HORIZON

The Berenberg Capital Market Outlook · Wealth and Asset Management

HIGHER FOR LONGER

The more robust economy and steadier inflation entail the risk of higher central bank interest rates for a longer period of time and thus an ultimately heavier strain on the economy. Therefore, uncertainty about growth and inflation remains unusually high.

LESS ATTRACTIVE

After the good start to the year, equity valuations are higher again, also because earnings expectations have been further reduced, and investor sentiment and positioning are less pessimistic.

TOUGH UNTIL AUTUMN

The recently bumpy phase is likely to continue, as equities are already pricing in an economic recovery. Investor positioning, however, still argues against a sharp downturn. We are more defensively positioned with a higher bond allocation than at the beginning of the year.

Q2 | 2023

BERENBERG
PARTNERSHIP SINCE 1590

FOREWORD

Prof Dr Bernd Meyer
Chief Investment Strategist

Dear reader,
The financial markets initially got off to a flying start to the new year as better-than-expected economic data and falling inflation met pessimistic investors. This boosted bonds and especially equities. European stocks were ahead. In fact, we had expected a better year, with equities recovering into 2023 after bottoming out in the second half of 2022. However, the strength in January also surprised us, as the potential of equities is limited due to a lack of potential for a significant increase in valuations and a lack of earnings growth. Thus, European stock indices were already approaching our year-end targets at the beginning of February, even though our targets were already optimistic compared with competitors. The rally then stalled from February onwards as bond yields rose again. With higher-than-expected growth and inflation, central bank interest rates look set to stay higher for longer, with the risk of a significant economic slowdown in the medium term.

Inflation and the expected central bank policy thus continue to determine financial market developments – equities and bonds are largely moving in tandem. Headline inflation, however, should fall more sharply in the coming months thanks to base effects. It will be interesting later in the year to see how far inflation will ultimately fall – it could remain higher than many think in the medium term. We therefore expect investors to temporarily shift their focus to economic growth. China should provide a tailwind here in the coming months. For the US, the key questions are how severe the downturn will be in the second half of the year and what distortions the debate about raising the debt ceiling will create. Europe is caught in the middle and seems to be scraping close to a recession at the moment. We expect a recovery from spring onwards. Uncertainty about growth and inflation, however, remains above average in view of the many risks, the longer-term higher central bank rates and the continuation of the war in Ukraine.

After the good start to the year, markets could thus experience the classic seasonal pattern of a weaker summer – especially since equity valuations have risen (partly because earnings expectations have been reduced) and sentiment and positioning are less pessimistic. Equity markets are already pricing in a global economic recovery in the second half of the year, while risks to the economy increase with prolonged high central bank interest rates, as the recent problems of individual regional US banks already show. Accordingly, we reduced our equity allocation, which had been neutral or overweight since September, to a slight underweight in favour of bonds towards the end of February. Our focus for equities remains on Europe and the emerging markets. Commodities have become more attractive since the beginning of the year.

In the Insights interview starting on page 14, our portfolio manager Robert Reichle discusses why emerging markets excite him, how his team works and why emerging-market bonds are currently attractive. I hope you enjoy reading this issue of Horizon.

CONTENTS

MORE GROWTH – HIGHER INTEREST RATES

IN A NUTSHELL

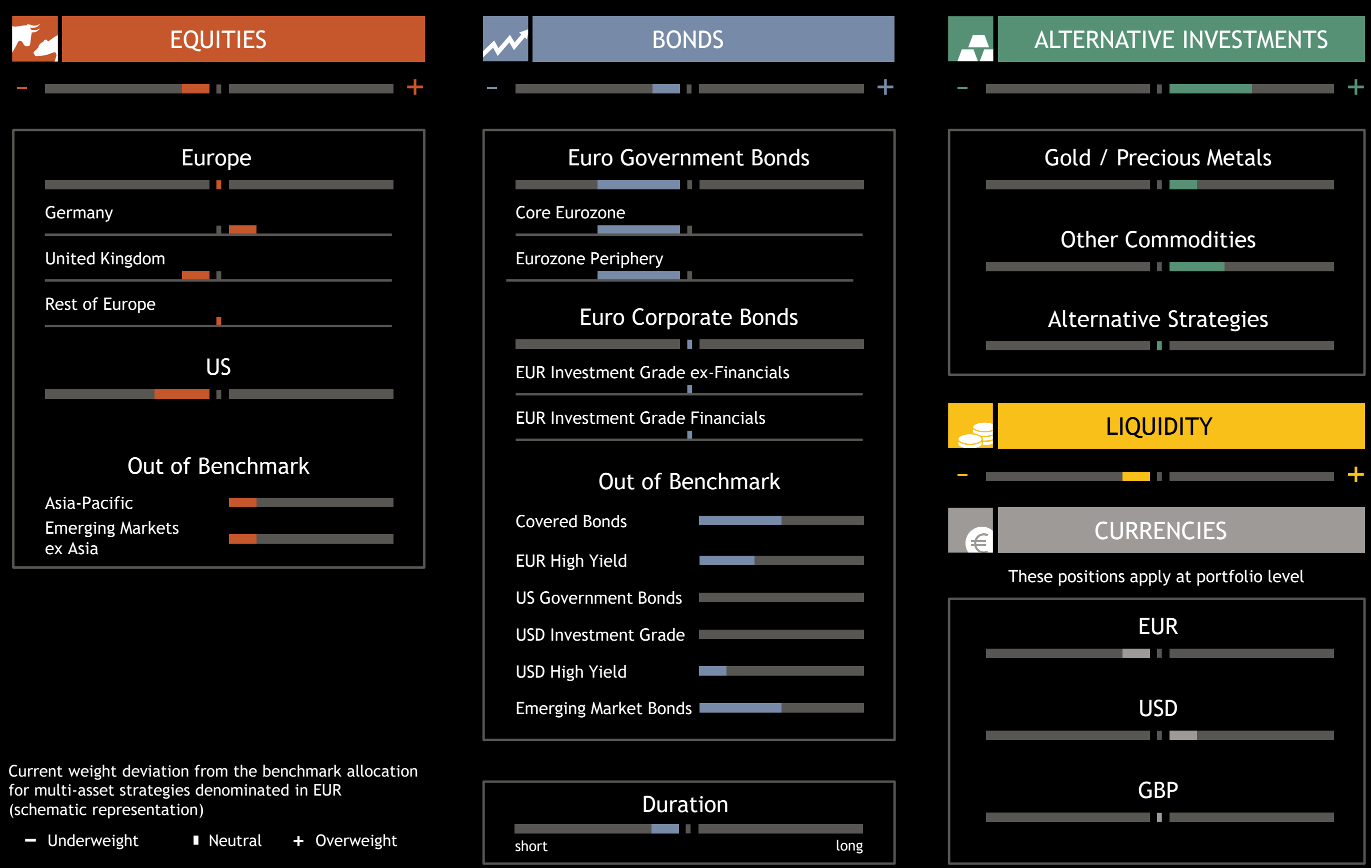
- Uncertainty about growth and inflation remains unusually high. So far, both have proved unexpectedly robust. Higher central bank interest rates loom for longer.
- We expect the European and Chinese economies to recover somewhat in spring, while the extent of the impending downturn in the US is completely unclear.
- Until the picture becomes clearer, the back-and-forth on markets will continue, especially since swings in both directions seem to be limited – on the one hand by fundamental developments, on the other by the largely still low investor positioning.

Portfolio positioning at a glance

Due to our equity focus on Europe and the emerging markets, we benefited from the equity rally at the beginning of the year. However, we did not chase this development, but repeatedly reduced the equity quota in several small steps towards neutral. Later in February, we finally reduced equities to a slight underweight by further reducing comparatively expensive US equities. We continue to favour European and emerging-market equities.

In return, we increased our holdings of short-dated euro bonds in order to take advantage of the renewed strength of the US dollar to further reduce our US dollar exposure. Within bonds, we had positioned the duration only slightly below neutral after the rise in yields in February. The focus remains on corporate bonds and emerging-market bonds.

Our broad positioning has a clear focus on commodities. In particular, we believe that industrial metals and energy commodities have become relatively more attractive since the beginning of the year. For diversification purposes, we have also built up a position in many strategies that benefits from a steepening of the US yield curve after it has inverted significantly.



First quarter review: January too good to be sustainable

It has long been our view that equity markets would bottom out in the second half of 2022 and then recover at the turn of the year, not least given the prevailing strong pessimism. Therefore, despite the multiple risks, we have not been underweight equities since the end of Q3 2022. The strong performance at the beginning of the year was triggered by declining inflation and a more robust economy. With bond yields rising again in February, however, equities also had a harder time and gave up some of their gains. In the end, however, equities led the way in Q1, especially European stocks. Bonds also performed positively, especially emerging-market bonds. Gold rose as well, while industrial metals and especially oil gave back some of last year's gains. The EUR/USD exchange rate remained almost unchanged.

Higher for longer: inflation and monetary policy remain in focus for the markets

Inflation has been falling, but at a slower pace than expected, for example as wage increases offset base effects in energy and industrial metals. The decline in the core inflation rate could thus remain limited for the time being. In February, the euro core inflation rate even rose from 5.3% to 5.6%, while headline inflation fell only slightly from 8.6% to 8.5%. The US core inflation rate for February also surprised to the upside. Inflation, together with central-bank policy, therefore continues to determine capital market developments – equities and bonds are clearly in sync. Thus, the expected 10-year US real yield, ie the yield on 10-year inflation-indexed government bonds (TIPS), and the stock market are moving almost exactly in opposite directions (middle chart on page 5). The equity rally at the beginning of the year was driven by real yields falling by almost 50bp in the wake of burgeoning hopes for a swift end to interest rate hikes by the US Federal Reserve. From early February, however, real yields rebounded to the levels seen at the start of the year as inflation proved more persistent and the economy more robust (top chart on page 5). The shock of the failure of two regional US banks in mid-March caused real yields to plummet briefly. However, this development is not likely to be sustainable as the subsequent implicit guarantee by the US authorities for bank deposits quickly stabilised the situation. Markets should again price in higher inflation and higher central bank interest rates for longer.

This environment is in line with our expectation that inflation will remain a key driver for markets in the coming years. After all, the supply bottlenecks in commodities and labour continue to drive inflation in the medium term and are likely to lead to rising inflation again and again as growth picks up – inflation is not only likely to be structurally higher, but also more volatile. This means that, at best, the inflation trend will temporarily fade into the background and the market focus will shift to growth. We should thus continue to find ourselves primarily in an environment of higher synchronisation between equities and bonds.

Hard, soft or no landing in the US?

A temporary change in market focus remains likely, however, if inflation falls more sharply in the course of spring and summer due to base effects. Then economic growth, and with it the question of

Clearly opposite trends to 2022 in equities, especially in Europe, bonds and oil. Gold again with positive return.

Total return	YTD and in 2022 (in %, EUR): YTD (31/12/22-14/03/23)	YTD and in 2022 (in %, EUR): 2022 (31/12/21-31/12/22)	12-month periods of the last 5 years (in %, in EUR): 14/03/22 14/03/23	14/03/21 14/03/22	14/03/20 14/03/21	14/03/19 14/03/20	14/03/18 14/03/19	CAGR* 14/03/18 14/03/23	Std. dev.* 14/03/18 14/03/23
DAX	9.4	-12.3	9.4	-4.0	57.1	-20.3	-5.3	4.5	20.9
Stoxx Europe 50	5.3	-1.8	11.6	10.7	34.1	-16.7	7.2	8.1	16.9
Gold	4.1	5.9	-0.5	23.4	4.9	20.2	7.0	10.6	12.9
S&P 500	2.2	-13.0	-2.3	16.8	37.2	0.4	14.1	12.4	21.7
US Sovereigns	1.9	-12.9	-6.8	-2.7	-2.9	13.2	3.3	0.6	4.9
EM Sovereigns	0.8	-11.2	-3.4	0.5	1.3	2.3	12.4	2.5	8.4
EUR Sovereigns	0.8	-11.8	-8.8	-3.5	1.7	1.7	1.5	-1.6	3.4
EUR Corporates	0.7	-14.2	-8.6	-5.7	4.4	1.4	1.3	-1.6	3.6
Euro Overnight Deposit	0.4	0.0	0.5	-0.6	-0.5	-0.4	-0.4	-0.3	0.0
USDEUR	-0.3	6.2	1.9	9.3	-7.1	1.8	9.4	2.9	7.2
MSCI EM	-1.2	-15.1	-5.7	-13.0	43.3	-11.1	-3.5	0.2	17.2
Brent	-9.1	50.7	-6.1	88.6	57.3	-39.9	17.8	14.6	40.6

Time period: 14/03/2018-14/03/2023.
Source: Bloomberg * CAGR = annualised return (in %, in EUR); Std. dev. = Annualised standard deviation (in %, in EUR).

whether the US economy will experience a soft landing or perhaps a notable recession, is likely to dominate market activity. The longer the economy proves robust and inflation and central-bank interest rates remain high, the harder the landing could ultimately be. Higher interest rates for longer not only lead to financing problems and loan defaults, but also to risks in the real estate sector. In many regions, eg Australia, New Zealand, Sweden and the UK, property prices are already declining significantly. The political drama surrounding the necessary increase in the US debt ceiling is also likely to cause unrest into the summer. Experts currently estimate that, without raising the debt ceiling, the US government will run out of money in August or September at the latest. It is not unlikely that the political wrangling will weigh on capital markets, at least temporarily, as time passes without an agreement. All of this suggests bumpy markets as the US economy is landing.

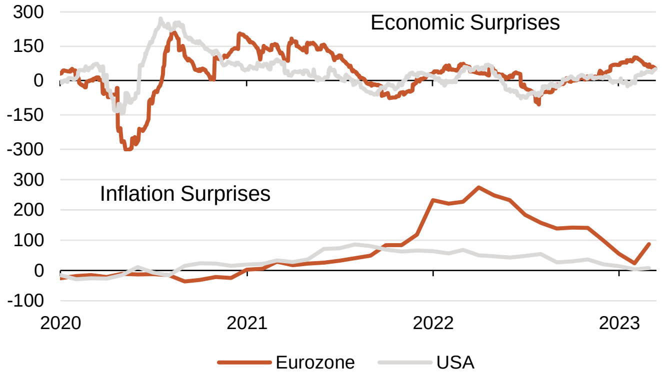
Probably a tough spring and summer for financial markets

Developments since the beginning of the year reinforce our long-term view that the interest rate turnaround is complete, that exceptionally low interest rates are a thing of the past and that will not return quickly. This is because inflation will not only be a temporary phenomenon, but will also be structurally higher and fluctuate more significantly. This weighs on the valuations of all investments. One should not assume that interest rates will fall towards zero again in the medium term and thus boost equity valuations, especially since equities have already priced in an economic recovery (lower chart). In addition, higher financing, wage and material costs are likely to weigh on profit margins and thus limit earnings growth. This means that bonds, which continue to offer notable yields, and commodities are at least as attractive as equities in the medium term – all asset classes thus offer positive return expectations for the coming years, and these are closer together than they have been for a long time, especially when viewed on a risk-adjusted basis. This continues to speak in favour of a broad, balanced positioning for the risk-reducing use of all diversification advantages, especially since the high level of uncertainty about the further development of the economy – now with less extreme investor positioning once again – also speaks against a very focused portfolio. We expect better opportunities to increase risk positions later this year.

Prof Dr Bernd Meyer, Chief Investment Strategist

Higher for longer: Growth and inflation surprise to the upside

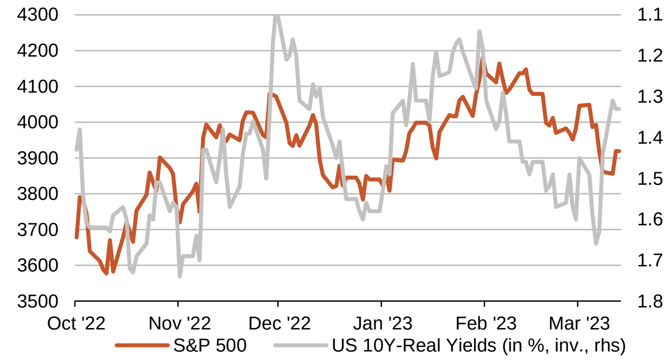
Economic and inflation data in the US as well as in the Eurozone have been higher on average than expected by the consensus in recent months.



Time period: 01/01/2020–14/03/2023.
Source: Bloomberg, Citi.

Inflation and monetary policy continue to drive financial markets

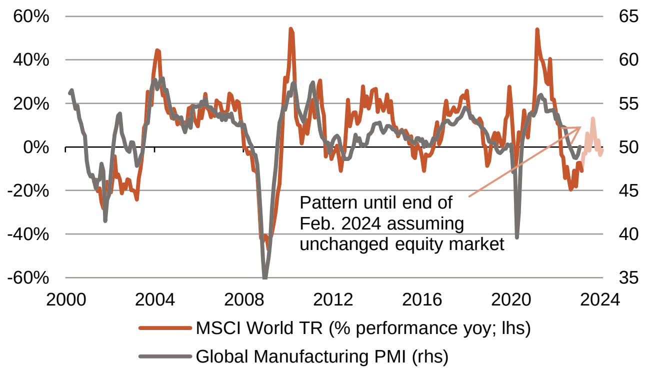
Real yields on 10-year US government bonds continued to determine the direction of equity markets.



Time period: 01/10/2022–14/03/2023.
Source: Bloomberg.

Equity markets are already pricing in an economic recovery

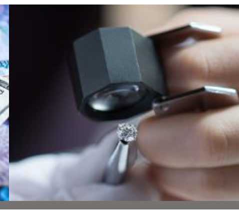
The rally in global equities already anticipates a rise in the global manufacturing Purchasing Managers' Index (PMI) to well above 50 in the second half of the year.



Time period: 01/01/2000–28/02/2024; As of 14/03/2023.
Source: Bloomberg, own calculations.





THE PUTIN SHOCK SUBSIDES

IN A NUTSHELL

- The global economy is holding up better than feared.
- US: mild recession in summer, recovery in 2024.
- Europe: Putin shock subsides; upswing in sight.
- Inflationary pressure is receding, but only slowly for the time being.
- Central banks continue to put the brakes on – but the end of the rate hike cycle is in sight.

The economy remains more robust than expected

The global economy seems to have started 2023 better than expected. In the US, consumers are drawing on the extra savings they built up during the pandemic. In this way they are cushioning the shock of high inflation, which is reducing the purchasing power of their incomes. In Europe, the gas storage tanks are still so well filled shortly before the end of the heating season that gas prices have dropped considerably, and the risk of a gas shortage is hardly a factor. China has achieved herd immunity, but the hard way. The country is opening up again. This will give the Chinese economy a noticeable boost in the short term, which will also spill over somewhat to China's trading partners. However, almost all major central banks tightened their interest rate policies once again at the beginning of 2023 and - at least in the US and the eurozone - have held out the prospect of further steps in the coming months. As the radical turnaround in monetary policy is only likely to unfold its full effect in the course of the year, the outlook for the global economy remains subdued for the time being.

Europe: The outlook continues to brighten

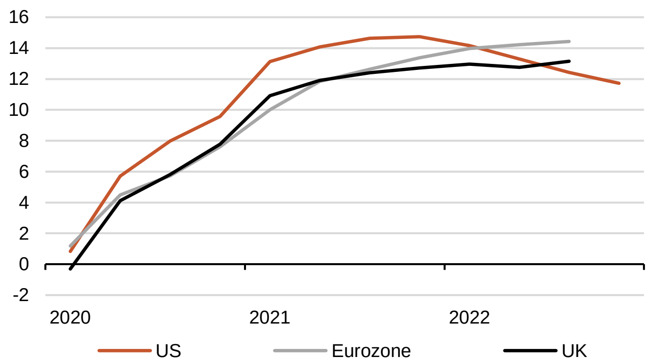
The high prices for energy and food hit the European economy hard in autumn and winter. After consumers had treated themselves to a good holiday season in the summer after two years of COVID-19, the region hardly grew at all in the fourth quarter. Stagnation is also on the horizon for the first quarter of 2023. In view of the high energy costs, consumers are limiting their spending on other goods. Private investment is also declining, especially in residential construction. However, in view of the continued high demand for labour, unemployment will rise only slightly. The high additional savings of consumers, the robust labour market and government aid are preventing a recession, even if economic performance in countries particularly affected by the reduction in Russian gas supplies, such as Germany and Italy, probably declined slightly in the winter half-year.

New upswing in summer 2023

Once the winter is over and the gas market continues to ease after the end of the heating period, the euro economy may pick up again after the winter stagnation in the summer of 2023. From then on, the rise in incomes could also be above the inflation rate again, so that consumers will have a little more money in their pockets in real terms. Europe is lucky when it comes to its export economy. This summer, the US recession, which is expected to be quite mild, will put the brakes on exports. But the simultaneous growth spurt in China can compensate for this. With well-filled storage facilities and lower consumption, there is probably no threat of a gas shortage or another explosion in energy costs in the coming winter. The eurozone will then be able to return to the dynamics of the pre-war period. After a modest increase in economic output of 0.7%

Additional savings of consumers

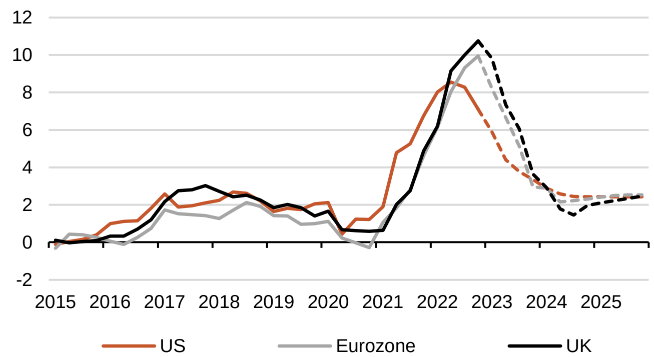
Gross household savings in excess of that implied by average savings rates 2015-19, as a percentage of consumption in 2022.



Q1 2020-Q4 2022. Sources: BEA, Eurostat, ONS, Berenberg.

The big inflation hump

Increase in consumer prices compared with the same period of the previous year in per cent.



Q1 2015-Q4 2025. Dashed: Berenberg forecast. US: CPI-U, Eurozone: HICP, UK: CPI. Sources: BLS, Eurostat, ONS, Berenberg.

in 2023, we expect growth of 1.6% in 2024, which would be slightly above the long-term trend of around 1.3%. For the UK, we expect a similar development as for the euro area, but with two differences. As a result of tighter fiscal policy and higher interest rates, the UK is likely to go through a mild recession until spring 2023. Since the government has finally settled the Brexit dispute with the EU and thus removed a major obstacle to investment, the British economy can then recover relatively quickly in 2024.

The transatlantic difference - Europe recovers, US weakens for the time being

Home-made problems in the USA

Unlike Europe, the US is suffering above all from home-made inflation. With its late but more forceful turnaround on interest rates, the Fed is likely to dampen demand to such an extent that the US economy could fall into a mild recession by mid-2023 – with declining consumption and less investment, especially in residential construction. For the election year 2024, there are then signs of a renewed upswing, supported by a noticeable increase in real disposable income and a then less tight interest rate policy. China's brief spurt in 2023, however, is likely to end in early 2024 with a reversion to the low trend growth of around 4%.

Highest inflation in 40 years

On both sides of the Atlantic, price pressures appear to have peaked. While wage increases will remain high for the time being, somewhat lower petrol prices will ease the burden on consumers. As the labour market in the US is also gradually losing momentum, wage pressures there could also ease slowly. By contrast, wages in the eurozone are likely to rise by 5% in 2023 before wage pressures fall back to around 4% in 2024 as inflation declines.

Although inflationary pressures are currently slow to subside in the US and Europe at the beginning of 2023, annual rates of inflation will soon fall noticeably on both sides of the Atlantic. In Europe, the rise in energy prices in 2022 will gradually fall out of the year-on-year comparison from March onwards. At the same time, the previous supply chain problems are easing. Transport costs have also fallen. This helps both to dampen inflation and to strengthen the upward forces of the economy again.

Central banks change course - interest rate summit in sight

To prevent high inflation from becoming entrenched, the Fed and the ECB are putting the brakes on interest rates. In the US, the Fed is likely to raise the key interest rate several more times until May. As soon as the Fed sees sufficient signs that the phase of economic weakness has sufficiently dampened inflationary pressures, it will then lower rates again somewhat, probably starting at the end of 2023. The ECB could raise its deposit rate to 3.5% by June 2023, followed by a long pause.

Dr Holger Schmieding, Chief Economist

Growth and inflation forecasts

	GDP Growth (in %)						Inflation (in %)					
	2023		2024		2025		2023		2024		2025	
		∅**		∅**		∅**		∅**		∅**		∅**
USA	0.6	0.8	0.7	1.2	2.2	2.0	4.3	4.1	2.6	2.5	2.4	2.4
Eurozone	0.7	0.5	1.6	1.2	1.5	1.5	5.7	5.6	2.4	2.4	2.5	2.2
Germany	0.1	0.0	1.6	1.2	1.6	1.5	5.9	6.2	2.4	2.6	2.5	2.1
France	0.7	0.5	1.7	1.0	1.7	1.4	5.5	5.0	2.3	2.4	2.5	1.9
Italy	0.6	0.5	1.1	0.9	1.1	1.2	6.5	6.6	2.3	2.2	2.5	2.0
Spain	1.3	1.2	1.8	1.6	2.0	1.9	4.9	4.3	2.5	2.5	2.5	2.0
UK	-0.1	-0.6	1.5	0.9	1.7	1.5	6.6	6.6	2.0	2.4	2.3	2.0
Japan	1.3	1.1	1.2	1.1	1.6	1.0	2.7	2.2	1.2	1.2	0.8	1.1
China	4.7	5.3	4.2	5.0	3.9	4.4	2.0	2.3	2.4	2.3	2.3	2.3
World*	1.8	-	2.3	-	2.5	-	-	-	-	-	-	-

* Berenberg data at actual exchange rates, not purchasing power parities (PPPs). PPPs lend more weight to the fast-growing emerging-market countries.
** Average, Bloomberg consensus as of 16/03/2023.

A SIDEWAYS MARKET FOR EQUITIES FOR THE TIME BEING

IN A NUTSHELL

- Earnings expectations have continued to come down since the beginning of the year, as we expected. In the meantime, hardly any growth is expected globally for 2023, which we consider realistic.
- Valuations have consequently risen across the board, also due to the equity rally. US stocks remain the most expensive.
- We do not expect much upside or downside potential in Q2; however, the risks are clearly to the downside. Commodity-heavy regions/segments remain attractive.

European equities clearly ahead in the first quarter

The stock markets got off to a great start in the new calendar year, with European equities leading the way. One reason for this was that the absence of a winter recession caught many pessimistic investors on the wrong foot. US equities, on the other hand, generally lagged behind. Robust economic and inflation figures put pressure on US equities, which tend to be highly valued, due to ongoing restrictive central bank policy. Investors in Asian equities were also cautious after the strong performance at the turn of the year. They want to wait and see how strong and positive the effects of China's opening after the years-long COVID-19 lockdowns actually are. In addition, there are new fears of action by the US against China.

Earnings expectations now somewhat more realistic

Analysts have revised Q1 earnings estimates down further, as we expected. Rising wages, higher refinancing costs and increased uncertainty about the economic outlook are weighing on profit margins. On the other hand, the recent positive economic surprises, especially in the US, should be supportive. A severe recession has thus become less likely, at least in the short term. Currently, the market is assuming 2023 earnings growth of just under 1% for the industrialised nations and a year-on-year earnings recession for the emerging markets. Accordingly, we think there should only be moderate profit reductions from here. The Q1 reporting season, which is about to start, should bring more clarity.

Economic downturn no longer priced in

Despite increasing quantitative tightening by central banks and bond markets pricing in more interest rate hikes this year, there has been a recent valuation expansion. The forward P/E ratio for the S&P 500 has risen from 16 to 18 since October last year, with 10-year Treasury yields being volatile, but roughly unchanged. This means that US equities are now again priced above average compared with their own history. European equities are now also more expensive than in October after the significant rally, but they are still cheap compared with their own history. At least they are not pricing in economic optimism, but also not a recession. In terms of valuation, there is hardly any room for improvement this year – especially since some valuation-insensitive strategies such as CTAs are now more heavily invested in (European) equities again.

Sideways phase likely into the summer

But fundamentally, too, markets are already in thin air. The reopening of China should be just as supportive as the robust economic data in the US and the Eurozone to date. However, the effects of restrictive central bank policies tend to take effect with a

Nearly all equity segments up year-to-date, but with considerable dispersion - European equities and cyclicals clearly in front

Total return	YTD and in 2022 (in %, EUR): YTD (31/12/22-14/03/23)	YTD and in 2022 (in %, EUR): 2022 (31/12/21-31/12/22)	12-month periods of the last 5 years (in %, EUR): 14/03/22 14/03/23	14/03/21 14/03/22	14/03/20 14/03/21	14/03/19 14/03/20	14/03/18 14/03/19	P/B* 14/03/23	Div.* 14/03/23	P/E* 14/03/23
Euro Stoxx 50	10.4	-9.5	14.6	-0.5	51.2	-20.5	1.3	1.7	3.5	12.4
DAX	9.4	-12.3	9.4	-4.0	57.1	-20.3	-5.3	1.4	3.5	11.7
Stoxx Europe Cyclicals	7.9	-14.3	4.5	2.7	58.3	-22.8	-3.9			
Stoxx Europe Small 200	5.8	-24.0	-6.6	-1.3	58.8	-19.6	0.0	1.5	2.8	19.7
Stoxx Europe 50	5.3	-1.8	11.6	10.7	34.1	-16.7	7.2	2.3	3.5	13.0
MSCI UK	3.6	1.4	5.5	15.3	32.9	-26.4	9.6	1.6	4.4	10.1
Stoxx Europe Defensives	2.3	0.0	5.5	14.7	27.8	-16.7	15.0			
S&P 500	2.2	-13.0	-2.3	16.8	37.2	0.4	14.1	3.5	1.8	17.9
MSCI USA Small Caps	1.2	-12.4	-2.9	-2.6	75.2	-18.2	11.2	1.7	1.9	17.9
MSCI EM Eastern Europe	1.1	-81.1	-6.1	-76.3	37.9	-20.2	6.5	0.8	5.3	5.0
MSCI Japan	0.8	-11.2	-1.6	-5.0	43.7	-11.8	-2.2	1.2	2.7	12.9
MSCI EM Asia	-0.8	-16.1	-5.1	-16.9	47.5	-5.6	-3.5	1.4	3.2	11.8

Time period: 14/03/2018–14/03/2023.
Source: Bloomberg * PBV = Price/book value ratio; Div. = Dividend yield (%); PER = Price/earnings ratio. Values based on estimates for the next 12 months.

time lag of up to 18 months, so they will probably not become markedly more visible until H2 2023. The first signs are already appearing in the form of weakening real estate markets and the crisis of individual regional banks in the US. At the same time, bonds have continued to become more attractive compared with equities as interest rates rose, which should encourage pension funds and insurance companies in particular to reduce their positions in equities and increase their positions in bonds. Therefore, the upside potential of equities is likely to be clearly limited for the time being. The typical seasonality also supports this. A good start to the year is often followed by a tough summer. On the other hand, most investors are aware of these points, so they are already cautiously positioned. This should also limit the downside potential of the equity markets. In addition to the US debt ceiling, a significantly more restrictive monetary policy on the part of the Bank of Japan, which will have a new governor from April, could cause more volatility for markets. If, contrary to expectations, Japanese interest rates were to rise sharply, many Japanese investors would withdraw their money abroad and invest in the domestic market. As a result, interest rates worldwide would probably continue to rise. Consequently, we have underweighted expensive equity regions such as the US and see potential in more cheaply valued regions such as Latin America, the UK and the Eurozone – especially as the first two should also benefit from a commodity recovery.

Ulrich Urbahn, Head of Multi-Asset Strategy & Research

WHAT IS ON COMPANIES' MINDS?

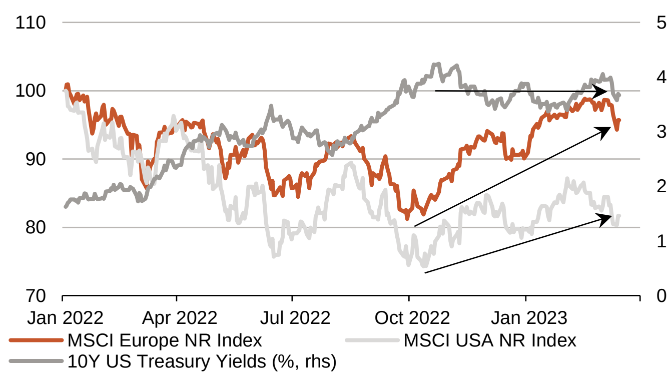
China is back

At the beginning of the year, company executives were largely optimistic, surprising a largely pessimistic investor base. This can be attributed to continued strong demand from consumers, but we also received reports from manufacturers that their order books were developing favourably. The high inflation figures of the past year have thus hardly weighed on demand so far. Board members also reported a positive development of input costs. Energy prices in particular have returned to normal surprisingly quickly in Europe, which has relieved many companies. The major tightening of supply chains has also largely dissipated. There was particular euphoria with regard to business in China. With many pandemic restrictions lifted, many companies were able to report a noticeable jump in demand from China. Consumer goods companies in particular are benefiting from this, led by manufacturers of luxury goods. It is likely to take a little longer for industrial companies, but here too they are much more confident than before Christmas. More cautious companies confirmed a positive development in recent months, but at the same time pointed to low visibility.

Matthias Born, CIO Equities

Rising equity (valuations) despite unchanged high interest rates

Net return indices for MSCI Europe (EUR) and MSCI USA (USD) normalised, 03/01/2022 = 100, as well as yields on 10-year US government bonds



Time period: 03/01/2022–14/03/2023.
Source: Factset, Berenberg.

Forecast overview: limited upside potential left until year-end

Berenberg and consensus forecast in comparison, values at year-end 2023 and mid-year 2024

	Currently	Berenberg		∅*
Index forecasts	**14/03/2023**	**31/12/2023**	**30/06/2024**	**in 12 months**
S&P500	3,919	4,150	4,350	4,612
Dax	15,233	16,200	17,300	18,011
EuroStoxx 50	4,179	4,350	4,700	4,898
MSCI UK	2,190	2,350	2,500	2,606
Index potential (in %)				
S&P500	-	5.9	11.0	17.7
Dax	-	6.3	13.6	18.2
EuroStoxx 50	-	4.1	12.5	17.2
MSCI UK	-	7.3	14.1	19.0

* Average, consensus as of 14/03/2023.
Source: Bloomberg, FactSet, Berenberg.

POSITIVE OUTLOOK IN ALL SEGMENTS

IN A NUTSHELL

- Safe government bonds offer attractive yields, but are not quite as interesting as other segments.
- European corporate bonds remain in demand at high interest rates; we prefer the financial sector.
- Emerging market bonds are back in vogue, local currencies with the best risk-reward ratio.

Constructive start to the year is not a flash in the pan

"Interest rates are back", we wrote in the last issue of "Horizon", and the first weeks of the year brought rising demand for fixed-income securities in many segments. Adequate yields and interesting coupons again provide for continued attractiveness despite temporary setbacks. We expect positive returns from bonds in the coming months.

Government bonds provide yields again; the US remains in the lead

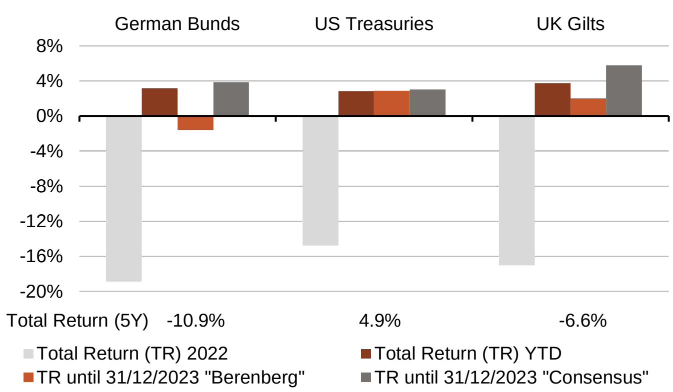
As expected, the losses of the previous year in the safe government bond segment did not continue during the first quarter. Although the recovery that started at the beginning of the year initially slowed down from the end of January, and yields subsequently climbed above the levels they were at the turn of the year, the trend reversed again. Going forward, current yields should be the main source of return, with the fact that inflation in the US is on the retreat earlier than in the Eurozone playing a role. In addition to an easing in long-dated bonds, this also leads to a divergence in central-bank policies. The US Fed and the Bank of England should begin to lower their key interest rates again in the second half of the year after further hikes in the second quarter, but the European Central Bank will not. In the Eurozone, we expect a total increase in the main refinancing rate to 4% by the summer, without a turnaround in the following months. Overall, the segment has clearly gained in attractiveness and adequate current yields are again being offered in all three currency regions.

Welcome back - demand for corporate bonds is rising

European corporate bonds in the investment-grade segment have held up well since the beginning of the year. The attractive risk premiums and the increased yield level attracted investors. This led to a slight decline in risk premiums. Even though the valuation now appears somewhat less attractive and the potential for a further narrowing of spreads is limited, we maintain our overall positive view. At over 4%, corporate bond yields are at their highest level in more than a decade. In addition, it is evident that yield-oriented investors, who have shifted to alternatives in the negative interest rate environment, are again showing interest in European corporate bonds, thus strengthening demand. This is partly met by the well-filled new issue pipeline, and we also continue to favour new issues as they offer a yield premium over outstanding bonds. Moreover, their coupon is at current market levels, which strengthens the generation of current income after years of very low coupons (see figure below left). Within corporate bonds, we prefer the financial sector. The balance sheet quality of European banks has

Safe government bonds should selectively make money again

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



Time period: 16/03/2018-16/03/2023.
Source: Bloomberg, own calculations, iBoxx Government Bond Indices (7-10 years, TR).

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

Berenberg and consensus forecast in comparison, values at year-end 2023 and mid-year 2024

	16/03/2023 Currently	31/12/2023	Ø*	30/06/2024	Ø*
USA					
Base interest rate	4.50-4.75	4.75-5.00	5.25	4.00-4.25	4.50
10Y US yield	3.58	3.50	3.48	3.70	3.30
Eurozone					
Base interest rate	3.50	4.00	4.10	3.75	3.85
10Y Bund yield	2.29	2.70	2.33	2.80	2.20
UK					
Base interest rate	4.00	3.75	4.25	3.00	3.80
10Y Gilt yield	3.42	3.50	3.15	3.60	3.03

* Average, consensus as of 16/03/2023.
Source: Bloomberg.

improved significantly in recent years. In addition to a significantly higher equity base, this is also reflected in the decline in the share of non-performing loans, as recently confirmed by aggregate data from the European Banking Authority. Compared with corporate bonds, the yields of financial securities are also higher and the maturity risks lower.

Emerging-market bonds: local-currency advantage

Emerging-market bonds were in a state of flux in the first quarter. While the start of the year was still promising and all three segments, ie both government and corporate bonds in hard currencies as well as local-currency bonds, were flushed upwards as part of a general liquidity rally, a reversal set in at the beginning of February after the strong US labour market data with rising US yields and a strengthening US dollar. The fact that the market performance proved to be very homogeneous across all asset segments, not only in the upward but also in the downward movement, shows that general risk sentiment was the dominant force for performance or that the market was driven by the movement of US yields and the US dollar, while individual country, sector or currency risks took a back seat. We expect this to change in the second half of the year at the latest, and the market to become more heterogeneous. In this case, we expect performance advantages in the local-currency segment. Compared with the hard-currency segment, the strongly increased local yields already offer an attractive current interest rate ("carry") with a lower duration. If the rate hike cycles in the emerging markets end earlier than in the US and Europe, price performance will gain in importance again in addition to carry. Thus, in the course of the year, a gradual increase in duration in the market for local currency bonds seems opportune to us in order to participate in this development.

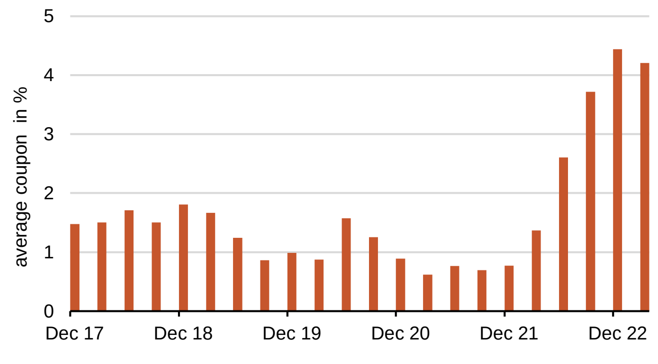
Conclusion: opportunities in all segments

After the "return of interest rates", we see opportunities in all three bond segments discussed here. Safe government bonds again offer interesting current interest rates, but the European corporate sector is even more attractive. Here we prefer the financial sector, and we also participate in new issues with yield premiums and adequate coupons. Finally, emerging markets will develop more heterogeneously over the course of the year than they have recently, which should benefit local currency bonds in particular. The latter and corporate bonds remain our favourites.

Martin Mayer, Senior Portfolio Manager Multi Asset
Felix Stern, Head of Fixed Income Euro Balanced
Robert Reichle, Head of Emerging Markets Selection

Euro corporate bonds: coupons are finally attractive again

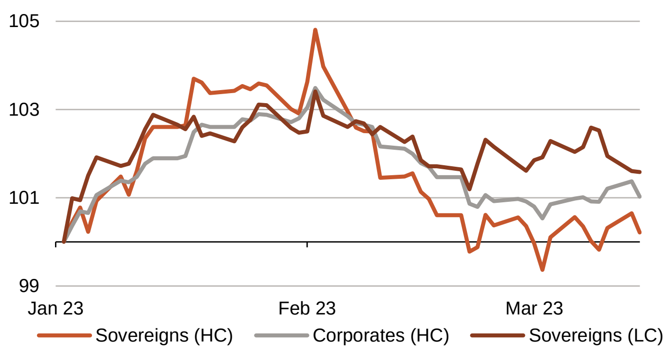
After previously meagre years, coupons on new issues at current levels are again helping to support decent returns for investors.



Time period: 31/12/2017-28/02/2023.
Source: Bloomberg, own calculations; rating universe: investment grade.

EM unusually homogeneous, local-currency bonds ahead

So far, 2023 stands out due to high homogeneity between hard and local currency (HC, LC); this will change in the second half of the year at the latest.



Time period: 02/01/2023-14/03/2023, indexed to 100 as of 02.01.2023.
Source: Bloomberg, own calculations.

COMMODITIES WITH LONG-TERM POTENTIAL

Oil: tailwind from demand recovery

Initially, crude oil continued its sideways movement in the first quarter. Driven by the news, the price of Brent crude swung erratically around the 80 US dollar per barrel mark and recently even fell significantly below it. The slower-than-hoped-for recovery in demand in China, the milder winter in the west and the further release of strategic oil reserves in the US dampened the price potential. Most recently, concerns about recession in the wake of the banking crisis also weighed on oil. On the other hand, producers are keeping supply tight: Russia's planned cut of 0.5m barrels per day from March adds up to OPEC cuts until the end of the year. While supply and demand are balanced in the short term, catch-up effects in Asia should support the oil price in the medium term – especially towards summer, when the US driving season gets underway.

Gold: upward potential fundamentally limited

Gold's rally at the start of the year was abruptly ended by the strong US labour market data. The more robust economic data strengthened expectations of a "higher for longer" scenario from the Fed. This led to a slide due to the double whammy of a higher US dollar and real interest rates. With the recently emerging concerns in the banking sector, however, gold gained strongly again and once more proved its unique diversification properties. The discussion about the US debt ceiling and geopolitical tensions (Russia-Ukraine war, US-China conflict) pose further risks. Fundamentally, however, the upside potential should remain limited. As an investment without cashflows, gold is becoming less attractive than other safe havens such as government bonds in an environment of higher real interest rates. Gold is only likely to benefit sustainably in the event of a turnaround in monetary policy.

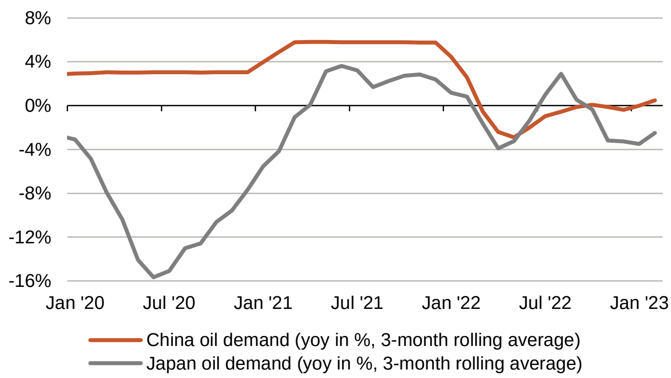
Industrial metals: postponed is not abandoned

After the initial China euphoria at the start of the year, industrial metals gave back (some of) the gains following signs of a tighter Fed and weaker demand in China in the short term. The markets are waiting for more concrete signs of an increase in demand in China. Nevertheless, postponed is not abandoned. After signs of initial improvement (China PMI), a sustained economic recovery in China should provide new momentum. At the same time, production difficulties and low inventories are widening the supply deficit and providing long-term support.

Philina Kuhzarani, Analyst Multi-Asset Strategy & Research

Catch-up effects in Asia should support oil in the medium term

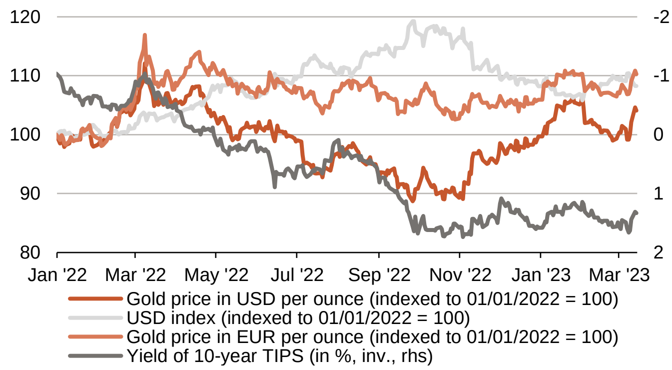
China and Japan's lower oil demand offers new tailwind in catch-up effects.



Time period: 01/01/2020-28/02/2023.
Source: Bloomberg, own calculations.

First headwinds, then tailwinds from real interest rates

First headwinds from a stronger US dollar and higher real interest rates after an initial upward movement, then tailwinds again from risk-off in markets.



Time period: 01/01/2022-14/03/2023.
Source: Bloomberg, World Gold Council, own calculations.

Rising activity in Chinese manufacturing supports metals prices

The manufacturing PMI in China is signalling rising activity again. Industrial metals should benefit from higher demand.

Time period: 01/01/2013-14/03/2023.
Source: Bloomberg, own calculations.

EURO COMEBACK WITH INTERRUPTIONS

Strong US labour market data interrupts euro recovery

The euro initially continued its recovery in the first weeks of the year. At its peak, the exchange rate rose to around USD1.10 per euro. However, the upward movement was interrupted after the US labour market data for January were reported. The labour market remains in strong shape. At 3.4%, the unemployment rate fell to its lowest level in over 50 years. This changed market expectations for US monetary policy, as the Federal Reserve has a dual mandate: in addition to price stability, it also aims for a high level of employment. Since the employment target can be considered achieved at an unemployment rate of 3.4%, the Fed can focus even more on the fight against inflation. As a result, market players braced themselves for a more pronounced tightening of monetary policy. This was immediately reflected in the foreign exchange market: after the labour market data were published, the dollar strengthened and the euro exchange rate gradually fell towards USD1.05 per euro. The further development of inflation and the development of the economy (and thus the situation in the labour market) remain the most important drivers on the foreign exchange market.

We see the setback in the EUR/USD exchange rate as temporary and not as a general trend reversal. The extremely low euro exchange rates below parity in autumn 2022 were due not only to the widening interest rate differential but also to the uncertainty as to how Europe would get through the winter without Russian gas supplies. Since the feared gas shortage did not materialise, the risk was gradually priced out of the exchange rate. In the course of the year, we expect the euro exchange rate to rise towards USD1.15 per euro.

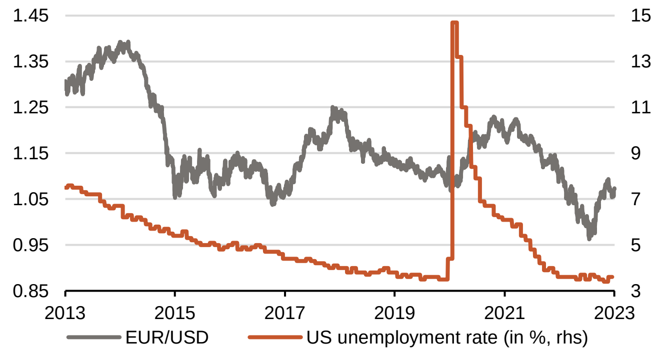
Swiss National Bank relies on strong franc

Against the Swiss franc, the euro is moving in a fairly narrow band. Although the lows at 0.94 francs per euro are a thing of the past, the attempts to break out above parity lasted only briefly. The exchange rate has settled at around 1.00, tending to be somewhat lower. The Swiss National Bank is now counting on a strong franc to curb inflation. The high franc exchange rate makes import prices cheaper, which contributes to a relatively moderate price increase: While inflation in the euro area peaked in the double digits, it has not risen above 3.5 % in Switzerland so far. We expect only a slight appreciation potential for the euro against the franc.

Dr Jörn Quitzau, Senior Economist

EUR/USD: economic risks are priced out, euro recovers

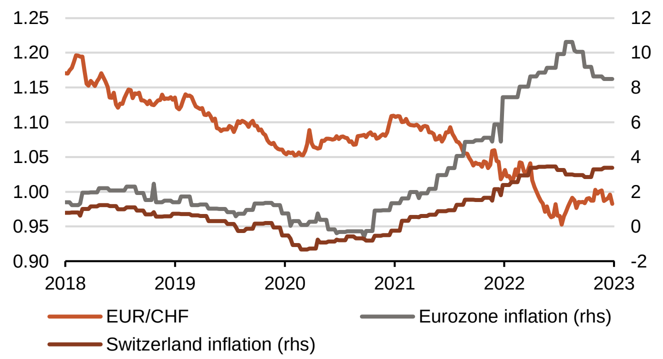
Geopolitical tensions had strengthened the US dollar for a long time. Since the situation has not escalated further, risk appetite rose again.



Time period: 14/03/2013–14/03/2023.
EUR in US dollars; unemployment rate in %. Source: Macrobond.

EUR/CHF: strong franc dampens inflation

In international comparison, Switzerland's inflation rate remains moderate. The strong exchange rate is - unlike in the past - in the interest of the central bank.



Time period: 14/03/2018–14/03/2023.
Euro in Swiss francs; inflation rate in %. Source: Macrobond.

Exchange rate forecasts

Berenberg and consensus forecast in comparison, values at year-end 2023 and mid-year 2024

	16/03/2023	31/12/2023		30/06/2024	
Exchange rate forecast	Currently		∅*		∅*
EUR/USD	1.06	1.15	1.11	1.17	-
EUR/GBP	0.88	0.85	0.90	0.85	-
EUR/CHF	0.99	1.02	1.01	1.02	-
EUR/JPY	142	144	139	147	-
Change against the euro in %					
USD	-	-7.7	-4.4	-9.3	-
GBP	-	3.1	-2.6	3.1	-
CHF	-	-3.3	-2.4	-3.3	-
JPY	-	-1.5	2.1	-3.5	-

* Average, consensus as of 16/03/2023.
Source: Bloomberg.

INTERVIEW WITH ROBERT REICHLE

Mr Reichle, you are Head of Fixed Income EM. Your focus as a portfolio manager is on emerging-market bonds. How would you describe your role?

We look after bonds issued by emerging-market countries or companies based there. We are active managers, ie we try to offer our clients added value compared with a benchmark and passive investment alternatives. Based on our analyses and convictions, we position ourselves in terms of interest rates, risk premiums, currencies, countries, regions and companies. The great thing about our job is the global aspect – there is always something going on somewhere in the emerging markets. These markets in particular are rarely priced efficiently, which entails risks, but also great opportunities.

That sounds exciting! What does your day-to-day work look like in practice?

We have a truly global investment universe to oversee. It starts with Asia in the morning, then we wander around the globe and end up in Latin America in the afternoon. We read and filter the news that has accumulated overnight, then the risk systems are reviewed. Have the risk premiums changed significantly? Do currency, bond or country allocations need to be adjusted? All of this has to be monitored and evaluated on a daily basis – ie our own analytical work in combination with external research, discussions with issuers, colleagues and analysts. Latin America is particularly challenging because this region is strongly linked to the US stock market and events in the emerging markets can change completely during the course of the day.

Emerging-market bonds are a broad field. Which segments should investors distinguish?

In particular, a distinction must be made between hard-currency and local-currency bonds, because many emerging-market bonds are not issued in the local currency but in US dollars or euros in order to collect funds more easily from globally oriented investors. This is especially true for companies that almost exclusively issue hard-currency bonds. Local-currency bonds are thus almost exclusively government bonds. This distinction is important because both have different value drivers. In the case of local-currency bonds, for example, currency developments play an important role in addition to local interest rate policies. In the case of hard-currency bonds, on the other hand, it is the risk premiums over the US dollar or euro yield curve. In the long term, both segments should perform comparably, but in the short term there are always valuation differences.

Accordingly, Berenberg offers one fund focused on local-currency bonds (Global Bonds Fonds) and two funds focused on hard-currency bonds (EM Bonds/Sustainable EM Bonds). What is your investment philosophy for these funds?

We are convinced that there are always inefficiencies, especially in the market for emerging-market bonds, eg attractive fundamental prospects are not yet fully reflected in prices. The general market sentiment, technical market factors or liquidity can be reasons for this. We aim to identify such inefficiencies and thereby generate alpha. The sheer size of the investment universe requires a structured and analytical investment process.

Keyword sustainability: at first glance, ESG and emerging markets hardly seem compatible; how do you work as an investor with a focus on sustainability in emerging markets?

Especially in emerging markets, a focus on sustainability is an essential element of risk management. In addition to the usual hard exclusion criteria, we select strong countries and companies based on their sustainability approach and their fundamental strength. Here, particular emphasis is placed on the issuer's medium- to long-term ESG strategy. General exclusion criteria are too shortsighted; transition processes, such as in the energy sector towards renewable energies, should also be taken into account. In addition to our own analyses, we use ESG company analyses and sustainability ratings from external providers.

What challenges do you face as a portfolio manager investing in bonds issued by companies, governments and institutions around the globe?

One of the biggest challenges is that western investors usually have a blanket positive or negative attitude towards emerging-market bonds as an asset class. But a closer look is worthwhile, as is a long-term strategic allocation. In general, emerging-market bonds are riskier than bonds from developed countries. Issues here are the sometimes substantial lack of transparency, corruption, especially in the government sector, and the still high dependence on commodity exports. But it is precisely in the areas of non-transparency and corruption that risks can be reduced and, in the best case, opportunities can even be identified through the integration of sustainability criteria (ESG). In this way, countries and companies can be selected that actively address such risks.

How do you manage risks and why should investors have emerging markets in their portfolios?

Market, credit and interest rate risks are considered individually and actively managed. In the current market environment, we often see the interest rate risk as decisive for the direction of risk premiums and accordingly active management creates significant added value. Emerging-market bonds should be in the portfolio if only because they have developed into a strategic asset class in recent years. Emerging-market bonds, especially those denominated in foreign currencies, not only offer attractive entry yields, but also a high degree of diversification in the portfolio – this helped a lot last year in particular.

Where exactly do you see the most attractive opportunities this year?

Thanks to strongly increased yields, emerging-market bonds generally appear very attractive. However, there are differences, both at the country level and within segments, ie government and corporate bonds in hard currency, as well as government bonds in local currency. We expect performance advantages in the local currency segment also this year. Although local yields have already risen sharply and current interest rates are thus attractive, we expect currency developments to determine performance in the short term. However, if the rate hike cycles end faster than in the US and Europe, price performance will again gain in importance alongside carry. Thus, a gradual increase in duration in the local-currency bond market seems appropriate to us over the course of the year.

Bonds thus offer a real alternative to equities again. How should investors react to the new market environment for bonds?

Investors should think outside the box again in the current market environment and reconsider their current weighting of bonds versus equities. Bonds should be a solid counterweight in multi-asset portfolios due to the new interest rate regime with adequate yields, especially in emerging markets. In particular, local-currency bonds offer high yields and a low correlation to equities and other fixed income segments and can thus significantly increase the degree of diversification of a portfolio.

BRIEF BIOGRAPHY

Robert Reichle, CFA, CQF has been a portfolio manager at Berenberg's Asset Management since January 2010 and heads the Fixed Income EM division. He is responsible in particular for the development and optimisation of investment processes in the context of the selection of emerging market bonds and global government bonds. Mr Reichle has been working in the financial services industry since 2004. Prior to joining Berenberg, he was a senior portfolio manager at Payden & Rygel Investment Management in Los Angeles. Prior to that, he worked as an emerging-market external debt and CDS trader at WestLB in London. An economics graduate, he is a Chartered Financial Analyst (CFA) and holds the Certificate in Quantitative Finance (CQF), the Certificate in Computational Finance, and the CFA Certificate in ESG Investing. He also holds a master's degree in International Economics from the Panthéon-Sorbonne University, Paris.

PUBLISHING INFORMATION

PUBLISHER

Prof Dr Bernd Meyer | Chief Investment Strategist

AUTHORS

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

Philina Kuhzarani | 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

Felix Stern| Head of Fixed Income Euro Balanced
is responsible for the selection of corporate and financial bonds as well as short-term bond market investments

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

IMPORTANT NOTICES

Date: 20 March 2023

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