefitted from the recovery rally, boosted by an encouraging Q3 reporting season, short covering and relatively cheap valuations. US equities also gained, but significantly less, weighed down also by US dollar weakness in Q4. Emerging Asian equities were among the underperformers with +3.5% in Q4, too.

Probably no earnings growth in 2023

Since the beginning of the year, 2023 earnings growth estimates for developed markets have been cut by a moderate 4ppt. The consensus now assumes a 4% growth rate for corporate earnings in 2023. Given the threat of recessions in many regions in 2023, we still think the consensus estimates are too optimistic, especially as corporate profit margins are likely to fall next year, for example due to higher salary and refinancing costs as well as increased planning uncertainty (currency volatility, China, Russia, etc.). Realistic earnings estimates are likely to be at least 5% lower, in our view. If a more severe and prolonged recession does occur, which our economists do not expect, earnings estimates are likely to fall by well over 10%. The Q4 reporting season, which is about to get underway, should give an indication of where we are headed, even if the lingering effects of the central banks' pronounced tightening policy will probably only be visible in later quarters.

Recession priced out again

In Q3 2022, the market had already priced in a mild recession, at least in many areas. For Europe, the valuation discount was even higher. Valuations have shot up again, especially in the US, following increasing hopes of a timely Fed turnaround and a soft landing. For example, the S&P 500 is currently trading at a forward P/E of 18.3, higher than the average of the last 35 years, despite the massive rise in real interest rates this year and the increased relative attractiveness of bonds. A key reason is likely to be the relatively large share of non-fundamental investors in US equities. Major demanders, besides companies via share buyback programmes, are the US pension market, which primarily invests in equities via index products, irrespective of valuation levels.

Major setbacks also likely in 2023

Even if the upside potential is likely to be limited next year, European and Asian equities in particular are likely to perform well in

Equities recovered significantly across the board in Q4, with European stocks in particular up

Total return	YTD and in Q4 22 (in %, EUR): YTD (31/12/21-13/12/22)	Q4 22 (30/09/22-13/12/22)	12-month periods of the last 5 years (in %, EUR): 13/12/21 13/12/22	13/12/20 13/12/21	13/12/19 13/12/20	13/12/18 13/12/19	13/12/17 13/12/18	P/B* 13/12/22	Div.* 13/12/22	P/E* 13/12/22
MSCI UK	5.3	11.6	9.2	24.0	-17.7	19.5	-6.3	1.7	4.0	9.8
Stoxx Europe Defensives	3.3	11.8	6.5	19.3	-6.1	16.7	1.9			
Stoxx Europe 50	2.3	14.4	5.2	23.8	-6.1	21.5	-7.7	2.3	3.3	12.4
Euro Stoxx 50	-4.9	20.4	-2.3	22.3	-4.6	23.3	-10.8	1.8	3.5	11.9
S&P 500	-8.1	3.8	-6.9	38.7	8.0	24.6	5.1	3.9	1.6	18.3
MSCI USA Small Caps	-8.2	3.2	-6.0	27.5	7.6	19.7	-0.6	1.9	1.5	18.3
DAX	-8.7	19.7	-7.2	19.1	-1.3	21.6	-16.8	1.5	3.5	11.5
MSCI Japan	-9.2	6.3	-10.3	12.3	2.3	17.6	-5.4	1.2	2.6	12.6
Stoxx Europe Cyclicals	-10.1	18.3	-6.8	25.7	-2.7	22.9	-13.9			
MSCI EM Asia	-14.3	3.5	-15.2	5.4	16.9	16.3	-8.0	1.6	2.6	12.8
Stoxx Europe Small 200	-20.9	16.4	-18.0	24.5	0.5	24.6	-9.1	1.4	3.2	15.5
MSCI EM Eastern Europe	-81.1	26.6	-80.5	20.7	-16.2	28.4	5.6	1.0	4.7	5.5

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

2023, as both regions have already priced in significantly more negatives than the US. The margin of safety is correspondingly higher. In addition, both regions are likely to benefit from the lagging effects of the USD strength, while US exporters are more likely to suffer. And as far as the economy is concerned, our economists have recently become more optimistic and now expect a somewhat less deep recession in the eurozone. Nevertheless, equity markets are also likely to experience stronger setbacks again in the course of 2023, not least due to negative earnings revisions and quantitative easing by central banks. This is especially true if systematic strategies continue to add to equities into 2023 due to the recent drop in volatility and better price momentum. This will then make markets more vulnerable again. However, with the market already looking ahead to what is likely to be a much better economic 2024 by the end of 2023, equity markets should recover from their setbacks. We expect a volatile, limited upward movement for equities in 2023. The US presidential cycle also argues for upward potential in 2023. The third year after the US elections is usually by far the strongest equity market year.

Ulrich Urbahn, Head Multi Asset Strategy & Research

WHAT IS ON COMPANIES' MINDS?

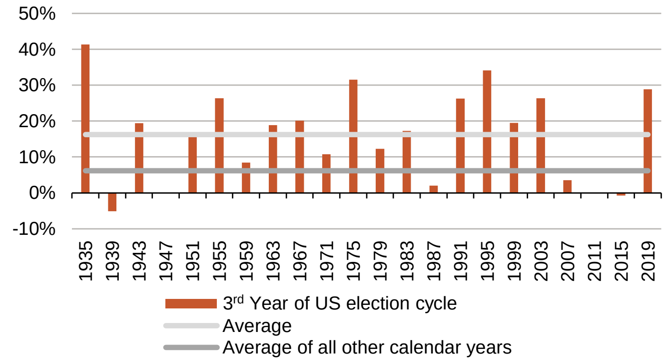
Looking towards 2023

A difficult equity year is coming to an end. In our many year-end discussions, among others at Berenberg's very well-attended Penny Hill conference, we looked to the future. For instance, we heard from the important for us semiconductor industry, which had recently seen a weak phase driven mainly by lower demand for PCs and smartphones, that a recovery is to be expected for mid-2023. This is also driven by continued robust demand from the automotive industry, which is suffering from a persistent semiconductor shortage. Apart from that, however, we heard from a wide range of economic sectors that supply bottlenecks should continue to ease, which is then likely to be reflected in a weakening of many inflation drivers - such as freight rates. This, however, will also be accompanied by the liquidation of existing inventories. Something that is causing headaches especially in the industrial sector. In the consumer goods industry, manufacturers of everyday goods expect a prolonged period of weakness and a trend towards "white label" products. Demand for luxury goods, on the other hand, is unbroken and is expected to benefit from the end of China's zero-covid strategy in the coming year.

Matthias Born, CIO Equities

Equities usually strong in third year of US Election Cylces

S&P 500 development depending on US elections. Year 3 represents the third year after the US elections, which take place in November every four years.



Time period: 31/12/1932-31/12/2020.
Source: Bloomberg, Berenberg.

Forecast summary: Equities with limited upside potential in 2023

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

	Currently			∅*
Index forecasts	**15/12/2022**	**30/06/2023**	**31/12/2023**	**in 12 months**
S&P500	3,896	4,150	4,300	4,519
Dax	13,986	15,000	15,700	17,557
EuroStoxx 50	3,836	4,100	4,250	4,645
MSCI UK	2,136	2,250	2,350	2,519
Index potential (in %)				
S&P500	-	6.5	10.4	16.0
Dax	-	7.2	12.3	25.5
EuroStoxx 50	-	6.9	10.8	21.1
MSCI UK	-	5.3	10.0	17.9

* Average, consensus as of 15/12/2022.
Source: Bloomberg, FactSet, Berenberg.

INTEREST IS BACK

IN A NUTSHELL

- For safe government bonds, we expect a clear regional differentiation – clear advantages for the US.
- European corporate bonds: We increase our overweight and build up the subordinated segment.
- Emerging market bonds: Local currency securities and selected sovereigns in the high-yield segment are our favourites.

Shadow is followed by light

For all segments of the bond market, 2022 proved to be an annus horribilis – stubborn inflation, yield rises, increased volatility and, against the backdrop of the approaching recession, rising risk premiums brought investors noticeable losses. Looking forward, however, this development leads to a clearly positive message: interest rates are back and money can be made with bonds again. Where exactly we see the most attractive opportunities, we show below.

Government bonds: Differentiation can pay off

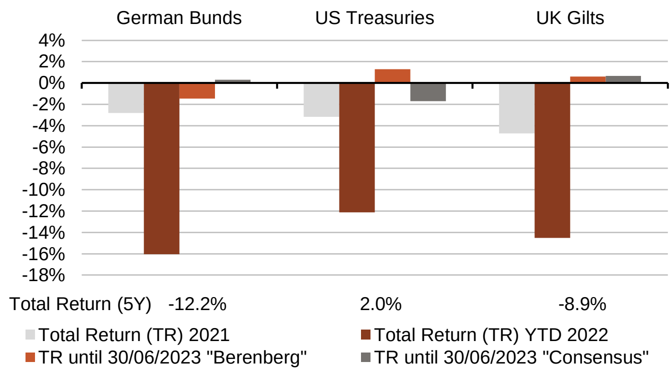
After double-digit losses in safe ten-year government bonds on both sides of the Atlantic in 2022, we expect a regionally heterogeneous development in the coming months. A key reason for this is that inflation is likely to have already peaked in the US, while in Europe the peak is still to come. As a result, monetary policy dynamics will differ between the currency areas. While the Fed is likely to raise its key interest rate to 5.25% already in the first half, only to cut it again in the second half of the year, we expect the ECB to take two steps of 50 basis points each by mid-year without subsequently lowering its main refinancing rate again. For the 10-year government bond segment, this means falling yields again in the US by the end of 2023, but the opposite for German bunds. Together with the higher current interest rate, this results in a clear attractiveness advantage for US government securities. Euro investors should, however, take into account the possible change in the exchange rate or hedging costs in their comparative calculation in this regard – we expect the US dollar to depreciate somewhat in 2023.

European corporate bonds with prospects for a positive year

At 3.6%, European corporate bonds in the investment grade segment are finally offering an adequate yield again, as we last saw at this level in 2012. Even in the event of moderate short-term increases in yields, it should be possible to achieve an absolutely positive development over the course of the year. Despite two and a half years of the COVID-19 pandemic, high energy prices and inflation-related cost pressures, corporate balance sheets appear tidy and robust. Accordingly, there are currently only a few defaults and rating downgrades. Until a few weeks ago, however, we had decided against a pronounced overweight. Both a jerky new start on the new issue markets and a persistently negative trend in capital flows held potential for setbacks. Both factors have brightened noticeably over the past few weeks: new transactions are attracting greater investor interest, and even supposedly riskier companies are finding their way back to the markets. In terms of fund flows

Safe government bonds: US clearly in the lead

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



Time period: 15/12/2017-15/12/2022.
Source: Bloomberg, own calculations, iBoxx government bond indices (7-10 years, TR).

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

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

	15/12/2022	30/06/2023		31/12/2023	
	Currently		∅*		∅*
USA					
Base interest rate	4.25-4.50	5.00-5.25	5.10	4.75-5.00	4.70
10Y US yield	3.45	3.50	3.88	3.60	3.50
Eurozone					
Base interest rate	2.50	3.50	3.10	3.50	3.05
10Y Bund yield	2.08	2.40	2.19	2.70	1.90
UK					
Base interest rate	3.50	3.75	4.10	3.25	4.00
10Y Gilt yield	3.24	3.40	3.39	3.40	3.18

* Average, consensus as of 15/12/2022.
Source: Bloomberg.

(see chart below left), a sustained stabilisation can be seen for both the investment grade and high-yield sectors. Accordingly, we are more constructive on corporate bonds and have recently increased our overweight. We continue to favour financial bonds and have confidence in subordinated positions in good quality banks and insurance companies.

Emerging market bonds: local currencies still preferred

The rally in emerging market bonds in the fourth quarter was driven by the hard currency segment in government securities, which had also previously seen the sharpest price declines. Despite this move, as well as a renewed decline in US yields and risk premiums, it was not enough for an absolutely positive performance in 2022. The degree of risk aversion is still elevated and unevenly distributed – both at the country level and between government and corporate bonds in hard currency or government securities in local currency. The latter, which we have favoured in the past, has been able to outperform its hard currency counterpart over the year. For the beginning of the new year, we expect the active positioning in the currency component to become somewhat less important due to already strongly increased local yields. When the key interest rate hike cycles come to an end in many emerging markets and inflation expectations have peaked, the current yield will become even more important in the medium term. In this respect, we are sticking to a successive increase in the duration of local currency bonds. From a market perspective, we are encouraged by the now low investor positioning. We believe most of the capital outflows caused by the market turmoil in 2022 are behind us. Risk premiums are also still at attractive levels despite the recent recovery. An entry into countries in the high-yield segment in particular, with little sensitivity to US yields and only small amounts of debt outstanding over the next one to two years, appears worthwhile. Finally, despite seasonally higher activity in the first quarter, overall issuance should remain manageable, providing additional support for the asset class.

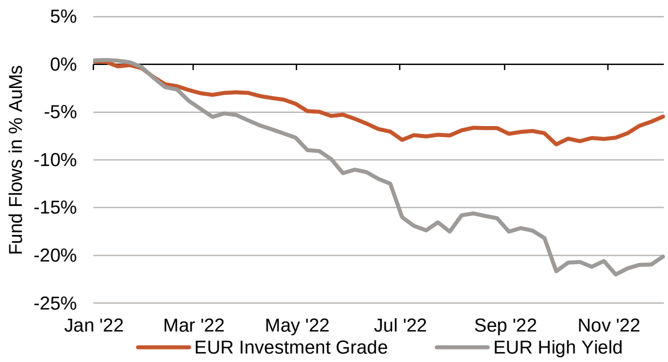
Conclusion: The return of the interest rate creates opportunities

We take a regionally differentiated view of government bonds with high credit ratings and see clear advantages for US over German bunds in the respective local currencies. Corporate bonds have become attractive again at now higher yield levels in both the investment grade and high-yield segments, and we particularly like the financial sector and subordinated issues of first-class borrowers. Finally, in emerging markets, we again prefer the local currency segment and find entry into selected high-yield countries interesting.

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

Euro corporate bonds: Capital outflows from funds stopped

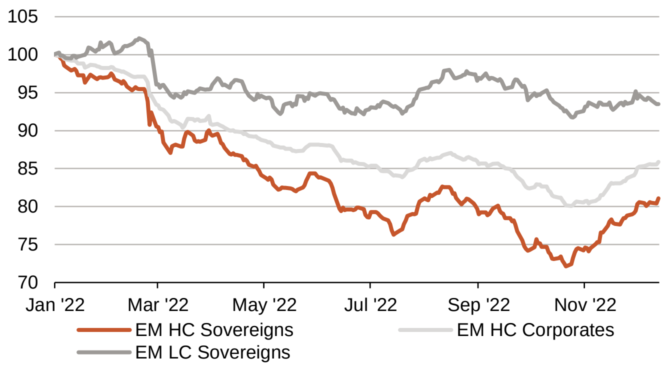
Flows in the investment grade (IG) and high yield (HY) segments have stabilised since the summer and the beginning of the fourth quarter respectively.



Time period: 31/12/2021–07/12/2022.
Source: Bloomberg, AuM = Assets under Management, HY = High Yield.

Emerging markets: local currency securities still preferred

Also for 2023, we expect a stronger development for the local currency (LW) segment compared to its hard currency (HW) counterpart.



Time period: 31/12/2021-13/12/2022, indexed to 100 as of 31/12/2021.
Source: Bloomberg, EM = Emerging Markets.

PRICES BACK TO THE BEGINNING, SUPER CYCLE REINFORCED

Oil demand weak in the short term, supply ultimately even weaker

Crude oil experienced a difficult fourth quarter. With recession worries in the West and rising COVID-19 cases in China, fears of weak demand dominated. As a result, oil is now trading roughly where it was at the beginning of the year. However, with a mild recession and a move away from the zero-covid policy in China, a drop in demand would only be temporary. The supply problems, on the other hand, seem structural. Oil producers in both the US and the Middle East are reluctant to invest, and with the EU oil embargo, some Russian supply is likely to be lost in the long run. In addition, supply support from the release of strategic US reserves will cease at the turn of the year. If these are replenished, this will even mean additional demand. We expect a tight oil market and rising prices.

Positive outlook for gold, but declining relative attractiveness

Gold managed to break the downward trend of the summer in Q4. The decisive factor for the new strength was the weakness of the US dollar. Meanwhile, stagnating real interest rates finally offered less headwind. As a result, gold is also trading more or less where it was at the beginning of the year. The downward potential should remain limited in the coming months. This is because investors have sold more than half of the gold holdings built up in the course of the COVID-19 crisis. The trend towards the de-dollarisation of central bank reserves, on the other hand, has accelerated significantly since Putin's war. Nevertheless, the attractiveness of gold has declined. Firstly, it remains a plaything of the Fed and thus positively correlated to equities and bonds. Secondly, other safe havens such as US or German government bonds are increasingly offering attractive current yields.

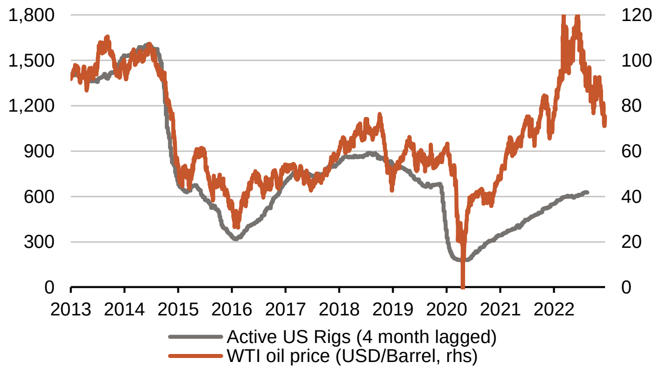
Long-term upward trend in industrial metals accelerates

Industrial metals performed well in Q4 despite the gloomy economic outlook in the West. Support came from China due to measures to support the real estate sector as well as demand from the grid expansion and e-mobility sectors. The very low inventory levels signal that the metals markets are already tightly supplied. In addition, continued high energy prices, a large part of production costs, should limit the downside potential. Once the recession is behind us, industrial metals should make strong gains. Not least because demand is likely to have accelerated due to the energy transition in the wake of the Russia-Ukraine war.

Ludwig Kemper, Analyst Multi-Asset Strategy & Research

US producers refuse to invest despite high oil prices

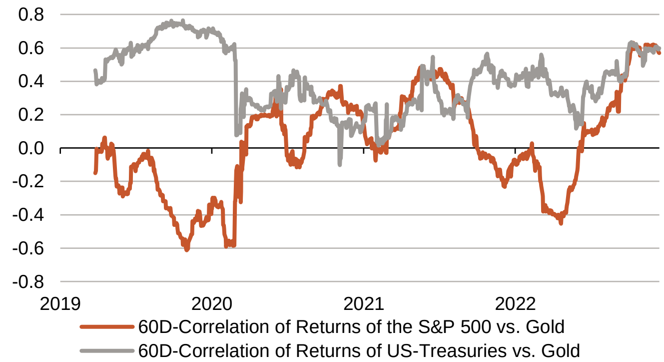
Drilling activity in the US shale oil industry typically follows the oil price. Since the oil price collapse in 2020, producers have held back on investments.



Time period: 01/01/2013–13/12/2022.
Source: Bloomberg, own calculations.

Diversification effect of gold currently limited

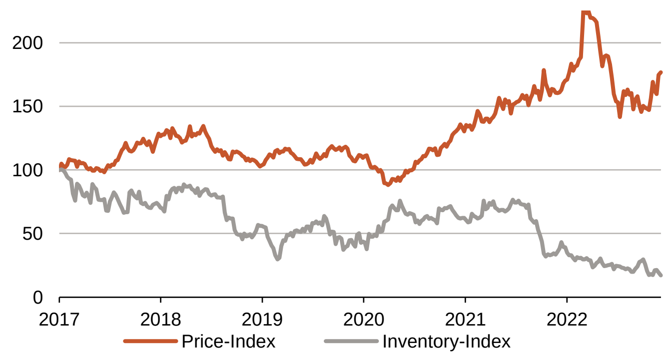
Normally, gold exhibits low correlation to equities and thus has a diversifying effect. Currently it is highly correlated to both equities and bonds.



Time period: 01/01/2019–13/12/2022.
Source: Bloomberg, own calculations.

Tight supply limits downside risks of industrial metals

Equal weighted price and stock index of copper, nickel, aluminium and zinc indexed to 100 on 01/01/2017.



Time period: 01/01/2017–13/12/2022.
Source: Bloomberg, own calculations.

EURO: ARDUOUS PATH TO THE TOP

Trend reversal for the euro?

A difficult year for the euro is coming to an end. The common currency started the year at a reasonable level of 1.13 US dollars per euro. But over the course of the year, it went down slightly. The euro fell below parity and, at the lowest, fell below the mark of 0.96 US dollars per euro. The main reasons for the euro's weakness – and, conversely, for the dollar's strength – are quickly listed: 1) the war in Ukraine, which stifled the economic upswing and led to a veritable energy crisis, including accelerated inflation; 2) the ECB's hesitant stance which it maintained for a long time, taking much longer than the other major central banks to change its monetary policy; and 3) while the US dollar benefitted from the crisis as a safe haven for investments, Europe lost the "peace dividend" of the last decades and with it the attractiveness for investors.

In the fourth quarter, the euro was able to stabilise and rise above parity again. This was largely due to the fact that the mood on the capital market brightened and put some pressure on the US dollar. The improved mood and the higher euro exchange rate were helped by the fact that the recession in the eurozone is likely to be less severe than had been feared in the meantime. The outlook for the coming year depends largely on how Europe comes through the winter. If our baseline scenario materialises, the eurozone will experience a mild recession in the winter quarters. From spring onwards, however, growth should return. The euro should gradually benefit from this. In addition, if things go smoothly through the first winter of the energy crisis, the energy crisis should lose some of its terror before the winter of 2023/24. The market players will then already be crisis-tested and will likely no longer be so frightened. We therefore see a price potential of up to about 1.15 US dollars per euro by the end of 2023.

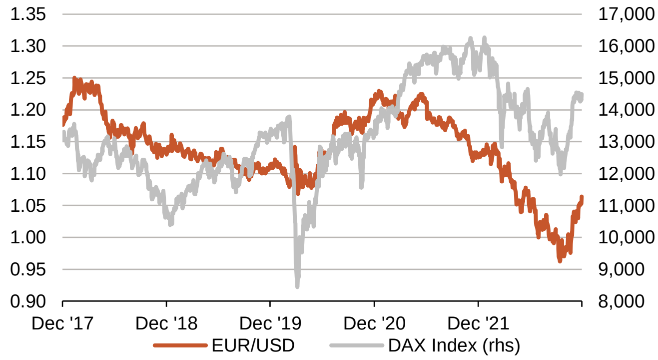
British pound leaves turbulent phase behind it

The government capers have not left the British pound unscathed. The "Trussonomics" with debt-financed tax cuts had led to panic on the bond market and a devaluation of the pound. There were a number of resignations (including that of Prime Minister Liz Truss) and, in addition to the personnel reshuffle, a political U-turn. The new finance minister is focusing on a higher degree of fiscal solidity. The pound is now reorienting itself and will probably fluctuate around the mark of 0.85 pounds per euro in 2023.

Dr Jörn Quitzau, Senior Economist

EUR/USD: Euro benefits from improved market sentiment

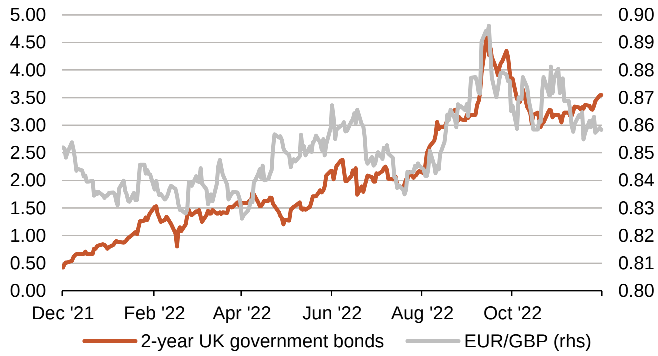
The war has put pressure on the euro and strengthened the US dollar as a "safe haven". With better stock market sentiment, EUR/USD also rises.



Time period: 13/12/2017-13/12/2022.
Exchange rate in US dollars, DAX index in points. Source: Macrobond.

EUR/GBP: Volatile sideways movement

The government's debt plans moved the bond and foreign exchange markets. Calm is now returning with the economic policy realignment.



Time period: 13/12/2021-13/12/2022.
Government bonds in %; exchange rate in GBP. Source: Macrobond.

Exchange rate forecasts

Euro: Upward potential in the coming year.

	15/12/2022	30/06/2023		31/12/2023	
Exchange rate forecast	Currently		∅*		∅*
EUR/USD	1,06	1,10	1,04	1,15	1,07
EUR/GBP	0,87	0,85	0,88	0,85	0,89
EUR/CHF	0,99	1,00	0,99	1,02	1,01
EUR/JPY	146	143	141	144	141
Change against the euro in %					
USD	-	-3,4	2,2	-7,6	-0,7
GBP	-	2,7	-0,8	2,7	-1,9
CHF	-	-1,3	-0,3	-3,3	-2,3
JPY	-	2,4	3,9	1,7	3,9

* Average, consensus as of 15/12/2022.
Source: Bloomberg.

INTERVIEW WITH ULRICH URBAHN

Mr Urbahn, as Head of Multi Asset Strategy & Research, you and your team are responsible, among other things, for generating investment ideas for the multi-asset strategies. How do you come up with investment ideas?

Probably the most helpful experience is that of having witnessed several economic cycles and crises on the financial markets in the course of my professional life. Even if the past does not repeat itself, it often rhymes, so historical comparisons are helpful in decision-making. To this end, we use our own models and think in scenarios, but also read a lot of external research or discuss with capital market strategists from the big financial houses as well as independent providers. This helps us to understand what the consensus thinks and what, if anything, is already priced in. Over the last few years, I have also started listening to financial podcasts, especially from the US, because that is where the big money is managed. It is therefore important to know how US investors assess the capital markets. In addition, specialists for different financial markets are interviewed, so you can constantly broaden your knowledge. You never stop learning.

Can you give us an example?

In early 2022, I noticed that hedge funds were betting heavily on a falling Brazilian real. There was a record short position – despite the fact that commodity prices were already rising and that the Brazilian central bank had raised interest rates much earlier and more than the major central banks, given the already high inflation in Brazil. At the time, Latin America/Brazil hardly featured (positively) in broker research reports and podcasts. Consequently, the consensus was not optimistic about Brazil. To verify this, I phoned ETF traders to see if they were seeing inflows in the area. In response, I was almost laughed at. Hardly anyone was interested in the topic. And brokers warned me that it was too early to invest in Latin America. But Latin American shares were extremely cheaply valued – the risk premium correspondingly high. Moreover, Latin America had just started to outperform in an environment of falling US equity prices – which is rather unusual and an indication that investors were not overly positioned there. Consequently, we assessed the risk-return profile as attractive, discussed the idea in the Investment Committee and decided to invest broadly in the Asset Allocation Committee – also in light of the fact that Latin American equities have little correlation with our in-house "Quality Growth" equity style and thus help to smooth the volatility of the multi-asset portfolios.

What other ideas are there and how are they implemented?

Above all, we try to create added value in the sub-allocation, ie which regions/sectors/segments represent a sensible addition to the existing multi-asset strategy. For example, within Alternatives, this could be industrial metals. If we find an idea attractive not only tactically but also in the longer term, we often publish a Focus article on it. This has the advantage that we deal with a topic even more intensively and thus penetrate it better. It also helps our clients to better understand our motives.

Our tasks also include reducing or substituting tactical positions after hopefully positive developments. In November, for example, we partially switched an S&P 500 ETF into a currency-hedged S&P 500 ETF after the EUR/USD had fallen significantly below parity and we saw upward potential for the EUR in the medium term. When generating ideas, we look not only at fundamentals but also at sentiment and positioning data. The ideas are then often implemented using ETFs, but also investment funds.

If we broaden the view, what is your very big picture for the next decade?

In the coming years, in our view, we can expect not only higher inflation on average than in the last decade, but also significant fluctuations in inflation, ie increased volatility in inflation. The reason lies primarily in the longer-term supply bottlenecks for raw materials, the energy turnaround, the increase in climate catastrophes, deglobalisation and the demographic development, which is likely to lead to an increasing shortage of labour.

What are the risks?

In an environment of increased inflation and, in particular, increased inflation volatility, economic cycles are likely to be shorter because central banks will have to act more restrictively than in the last decade in order not to fuel inflation further. As a result, planning certainty is significantly lower for companies and investors, which is why they are more reluctant to invest and demand a higher reward for the risks taken. This weighs on investment valuations and also suggests increased volatility across all asset classes.

A strong focus on real assets also remains appropriate against the backdrop of high government debt levels worldwide, as higher inflation rates are likely to be used by governments through financial repression to ensure debt sustainability. With nominal investments, it is not likely to be easy to achieve clearly positive real returns in such an environment. In equities, investors should focus on the lowest possible valued companies with strong market positions (pricing power) and robust cash flows. Higher inflation volatility in the coming decade thus harbours risks for the capital markets, but also opportunities for flexible investors.

What do you think of cryptocurrencies as a new asset class?

In recent years, the narrative about cryptocurrencies has been that they are uncorrelated to risk assets and represent a protection against inflation. I have always been suspicious of this view because Bitcoin & Co. do not yet have a long history and consequently have not experienced periods of high inflation. Moreover, it has once again proven true that as soon as there are futures and ETFs for asset classes, the correlation automatically increases because these can then simply be sold in a global de-risking – they therefore no longer benefit from the illiquidity that had led to a certain uncorrelatedness. Fortunately, real estate is illiquid, otherwise house prices would also fluctuate much more and make owners correspondingly nervous.

Nevertheless, I have to say that I find the applications of blockchain technology very exciting and am also somewhat invested in cryptocurrencies for my children. For me, it is a kind of call option. You invest some money, but you have to be aware that it can fall towards zero. On the other hand, it has a lot of potential if the optimists' forecasts come true. Ultimately, however, this is more speculation than investment.

Has much changed in your work in recent years?

In terms of content, three fields in particular have come into sharper focus. Central banks have become even more important for the financial markets with their huge purchase programmes, so that even more attention must be paid to them. If liquidity is withdrawn from the market, all investments fight for less liquidity, which puts pressure on valuations. On the other hand, the bond side is fun again, because you can earn yields here again. Since the COVID-19 crisis at the latest and with the energy turnaround, the focus has also increasingly been on raw materials. And this trend is likely to continue over the next decade thanks to the energy transition, so we are also investing a lot of time in research and analysis. Last but not least, the options market has become much more relevant. Options on individual shares have seen extraordinary growth. In 2021, for example, the total volume of options traded exceeded the traded volume of the underlying shares for the first time. Accordingly, options markets are having an increasing impact on equity markets, particularly in terms of volatility and event risks. Against this background, it is important to understand who the major players in the options market are and how options traders are positioned. Moreover, 2022 has just taught that it can make sense to hedge with options because correlations between different asset classes are not stable.

BRIEF BIOGRAPHY

Ulrich Urbahn has been working for Berenberg since October 2017 and is responsible for quantitative analyses and the development of strategic and tactical allocation ideas, and is involved in capital market communications. He is a member of the Asset Allocation Committee and portfolio manager of the Berenberg Variato. After graduating in economics and mathematics from the University of Heidelberg, he worked for more than 10 years at Commerzbank, among others, as a senior cross asset strategist. Mr Urbahn is a CFA charterholder and was part of the three best multi-asset research teams worldwide in the renowned Extel survey for many years.

PUBLISHING INFORMATION

PUBLISHER

Prof Dr Bernd Meyer | Chief Investment Strategist

AUTHORS

Christian Bettinger, CFA | Head of Fixed Income Euro
is responsible for the investment strategy for euro bonds and manages the Berenberg Euro Bonds and Berenberg Credit Opportunities funds

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

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

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

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

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

Robert Reichle, CFA, CQF | Head of Fixed Income Global & EM
is responsible for the investment strategy for emerging markets bonds and global bonds

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

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

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