HORIZON

The Berenberg Capital Market Outlook · Wealth and Asset Management

SURPRISINGLY ROBUST

Equities gained somewhat in Q2 despite high economic uncertainty and investor scepticism. Buying by systematic investors was supportive, but now makes the market more vulnerable to setbacks. AI euphoria boosted individual stocks; market breadth was low.

INCONSISTENT MARKETS

Weakness in commodities, small caps, emerging market and cyclical equities, as well as priced-in Fed rate cuts, reflect market expectations of further economic weakness. Optimistic earnings expectations and high equity valuations do not fit the picture.

CAUTION REQUIRED

Liquidity withdrawal looms in H2. Only with a view to an upswing on both sides of the Atlantic in 2024 do equities offer fundamental potential. Commodities, on the other hand, are already pricing in significant economic weakness. Bonds offer hedging and attractive yields.

Q3 | 2023

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FOREWORD

Prof. Dr Bernd Meyer
Chief Investment Strategist

Dear readers,
with declining inflation and the problems of individual banks, investors' focus shifted from inflation to economic growth early in the second quarter. Uncertainty about this dominated with the discussion about the US debt ceiling and disappointing economic data from China and Europe. Investors remained sceptical, favouring large caps, defensive stocks and developed equities. Equity funds saw outflows. Nevertheless, US equities in particular continued to rise. Better-than-expected Q1 corporate results helped, as did AI euphoria, which boosted individual mega caps. However, the main drivers may have been rule-based investment strategies, as more momentum indicators turned positive, implied and realised equity volatilities fell and a negative correlation of equities and government bonds returned with the focus on growth. All of this favoured the build-up of equity positions through rule-based investment strategies.

What's next? The slow decline in core inflation and the robust labour market in the US should allow the Fed to keep interest rates higher for longer. Although the market has already retreated somewhat from the expectation of rapid, significant rate cuts, it is still pricing in more than 130 basis points lower US central bank rates for the end of 2024. However, this is only likely to happen in the event of a more pronounced economic slowdown. The stock markets, on the other hand, seem to be betting on an economic recovery. But if interest rates remain higher for longer and the yield curves remain inverted, this is likely to leave further marks, as already seen in the real estate market, at regional US banks or in the form of tighter credit conditions, falling demand for credit and weaker consumer confidence. Economic risks remain high. In addition, declining net liquidity is likely to become a headwind. The US government's exhaustion of all cash holdings since reaching the debt ceiling in January and support measures by the Fed after the Silicon Valley Bank failure have increased liquidity despite quantitative tightening. Now that the debt dispute has been settled, spending cuts and a significant withdrawal of liquidity are likely to weigh on markets. In addition, the risk of rising US unemployment and, therefore, fewer ETF inflows remains. The higher equity positions of systematic strategies make markets more vulnerable. In the event of a rise in volatility or a more positive correlation between equities and bonds again, e.g. due to the withdrawal of liquidity, these may be forced to reduce equity positions in a falling market. Caution therefore remains the order of the day. The upside potential seems limited for the time being given the multitude of risks and simultaneously increased valuations. However, with a view to a coinciding economic upswing on both sides of the Atlantic in 2024, we see longer-term potential for equities. Still, we expect better entry levels in the second half of the year.

In the Insights interview starting on p. 14, our fund manager Javier Garcia explains what excites him about Asian emerging market equities, where he sees opportunities and what distinguishes the Berenberg Emerging Asia Focus Fund. I wish you an exciting read.

Bernd Meyer

CONTENT

EQUITY MARKETS VULNERABLE – IT SHOULD REMAIN TOUGH

IN A NUTSHELL

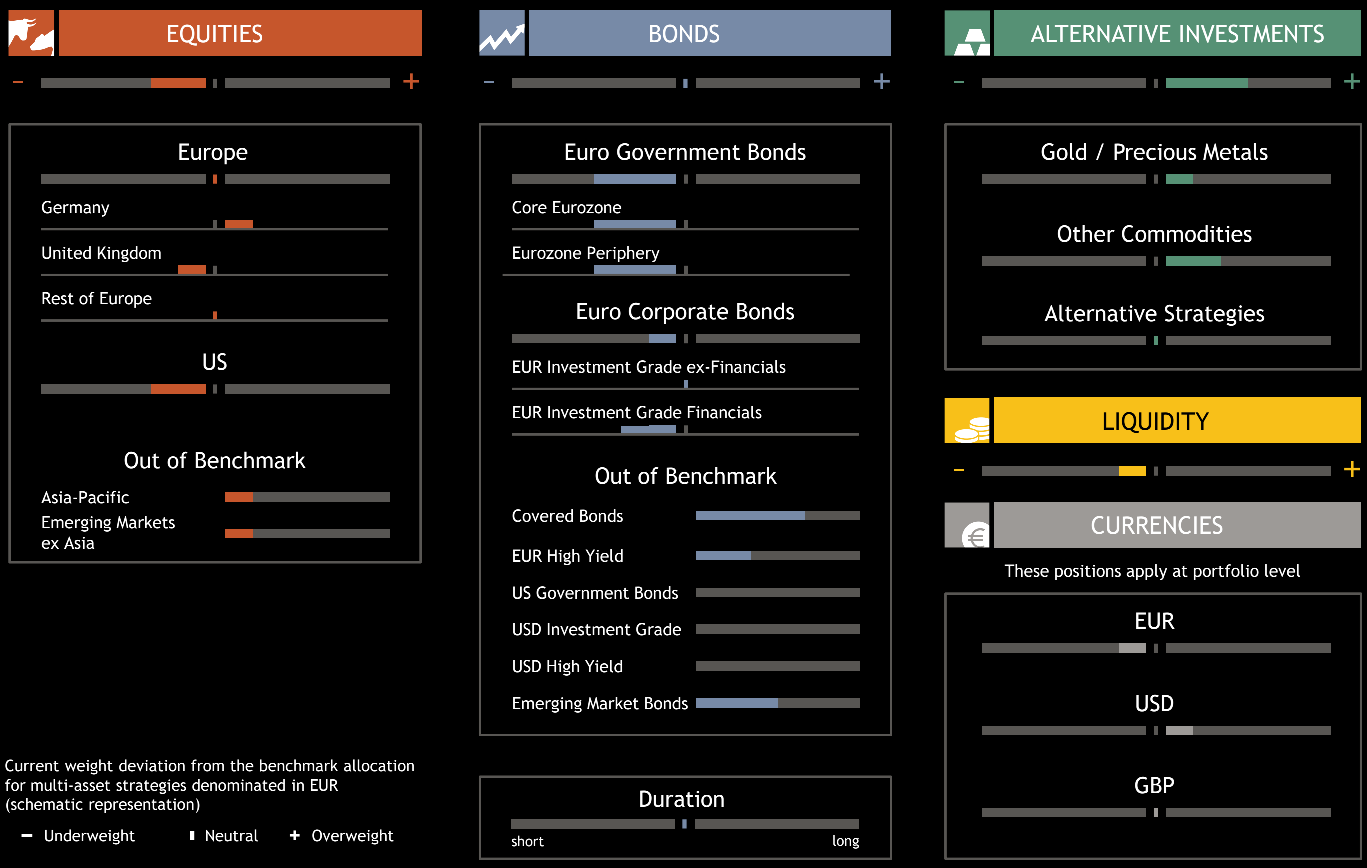
- Investor focus has shifted from inflation to growth – uncertainty about which remains unusually high. Equities and government bonds moved back into negative correlation, which benefitted multi-asset investors.
- Purchases by systematic strategies and a positive liquidity supply have supported equities recently – despite scepticism from discretionary investors. With the higher equity positions of systematic investors and the threat of liquidity withdrawal, we expect at best a back-and-forth in the markets.
- Bond yields are no longer likely to rise sharply, which makes interest rate duration more interesting. Commodities are pricing in a significant economic downturn. We are more cautious on equities.

Portfolio positioning at a glance

After the strong start to the year, we reduced the equity quota in several steps to a slight underweight in the first quarter, starting in February. In the second quarter, we took advantage of phases of strength to make further reductions to a now moderate underweight.

In return, we further expanded the bond side. In view of the economic risks and the foreseeable end of interest rate hikes, we raised the interest rate duration to near neutral. We also consider the risk premiums of good quality corporate bonds to be attractive, but are sticking to shorter maturities here, as risk premiums above the historical median could also widen further in the event of economic weakness. Overall, we have reduced credit risk in favour of interest rate risk, for example by exiting USD high-yield bonds. Emerging market bonds, especially in local currency, remain attractive given higher real interest rates and the chance of earlier rate cuts.

Commodities are already pricing in an economic downturn the most. In conjunction with the structural demand from the energy transition, we remain overweight cyclical commodities. Gold as a diversifier also remains overweighted.



Second quarter review: slightly reduced momentum

For the markets, the picture from the first quarter continued, superficially, at a reduced pace. Equities and bonds continued to rise, while industrial metals and energy commodities fell further and gold stagnated. Under the surface, however, there were several trend reversals. In contrast to the first quarter, defensive stocks outperformed cyclicals for a long time in the second quarter, US equities outperformed European equities and the US dollar strengthened. EUR/USD is now almost unchanged since the beginning of the year. Together with the relative weakness of small caps vs. large caps and of emerging market equities vs. developed market equities, this signals a more sceptical assessment of global economic development by the markets than in the first quarter. In view of the problems of individual banks, higher central bank interest rates and very mixed economic data, this is not surprising.

Continued high uncertainty about economic development

The economic upswing expected for spring has so far failed to materialise in the Eurozone – economic data have increasingly disappointed from April onwards (upper chart p. 5). Besides the less bad than feared winter in the Eurozone, China's somewhat weak recovery following the end of its COVID-19 restrictions is one reason for this. The US economy is also showing signs of weakness, especially in manufacturing. However, the labour market and services continue to prove more robust than expected – positive and negative economic surprises balance each other out. The question remains whether a "soft landing" succeeds, i.e. can a recession be avoided? Less fiscal stimulus and liquidity withdrawal after the agreement to suspend the US debt ceiling, tighter credit conditions and weakening credit demand (middle chart, p. 5) support our expectation of a further economic slowdown and a possible recession until spring 2024. One should not forget that effects of monetary policy usually show up in the economy only 12-18 months later – currently with an additional delay, e.g. because many consumers initially still had COVID-19 savings and fiscal policy remained expansionary. We maintain our view that the longer the economy proves robust, and the longer inflation and central bank rates remain high, the harder the landing could ultimately be.

Liquidity withdrawal likely to weigh in the coming months

In addition to the economic risks, sharply falling net liquidity is likely to become a headwind for the markets in the coming months. The Fed and the ECB are already continuously withdrawing liquidity through quantitative tightening. Since the beginning of the year, liquidity has nevertheless increased in the US and supported the markets (lower chart, p. 5). On the one hand, the Fed has once again provided liquidity with an emergency programme in the wake of the bankruptcy of the Sillicon Valley Bank. On the other hand, the reaching of the debt ceiling in the US in January prevented the issuance of new government securities, so that the US government drew on its "savings" until the cash reserves were exhausted at the end of May. With the suspension of the debt ceiling until early 2025, the issuance of large volumes of US government securities is now expected, and cash balances are to be replenished quickly. Analysts at Morgan Stanley estimate that USD net liquidity will fall by 8-14% over the next six months – a level

Second quarter slightly less dynamic than first. (US) equities, bonds and the US dollar gained. Oil fell again

Total return	YTD (31/12/22-13/06/23)	Q2TD (31/03/23-13/06/23)	13/06/22 13/06/23	13/06/21 13/06/22	13/06/20 13/06/21	13/06/19 13/06/20	13/06/18 13/06/19	CAGR* 13/06/18 13/06/23	Std.-dev.* 13/06/18 13/06/23
	YTD and in Q2 (in %, in EUR)		12-month periods of the last 5 years (in %, in EUR)						
DAX	16.6	3.9	20.9	-14.4	31.3	-1.8	-5.6	4.7	20.9
S&P 500	13.7	7.3	14.5	3.8	31.7	7.7	11.2	13.4	21.6
Stoxx Europe 50	11.4	2.5	19.1	-0.1	24.0	-4.2	5.4	8.3	16.9
MSCI EM	6.1	3.6	-0.8	-12.7	32.7	-0.7	-3.4	2.0	17.2
Gold	5.7	-0.9	3.1	12.7	0.7	29.3	8.0	10.3	13.2
EUR Corporates	2.4	0.6	0.3	-13.0	3.7	0.5	4.1	-1.1	3.7
EM Sovereigns	2.1	1.3	1.6	-6.1	0.6	2.2	15.1	2.5	8.5
EUR Sovereigns	2.0	0.2	-1.0	-9.9	0.9	1.1	3.5	-1.2	3.5
Euro Overnight Deposit	1.2	0.6	1.4	-0.6	-0.5	-0.4	-0.4	-0.1	0.0
US Sovereigns	0.6	-1.2	-3.9	3.7	-10.0	11.2	12.5	2.3	4.6
USDEUR	-0.8	0.4	-3.6	16.3	-7.0	0.2	4.6	1.8	7.3
Brent	-11.0	-4.7	-28.3	129.1	68.6	-36.3	-13.2	8.9	40.9

Time period: 13/06/2018-13/06/2023
Source: Bloomberg * CAGR = annualised return (in %, in EUR); Std. dev. = annualised standard deviation (in %, in EUR).

that has recently been a drag on equity markets (bottom chart). In the Eurozone, in addition to the monthly quantitative tightening, there is also a significant withdrawal of liquidity due to the ECB's TLTRO loans to banks coming to an end. In the event of stress, the central banks are likely to step into the breach again. However, this will probably only happen after a stronger sell-off.

Position building by systematic investors makes equities more vulnerable

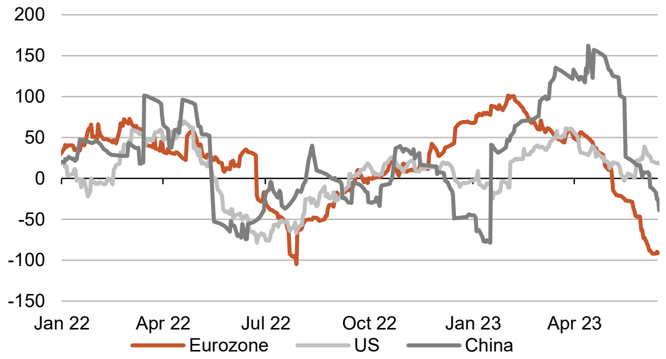
While discretionary investors, like us, tend to be sceptical, as sentiment surveys confirm, rule-based investment strategies have significantly increased their equity positions from low levels in recent months. Momentum indicators increasingly turned positive as equity performance is now also positive over six and twelve months in Western markets. Implied and realised volatilities declined. The VIX Index, a measure of the implied volatility of US equities, fell from an average of 25.1% in Q4 2022 to 17.1% since the beginning of April. In June, the VIX index closed below 15% for the first time since February 2020. Realised volatility, which is even more important for most systematic investment strategies, fell even more. This allows them to build up risk positions. The fact that volatilities fell more for equities than for bonds favoured the relative build-up of equity positions in risk parity strategies.

Another driver is the return of the negative correlation of equities and government bonds. The correlation of US government bonds and US equities over the last 60 trading days has fallen from over +0.4 in January and early February to below -0.5 in early June. As the diversification effect increases, the overall risk of multi-asset portfolios decreases significantly. Rule-based strategies then continued to expand risk positions. With the build-up of equity positions through systematic strategies, however, equity markets have again become more susceptible to setbacks. In the event of a significant increase in volatility and/or a renewed synchronisation of equities and bonds, rule-based strategies may be forced to sharply reduce equity positions in a sell-off. If this leads to a stronger correction, we would likely seize the opportunity and expand equity positions again.

Prof. Dr Bernd Meyer, Chief Investment Strategist

Economy disappoints in China and the euro zone, US still stable

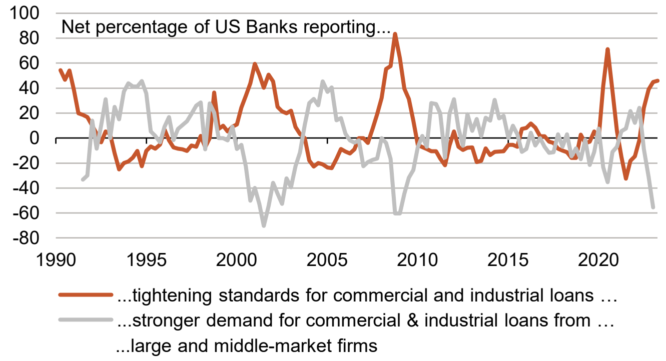
Economic data in the Eurozone and China increasingly disappointed consensus in the second quarter, US data was close to consensus expectations



Time period: 01/01/2022–13/06/2023
Source: Bloomberg, Citi

US: tighter credit conditions, weakening demand for credits

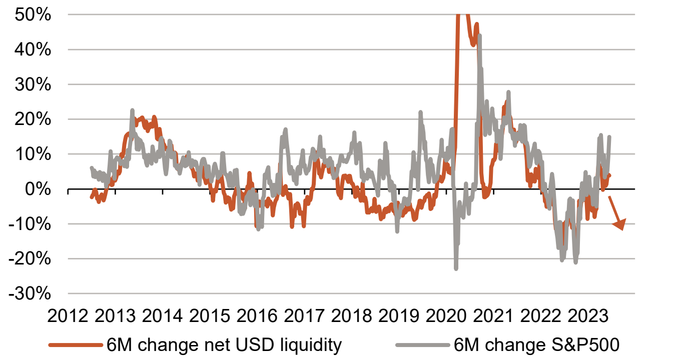
Tighter credit conditions are likely to weigh on the economy. Historically, this has been followed by an increase in bankruptcies with a lag of 6-9 months.



Time period: 01/01/1990–31/05/2023
Source: Bloomberg, own calculations

Liquidity boost supported since start of year, now withdrawal looms

The change in USD net liquidity looks at the Fed balance sheet, the volume of Fed reverse repurchase agreements and the government's cash balance



Time period: 01/01/2012–14/06/2023
Source: Bloomberg, own calculations

HEADWIND FROM OVERSEAS

IN A NUTSHELL

- The global economy temporarily loses momentum.
- US: mild recession ahead, recovery in 2024.
- Europe: Putin shock is over, but exports weaker.
- Inflationary pressures continue to decline.
- Central banks continue to put the brakes on – but the end of the interest rate cycle is in sight.

A good start into 2023

The global economy started 2023 better than expected. In the US, consumers drew on the extra savings they built up during the pandemic. This has cushioned them against the shock of high inflation, which reduces the purchasing power of their incomes. Europe has survived the winter (almost) without Russian gas so well that gas prices on the market have dropped considerably. Real savings have contributed to this much more than the mild weather. Since gas storage in the EU was already 72.6% full again on 12 June, after a seasonal low of 55% at the end of March, there is no serious risk of a gas shortage for the heating season next winter. Meanwhile, with China having achieved herd immunity the hard way, Chinese consumers have been spending significantly more again since the beginning of the year, giving the economy a temporary, noticeable boost. With more growth than expected, central banks in the US and Europe have also continued to tighten their interest rate policies noticeably in order to get a grip on the still high inflation.

Downturn in the US

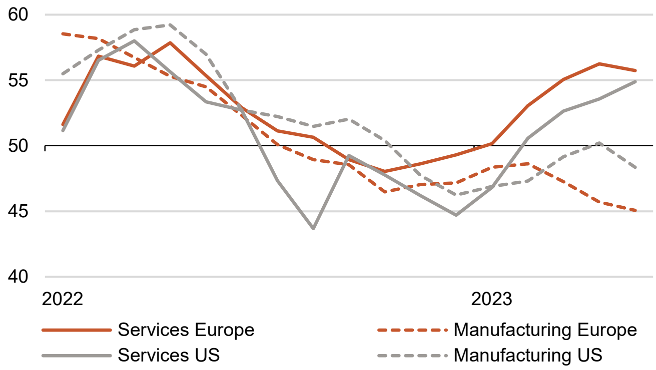
The US continues to suffer from home-grown inflation. With its late but more vigorous interest rate pivot, the Fed is likely to dampen demand to such an extent that the US economy could fall into a mild recession in the second half of 2023 – with somewhat declining consumption and less business investments. Especially in the manufacturing sector, leading indicators point to a noticeable downturn. A renewed upswing then emerges for the election year 2024, supported by a rise in real disposable income with easing inflation as well as a increase in residential construction after the end of the current interest-rate-induced correction. A less tight interest rate policy should strengthen the economic upswing. We expect the US economy to return to an annualised growth rate of 2% in spring 2024.

Mixed outlook for Europe

Two very different forces are shaping the outlook for the European economy in the coming months. On the one hand, the continent has weathered the Putin shock well. With declining inflation, a stable labour market and higher wage increases, consumer incomes can rise more strongly than prices again from the summer onwards. Since consumers then have more money in their pockets in real terms – i.e. after deducting inflation – private consumption can pick up again after a decline in the winter half-year. On the

Services robust, industry weak

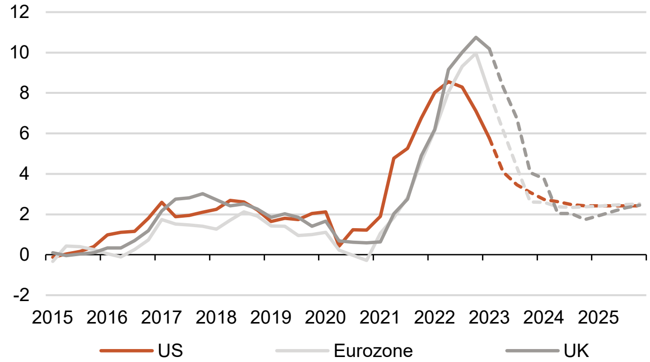
Purchasing managers' indices Europe and US



Europe: weighted average of Eurozone (80%) and GB (20%) 50+/- means expansion/contraction. January 2022-May 2023. Sources: HIS Markit, Berenberg calculations

The big inflation hump

Increase in consumer prices compared to 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 other hand, the wind is currently blowing in the manufacturing sector's face. There are three reasons for this. First, many companies around the world are reducing the inventories they built up last year amid great concerns about the stability of supply chains. Second, the slowdown in the US is most evident in goods, while demand for services remains more robust. In Europe, too, the purchasing managers' indices indicate a strong gap between services and manufacturing. This is partly due to the fact that consumers had to forego services more than goods during the years of the pandemic and accordingly have a greater backlog demand for travel, restaurant visits and other services. Thirdly, the hoped-for temporary tailwind from China has failed to materialise. There, after the end of the pandemic, demand from private consumers has picked up, but not investment activity. Especially for core Europe, which traditionally exports a lot of machinery, this has a negative impact.

Europe: Tailwind from home – headwind from overseas

With a tailwind from private consumption but a headwind from abroad, economic output in the eurozone will probably only increase slightly in the coming quarters. In the spring of 2024, with the US economy returning to strong growth, the European economy could return to the dynamics of the period before the Russian attack on Ukraine. After a modest 0.3% increase in economic output in 2023, we expect growth of 1.2% in 2024 and 1.8% in 2025. For the UK, we expect a similar course as for the eurozone.

Inflation continues to decline

Price pressures have peaked on both sides of the Atlantic. As the US labour market very gradually loses momentum, wage pressures there are slowly declining. By contrast, wages in the eurozone are likely to rise by at least 5% in 2023, before wage pressures are then expected to fall back to around 4% over the course of 2024 as inflation declines. In the US and Europe, inflation rates will continue to fall in the second half of 2023. In Europe, the 2022 rise in energy and food prices gradually drops out of the year-on-year comparison. As supply chain problems have eased and transport costs have also fallen, price pressures in this area will ease significantly as demand for goods weakens. However, higher wage increases will continue to push up prices for wage-intensive services, so inflation rates in Europe are likely to settle at around 2.5% from mid-2024 onwards instead of the roughly 1.5% as seen in the pre-pandemic years.

Central banks - interest rate peak in sight

To prevent inflation from becoming entrenched, the Fed and the ECB are stepping on the interest rate brakes. In the US, the central bank is likely to raise the key interest rate by another 25 basis points, probably in July. As soon as the phase of economic weakness has sufficiently dampened inflationary pressure, the Fed will then lower interest rates again somewhat, probably starting at the end of 2023. The ECB will most likely raise its deposit rate in July by 25 basis points to then 3.75%, 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	1.1	1.1	0.5	0.7	2.0	2.0	4.1	4.1	2.6	2.6	2.4	2.4
Eurozone	0.3	0.6	1.2	1.0	1.8	1.6	5.2	5.5	2.4	2.5	2.5	2.1
Germany	-0.4	-0.2	1.3	1.1	1.7	1.6	5.8	6.0	2.3	2.6	2.5	2.1
France	0.6	0.6	1.5	1.0	1.7	1.6	5.3	5.5	2.2	2.5	2.5	2.0
Italy	1.1	1.0	1.0	0.8	1.2	1.1	6.1	6.3	2.1	2.4	2.4	2.0
Spain	1.9	1.9	1.6	1.4	2.1	2.0	3.2	4.0	2.7	2.6	2.7	1.9
UK	0.4	0.2	1.2	0.9	1.7	1.5	7.3	7.1	2.4	2.8	2.2	2.1
Japan	1.2	1.2	1.1	1.1	1.3	1.0	3.0	2.8	1.8	1.5	1.3	1.3
China	5.3	5.5	3.9	4.9	3.9	4.7	1.1	1.5	2.5	2.3	2.2	2.2
World*	2.1	-	2.1	-	2.6	-	-	-	-	-	-	-

* Berenberg data at actual exchange rates, not according to purchasing power parities (PPP). PPPs lend more weight to fast-growing emerging markets.
** Average, Bloomberg consensus as of 15/06/2023

EMERGING MARKETS WITH SURPRISE POTENTIAL

IN A NUTSHELL

- Earnings growth expectations close to zero are probably realistic for 2023. 2024 should be better, but the consensus expectation of double-digit growth seems high.
- The threat of liquidity withdrawal is likely to cap valuations in the coming months.
- We see an increased risk of a setback in Q3, but the downside potential is likely to be limited due to positioning. EM equities could surprise positively.

Heterogeneous equity market performance in Q2

While European equities stayed flat in the second quarter – after the massive outperformance in Q1 and Q4 last year – Japanese and US equities performed more favourably. Japanese equities gained more than 9%, driven by strong inflows from international investors. Meanwhile, US equities and our preferred growth stocks benefited from AI euphoria. The USD appreciation also helped euro investors.

Optimistic profit expectations for 2024

The stabilisation of earnings expectations also helped. The Q1 reporting season surprised positively. This was well received by the markets, especially because expectations were very low beforehand. However, the consensus still expects a profit recession for Q2 and part of Q3 before a return to positive profit growth in Q4. Profit growth should be positive overall in the industrialised nations in 2023 and 2024 despite ongoing recession concerns. Analysts expect earnings growth of just under 10% in 2024. For emerging markets, the consensus assumes an even stronger recovery in 2024 after a profit recession this year. However, rising corporate wages and refinancing costs, together with a likely decline in pricing power due to disinflation and the lack of a strong China recovery so far, are likely to limit earnings growth – especially for a large share of cyclical companies. While we are also more positive about 2024 than 2023, it will not be easy for companies to outperform the optimistic forecasts for 2024.

Only little room for improvement in terms of valuation

Despite increasing quantitative tightening by central banks, there has recently been a valuation expansion. The forward P/E ratio for the S&P 500 has risen from 17 to 20 since the beginning of the year, with volatile but almost unchanged 10Y Treasury yields. This means US equities are now again highly priced relative to their own history and relative to bonds. European equities are still cheap relative to their own history despite the YTD rally. In terms of valuation, there should be hardly any room for improvement this year, especially since some valuation-insensitive strategies such as CTAs are now already more clearly invested in equities again. Moreover, the strong withdrawal of liquidity over the summer is not likely to help valuations either.

Increased risk of setbacks over the summer

The markets have recently been supported by only a few stocks, especially in the US. US small caps as well as the equally weighted S&P 500 have gained only slightly since the beginning of the year.

Wide spread in Q2 - Eastern Europe, Japan and US large caps ahead, small caps and EM Asia behind

Total return	YTD and in Q2 (in %, in EUR): YTD (31/12/22-13/06/23)	Q2TD (31/03/23-13/06/23)	12-month periods of the last 5 years (in %, in EUR): 13/06/22 13/06/23	13/06/21 13/06/22	13/06/20 13/06/21	13/06/19 13/06/20	13/06/18 13/06/19	P/B* 13/06/23	Div.* 13/06/23	P/E* 13/06/23
MSCI EM Eastern Europe	20.5	17.3	26.2	-81.2	25.6	-11.2	23.7	1.0	5.2	8.0
Euro Stoxx 50	17.0	2.4	27.3	-12.9	33.8	-5.4	0.1	1.8	3.5	12.4
DAX	16.6	3.9	20.9	-14.4	31.3	-1.8	-5.6	1.4	3.4	11.4
MSCI Japan	14.2	9.5	12.9	-5.2	16.1	6.4	-5.4	1.4	2.4	16.2
S&P 500	13.7	7.3	14.5	3.8	31.7	7.7	11.2	3.9	1.6	20.0
Stoxx Europe Cyclicals	12.9	3.9	18.4	-12.4	43.0	-8.2	-6.2			
Stoxx Europe 50	11.4	2.5	19.1	-0.1	24.0	-4.2	5.4	2.4	3.5	13.4
MSCI US Small Caps	7.7	5.3	10.1	-9.4	54.7	-6.8	0.6	1.8	1.8	20.3
Stoxx Europe Small 200	7.7	1.5	5.0	-18.3	42.9	-3.2	-4.3	0.8	3.9	14.2
MSCI UK	7.2	2.8	8.9	8.1	25.4	-16.0	-0.8	1.6	4.3	10.3
Stoxx Europe Defensives	6.6	1.8	7.6	7.9	14.4	0.8	7.3			
MSCI EM Asia	5.8	2.4	-2.3	-13.6	33.7	7.1	-8.4	1.5	2.4	14.5

Time period: 13/06/2018-13/06/2023
Source: Bloomberg * P/B = price-to-book ratio; Div. = dividend yield (%); P/E = price-to-earnings ratio. Values based on estimates for the next 12 months.

The low market breadth does not signal high investor conviction and, along with restrictive central bank policies and negative leading economic indicators, continues to call for caution. Among equity regions, emerging markets are likely to exhibit the biggest positive surprise potential. Investor sentiment and earnings expectations tend to be negative here. However, if, contrary to expectations, China were to recover more strongly, albeit later, this would catch many investors on the wrong foot. For example, the Chinese government could feel compelled to stimulate more strongly in H2. The same applies if geopolitical tensions between China and the US subside. The strong outperformance of European versus US equities since October could at least pause. On the one hand, many investors in Europe are already more strongly positioned, also because they have used Europe as a proxy trade for China. On the other hand, the Fed is likely to be further along in the tightening cycle than the ECB and will therefore start to ease monetary policy more quickly. Moreover, recent economic data in Europe have surprised more negatively than in the US. US equities are also benefiting much more than European equities from the AI boom. However, the relative valuation still speaks in favour of Europe. Overall, we consider both the upside (fundamental) and downside (positioning) potential for equities to be limited. After a setback over the next few months, there could be a recovery at the end of the year when the market looks towards 2024.

Ulrich Urbahn, Head of Multi Asset Strategy & Research

WHAT IS ON COMPANIES' MINDS?

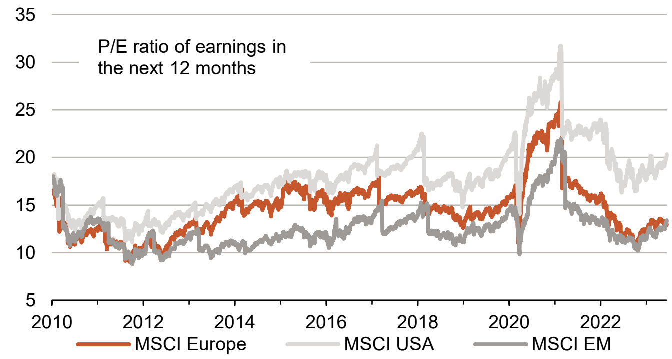
Recession worries also trouble corporate leaders

It is not just investors, like us, that are on the lookout for signs of a stronger economic slowdown. At various conferences and a large number of direct meetings with the companies relevant to us, we of course also could not avoid the proverbial elephant in the room in the second quarter either. In the industrial sector, high inventories and the associated low level of new orders continue to cause problems for the majority of companies. In the consumer goods sector, it was again possible to push through price increases at the start of the year, but here, too, increasingly weak demand is becoming apparent. However, a particularly high decline has only been seen in a few cases so far. However, demand in the luxury goods sector remains strong. Despite several price increases, customers are still extremely willing to pay. In medical technology, which is important for us, companies benefited from the continuing normalisation in the health care system after years of COVID disruption. The entire sector was able to present good Q1 figures. In sub-sectors dependent on the capital markets, however, the environment remains particularly difficult. Demand for private equity products, for example, has weakened significantly and deal activity has also plummeted.

Matthias Born, CIO Equitites

A lot of positives have already been priced for the US

P/E ratios of estimated earnings for the next 12 months for selected stock indices



Time period: 01/01/2010-13/06/2023
Source: Factset, Berenberg

Forecast overview: Sideways trend until year-end

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

	Current			Ø*
Index forecasts	**15/06/2023**	**31/12/2023**	**30/06/2024**	**In 12 months**
S&P 500	4,426	4,300	4,600	4,792
DAX	16,290	16,200	17,300	19,610
Euro Stoxx 50	4,365	4,350	4,700	5,054
MSCI UK	2,182	2,200	2,350	2,597
Index potential (in %)				
S&P 500	-	-2.8	3.9	8.3
DAX	-	-0.6	6.2	20.4
Euro Stoxx 50	-	-0.3	7.7	15.8
MSCI UK	-	0.8	7.7	19.0

* Average, consensus bottom-up as of 15/06/2023
Source: Bloomberg, Factset, Berenberg

BOND MARKETS CONTINUE TO OFFER RETURN OPPORTUNITIES

IN A NUTSHELL

- Safe government bonds offer greater return opportunities in the US and the UK than in Germany.
- In European corporate bonds, we prefer short-dated securities from the investment grade segment.
- In emerging markets, local currency bonds remain our clear favourites.

Bonds remain (selectively) interesting also in the second half-year

After the upheavals surrounding Silicon Valley Bank and Credit Suisse in March, the dispute over the US debt ceiling was once again a central topic that affected all segments of the bond market in recent weeks. Ongoing recession concerns and inflation rates that are still well above the levels targeted by the central banks are also providing partly contradictory signals. In the following sections, we show where we see opportunities for returns in this situation.

Government bonds in local currency outside euro area more attractive

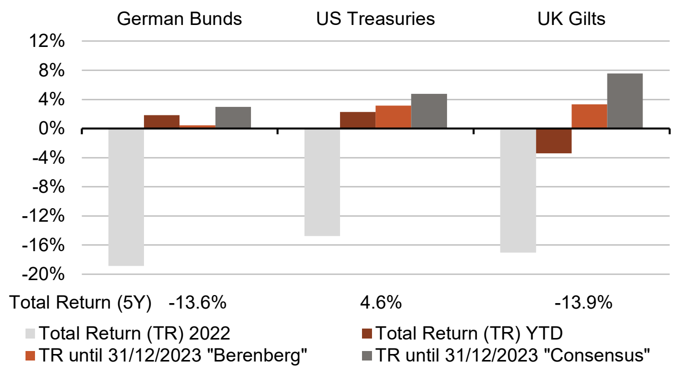
The yields of sovereigns with strong credit ratings mostly moved upwards in the second quarter, but there were no relevant price gains to be made. UK gilts have even shown a negative development since the beginning of the year (see figure below left). The major central banks delivered no surprises recently – the European Central Bank raised its key interest rates, the US Fed paused. In the euro area, further increases in key interest rates on the one hand and recession concerns on the other will work in opposite directions, while in the US a rate hike is also expected initially, but this could be followed by a first cut as early as December. We expect both UK and US government bonds to outperform German Bunds in local currency terms. Against the background of economic risks, issuers with high credit ratings, even with longer maturities, are interesting for hedging in the overall portfolio context. We have therefore increased our interest rate duration to an almost neutral weighting, while we remain cautious in regards to risk premiums ("spread duration") in view of possible widening.

Corporate bonds: boringly good

Sometimes boredom can be a good thing: European corporate bonds in the investment grade segment rose by +0.9% and high yield by +1.1% in the second quarter, with risk premiums remaining almost unchanged and thus still very attractive. The picture in the financial sector was different: although European banks posted solid quarterly results despite recession worries and real estate market stress, the fear stemming from the US banking sector could not be shaken off. Risk premiums over non-financial bonds also widened noticeably in the euro area (see chart on the left of p. 11). Looking ahead, solid credit metrics, very active new issuance amid brisk demand, and moderate inflows into European corporate bond funds should continue to be supportive. A surprisingly positive rating trend in the investment grade segment and so far only minor defaults in high yields add to this. In view of a possible economic downturn, upward pressure on corporate interest costs and already adequate yields in the investment grade segment, we prefer this sector to investments in high yield. Although financial bonds

Safe government bonds: Outlook for Bunds weakest

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



Time period: 15/06/2018-15/06/2023
Source: Bloomberg, own calculations, iBoxx government bond indices (7-10 years, TR)

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

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

	15/06/2023	31/12/2023		30/06/2024	
	Current		∅*		∅*
USA					
Key interest rate	5.00-5.25	5.00-5.25	5.20	4.00-4.25	4.40
10Y US yield	3.72	3.60	3.39	3.80	3.29
Eurozone					
Key interest rate	4.00	4.25	4.20	4.25	3.90
10Y Bund yield	2.50	2.60	2.29	2.80	2.21
Great Britain					
Key interest rate	4.50	5.00	4.95	4.00	4.50
10Y Gilts yield	4.38	4.30	3.73	4.20	3.54

* Average, consensus as of 15/06/2023
Source: Bloomberg

and especially banks are tempting us with unusually high risk premiums, we remain cautious here as well in view of the problems in the US banking sector and focus on the systemically important major European banks. If the yield curves continue to be inverted, we will remain short in maturity in order to capture the higher yields and avoid excessive credit risks in the event of economic weakness. However, as soon as there are signs of a turnaround in the central banks' interest rate policy, we would prefer medium to longer maturities.

Emerging market bonds: local currencies still favourite

The homogeneous development of emerging market bonds from the beginning of the year came to an end in the second quarter. While the local currency segment developed positively, especially since May, government and corporate securities in hard currencies came under pressure over time. This was due to rising US yields and a revived US dollar. Falling inflation figures coupled with positive real interest rates, especially in Latin America, were and are the fundamental drivers for the outperformance of the local currency segment. Technical factors – such as still manageable investor positioning – support this development, and we expect the divergence in favour of the local currency segment to continue in the second half of the year. Local yields, which have already risen sharply, offer an attractive current yield compared to hard currency bonds at a lower duration. The high volatility in the US government bond market, which we expect to continue in the third quarter, makes an investment in local currency securities equally attractive from a risk perspective. In addition, core inflation rates in Europe and the US remain at a high level – if the interest rate increase cycles in the emerging markets run out faster than in the US and Europe, price performance will become more important again in addition to current interest rates. Therefore, in the course of the second half of the year, a gradual increase in duration in the market for local currency bonds seems opportune to us in order to also participate in this development.

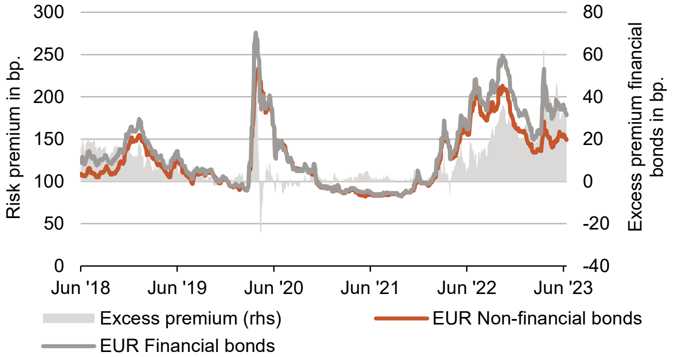
Conclusion: Uncertainties exist, opportunities remain

Interest rate policy, fears of a downturn, falling but still too high inflation – these and other risks exist, but we also see opportunities to continue earning money with bonds. Safe government bonds are more interesting beyond the euro area, but only in local currency, as currency uncertainty must be taken into account, especially in the case of US securities. The corporate bond segment is our favourite – we focus on good credit ratings with short maturities and avoid high-yield paper as well as banks outside systemically important large institutions. In emerging markets, we continue to prefer local currency investments, whereby a gradual increase in duration in expiring interest rate hike cycles in the second half of the year makes them even more attractive.

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

Euro financial bonds with clear risk premium edge

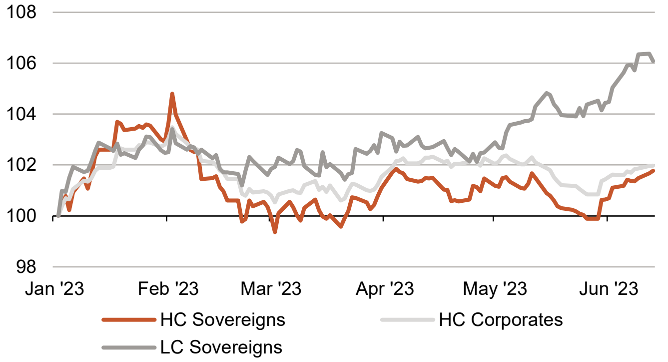
Risk premiums of financial versus non-financial bonds have widened significantly amid concerns in the banking sector



Time period: 01/06/2018-13/06/2023
Source: Bloomberg, own calculations

Local currency securities in emerging markets pick up speed

Homogeneity between hard and local currency bonds (HC, LC) came to an end in May – we expect the latter to continue to perform stronger



Time period: 02/01/2023-13/06/2023, indexed to 100 as of 02/01/2023
Source: Bloomberg, own calculations

COMMODITIES MORE PESSIMISTIC THAN OTHER ASSETS

Oil price recovery still pending despite positive developments

Brent oil fluctuated between 72 and 88 US dollars per barrel in the second quarter. In this context, the downward movements were mainly driven by economic concerns and systematic investors rather than by poor oil fundamentals. On the contrary, many things point to a tight oil market. For example, China is seeing strong oil demand growth as it opens up after COVID-19 and the positive summer seasonality (Driving-/AirCon-Season) is just around the corner. On the supply side, OPEC as a "swing producer" continues to proactively counter weak demand. The US fracking industry, meanwhile, is recording a year-on-year decline in drilling activity. Only Russia's production is more robust than expected. Moreover, contrary to expectations, the strategic oil reserve in the US was further reduced. All in all, the outlook remains positive, even though the potential now seems smaller than a few months ago, now that demand in China has already partially recovered and OPEC has already cut its quotas.

Gold remains an important but expensive hedge in the portfolio

Gold initially rose towards an all-time high in Q2 despite a stronger dollar and higher real interest rates but was then unable to break through. As concerns about the US banking sector subsided and an agreement was reached in the US debt dispute, valuation headwinds prevailed. In our view, a sustained upward trend requires a Fed pivot and thus lower real interest rates. Since we expect a pause rather than a pivot in the near future, the fundamental upside potential is likely to remain limited for the time being. At the same time, however, gold does not seem particularly vulnerable to major setbacks, as investor positioning remains moderate and economic uncertainty high. Therefore, gold will remain primarily a portfolio component for hedging risk scenarios in the coming months.

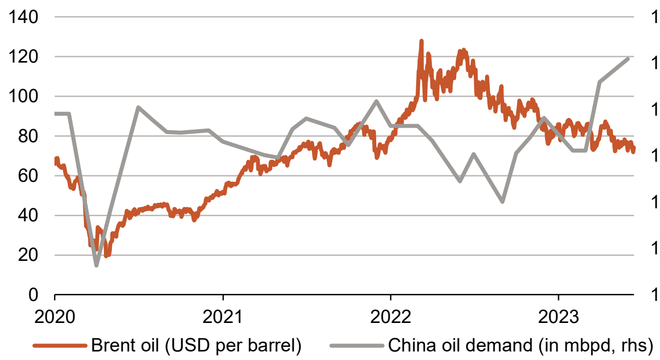
Industrial metals currently scarce, even scarcer in the future

Industrial metals came under increasing pressure in the second quarter as early indicators from the manufacturing sector deteriorated. However, inventories on the LME, which are extremely low by historical standards, have only risen slightly so far and continue to point to tight supply. Although the industry currently seems to be weakening somewhat, there is strong growth in demand from the green technology sector, especially in China. In the short term, the economic trend is predominant; in the long term, the trend towards decarbonisation should give industrial metal prices a significant tailwind.

Ludwig Kemper, Analyst Multi Asset Strategy & Research

Oil: Strong demand recovery in China, but oil price stagnates

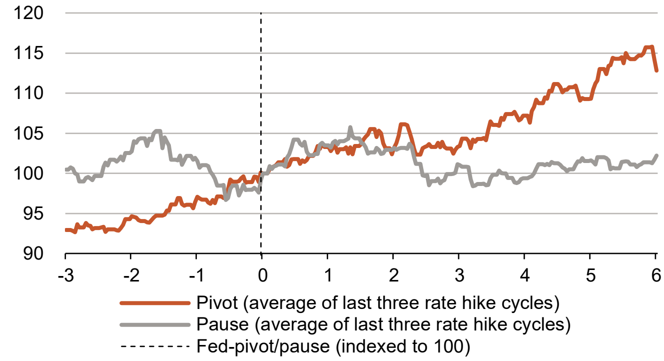
Brent oil price versus demand development in China



Time period: 01/01/2020-13/06/2023
Source: Bloomberg, own calculations

Gold: Sustained upside potential only with Fed pivot

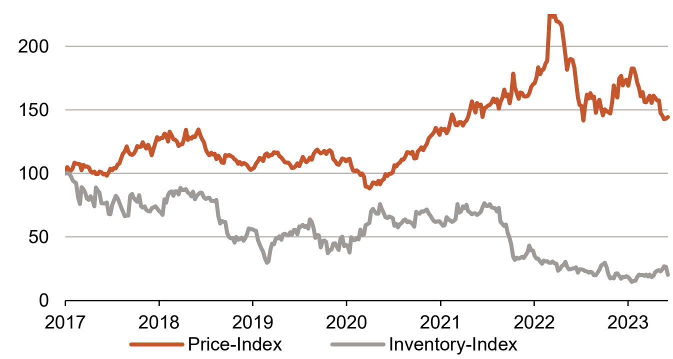
Average gold price development 3 months before to 6 months after the last 3 Fed pivots (first rate cut) or pauses (last rate hike)



Time period: 05/10/2000 – 31/01/2020
Source: Bloomberg, own calculations

Metals: Low inventories despite a weakening industry

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



Time period: 01/01/2017-09/06/2023
Source: Bloomberg, own calculations

EURO/US DOLLAR: TWO STEPS FORWARD, ONE STEP BACK

Many imponderables on the foreign exchange market

The euro was initially in good shape in the first half of the year. The European single currency continued its recovery against the US dollar for a long time and at the beginning of May had already covered a good part of the way to our year-end target of now 1.12 at just under 1.11 US dollars per euro. However, the way up is not without obstacles. In May, for example, the euro fell back to its value from the beginning of the year. In view of the fragile geopolitical and macroeconomic situation, this should not come as a surprise.

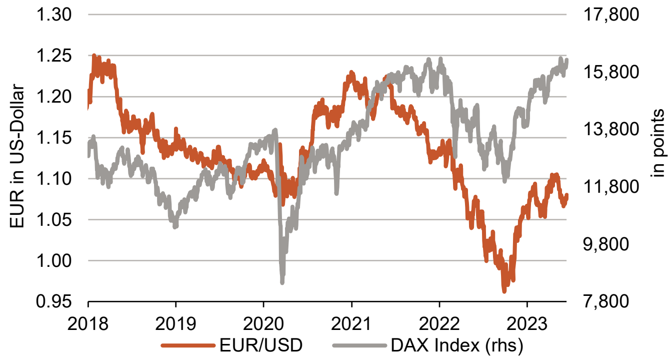
The foreign exchange markets have to deal with a number of factors and events that are not part of the usual daily business. Above all, the extraordinary inflation episode and the resulting monetary policy require permanent revaluations. Inflation rates are now falling in all major economic areas. However, the disinflation process still has quite some way to go before the monetary guardians can sit back. In this respect, market players and observers are still trying to assess whether the central banks will tighten monetary policy further (US Fed, Bank of England) or how far the tightening will go (ECB). The assessment is made more difficult by diffuse economic signals. While a recession is expected for the US (which tends to have a dampening effect on prices), the US labour market surprises again and again with its considerable strength (which tends to have a wage- and price-increasing effect). In the eurozone, on the other hand, the economic recovery is likely to be somewhat weaker than previously expected. German economic data in particular have been disappointing recently. The weaker economy suggests that monetary policy should not be tightened too much. Finally, the currency market had to deal with the imponderables of the US debt ceiling. The conflict has been resolved in the meantime, but a default could have led to severe distortions in the financial markets.

In this context, it is remarkable that the safe havens of the US dollar and the Swiss franc react differently to the respective risk situation. While the euro can visibly gain against the US dollar when the risk appetite on the markets increases, the euro hardly succeeds in making up ground against the franc. This is where the fact that the Swiss National Bank (SNB) has committed itself to a strong franc policy in order to fight inflation comes into play. The euro's upward potential against the franc therefore remains limited.

Dr Jörn Quitzau, Senior Economist

EUR/USD: Upwards, but with obstacles

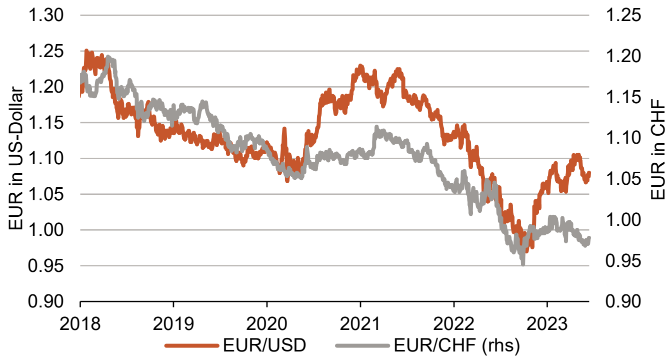
EUR/USD strongly dependent on market players' risk appetite. Many imponderables repeatedly interrupt the euro recovery



Time period: 01/01/2018–13/06/2023
EUR in US dollars; DAX in points. Source: Macrobond

EUR/CHF: Chronically strong franc

The US dollar reacts more strongly to changing risk situations. The Swiss franc remains chronically strong thanks to the SNB



Time period: 01/01/2018–13/06/2023
Euro in Swiss francs and in US dollars. Source: Macrobond

Exchange rate forecasts

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

	15.06.2022	31.12.2023		30.06.2024	
Exchange rate forecast	**Current**		∅*		∅*
EUR/USD	1.09	1.12	1.12	1.15	1.15
EUR/GBP	0.86	0.85	0.88	0.85	0.89
EUR/CHF	0.98	1.00	1.00	1.00	1.01
EUR/JPY	154	146	144	147	144
Change against the euro (in %)					
USD	-	-2.3	-2.3	-4.8	-4.8
GBP	-	0.7	-2.7	0.7	-3.8
CHF	-	-2.4	-2.4	-2.4	-3.4
JPY	-	5.2	6.6	4.5	6.6

* Average, consensus as of 15/06/2023
Source: Bloomberg

INTERVIEW WITH JAVIER GARCIA LAPARRA

Mr. Garcia, as the fund manager of the Berenberg Emerging Asia Focus Fond, your focus is on equities from Asian emerging markets. Do you have a personal connection to Asia? What do you think makes the profession so fascinating?

I have been investing in emerging Asian equities for more than 16 years and I still learn something new every day. Asia is one of the most dynamic and also exciting regions in the world, which has already undergone a major transformation and is constantly evolving and, to a certain extent, reinventing itself. What particularly fascinates me from an investor's point of view is the diversity and variety of countries and sectors. The growth potential is far from exhausted and continues to offer exciting investment opportunities.

I am thinking, for example, of a country like Indonesia: with 270 million people, the island kingdom is the fourth most populous country in the world. But what makes it special is that the median age is just 29.4 years. In some other countries in the region, it is even lower. In 2021, for example, it was 27.6 years in India and 24.5 years in the Philippines. By comparison, in Switzerland, where I live, it is just over 43, and in Germany it is as high as 45.9. In Indonesia, more than half the population is younger than 30. This offers enormous potential for growth, consumption, and investment. In addition, the country is very rich in raw materials and has extensive resources of oil, gas, coal, nickel, and gold. Furthermore, the country is politically stable and shows strong economic growth, supported by structural reforms.

Asia is geographically far away and the timing is a challenge, how do you manage that in your daily work? And how do you select individual stocks?

I would rather emphasise the time gap to the markets as a positive aspect. We can talk to analysts, industry specialists and especially management in the morning and focus on analysing the investments in the afternoon when the market is closed. We are long-term investors and make our investment decisions for a period of at least three years. Short-term price fluctuations are relevant for us, but in the end, they hardly influence our investments. We have a very intensive and concentrated approach. From the total universe of about 1,500 stocks, we select a portfolio of 40 to 45

companies with strong exposure to small and mid caps using our bottom-up quality growth approach. As an investor, however, you also have to be able to deal with the very high volatility of the various markets and the high speed of development. So, you have to keep track of the risks, but on the other hand, of course, this also opens up many exciting investment opportunities.

How does Asia differ from other equity regions? Why should investors have this region in their portfolio?

The combination of many market leaders in the promising technology sector and the positive demographic trend of a growing population play a major role. Asian emerging markets are home to many strong companies in promising fields such as solar energy or batteries for electric vehicles. Asia is the market leader in high-end chip production and the largest semiconductor producer in the world. This makes Asian emerging market stocks a good long-term addition to a balanced portfolio.

How do you assess the tensions between China and Taiwan or the US?

The geopolitical tensions between China and the US will continue to cause volatility. But I think the Chinese government has other priorities at the moment. It needs to get the country growing again, revive consumption and stabilise the real estate market. Despite all the discussion about Taiwan and China's role in the Russia-Ukraine war, I would rate the political relationship with the US as slightly better than a year ago.

Since autumn of last year, you have been strengthening the equity platform at Berenberg with the new Berenberg Emerging Asia Focus Fund. How was the start?

We had a good start, but it was not an easy year. We had a strong China rally in December and January, but it faded away very quickly. On the other hand, there were strong fluctuations in the different sectors. At the moment, the market is dominated by inflation expectations and recession scenarios in the West. There are no clear trends and this makes it difficult to generate alpha. Despite all of this adversity, we were able to outperform the Asian market.

What makes your fund special compared to other Asia equity funds? What do you do differently?

In Asia, we continue to rely on our proven investment philosophy and the process behind it – quality growth is a good way to generate respectable returns also in Asia. Compared to our competitors, we have a much more concentrated portfolio with only 40 to 45 stocks. We also have greater exposure to small- and mid-caps and to structurally growing sectors such as technology, green energy and consumer goods, which I would describe to a certain extent as being Berenberg's DNA. ESG criteria also play a greater role for us than for many other Asia funds.

How have the markets changed over the last few years? Why do you see opportunities in Asia right now? Where do you see opportunities?

Of particular interest are values that should benefit from structural megatrends such as digitalisation, the green revolution and the effects of demographic and social change. The region's very young population on average represents more than one billion young people who want to travel, need education and bank accounts, and are potential users of social media. There are already more than two billion internet users in Asia, and nowhere else in the world are there more. This is one of the reasons why the region is a leader in e-commerce innovation, 5G technologies, social media, and payment and transfer platforms. Topics such as cloud computing, big data, and the Internet of Things will continue to positively influence Asia's growth. One should also not forget the megatrend of AI, from which Asia is benefiting very strongly. The large and powerful computers needed for this are produced in Taiwan, and chip production is also a very strong sector there. This sector is also strongly characterised by small and medium-sized companies, which is why we have a good starting position with our strong small and mid-cap expertise. The market is only to a small extend penetrated by analysts, which gives a lot of potential for a fundamental approach.

SHORT VITA

Javier Garcia has been a portfolio manager at Berenberg since October 2022. He started his investment career in 2002 at Julius Baer Asset Management (later Swiss & Global Asset Management), where he became co-manager of the JB Global Emerging Markets Equity Fund from 2006 and additionally served as lead fund manager of the JB Black Sea Fund and the JB Russia Stock Fund from 2009. From 2013 to 2022, he was Senior Portfolio Manager Emerging Markets Equities at UBS Wealth Management. In this role, he built and managed the Global Emerging Markets and Asian Equities business. Javier Garcia holds a Bachelor in Business Administration and Economics from the University of Zurich and is a CFA Charterholder.

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IMPORTANT NOTICES

Date: 19 June 2023

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