HORIZON

The Berenberg Capital Market Outlook · Wealth and Asset Management

LANDING AHEAD

The US economy has long surprised on the upside, but now, signs of a slowdown are mounting. The question of how soft or hard the landing will be is likely to be on investors‘ minds in the fourth quarter. With a stronger focus on growth than inflation, equities and government bonds are likely to show less synchronisation, and quality and growth stocks are likely to benefit.

MORE TURBULENCE

Equity markets are pricing in a very soft landing with high valuations and earnings expectations. The potential for positive surprises seems limited. Global liquidity is weakening, and energy prices, weather and China could also cause turbulence.

DELAYED RESTART

The subsequent weakening of the US economy could also delay the ensuing recovery. It is still possible, but less likely, that the markets will target a renewed upswing in 2024 on both sides of the Atlantic with a year-end rally.

Q4 | 2023

BERENBERG

PARTNERSHIP SINCE 1590

FOREWORD

Prof Dr Bernd Meyer
Chief Investment Strategist

Dear readers,
The third quarter of 2023 brought a lot of back and forth on capital markets. Significant changes occurred in commodities. Industrial metals and especially crude oil recovered markedly from the losses of the first half of the year. Stock markets moved in a volatile sideways manner after the strong first half of the year. The continued positive surprise in the US economy fuelled expectations of higher interest rates for longer. Expectations of swifter rate cuts were priced out. Bond yields, especially real yields, rose. All in all, markets now appear much more consistent than they did three months ago. In our view, they are more uniformly betting on no or a very soft landing for the US economy.

Whether this happens is likely to be the dominant theme in the fourth quarter. The impact of higher interest rates has so far been more muted than in past cycles, as the additional savings from the COVID-19 pandemic period, the record US budget deficit outside times of war and recession and the long-term, cheap corporate financing of recent years are still cushioning the impact. But these effects are not lasting. How severe the downturn will really be, will probably only be known much later and will depend on how quickly the Fed can lower interest rates again when the economy slows down. After all, the longer interest rates stay high, the more likely they are to have a stronger impact after all. A resumption of inflation – with a simultaneous economic slowdown – would probably be the worst scenario for markets.

Caution and a balanced positioning therefore remain appropriate for the time being in our view. The signs that we are late in the cycle and that the US economy is weakening are mounting. The labour market has begun to cool. Credit defaults and bankruptcies are on the rise. Recently, the stock markets have reacted positively to weaker economic data because this slows down the rise in interest rates. But this does not have to remain the case. If signs of a slowdown increase while core inflation continues to fall, as we expect, investors' focus should shift from inflation to economic growth. Markets should react more strongly to economic data, the third-quarter synchronisation of equities and government bonds should weaken and, after the underperformance of quality and growth equities in the third quarter, they could be in higher demand again.

Investor sentiment has deteriorated over the tough summer, but systematic investor positioning is still high as a sharp increase in volatility has so far failed to materialise. The markets thus remain more vulnerable to a more pronounced correction, with the month of October historically showing the highest volatility. Given the large number of risks, the upside potential for equities seems to remain limited for the time being.

In the Insights interview starting on page 14, our fund manager Felix Stern talks about the attractiveness of euro bonds with shorter maturities and what sets the Berenberg Euro Target 2028 defined term fund apart. I wish you an exciting read.

CONTENT

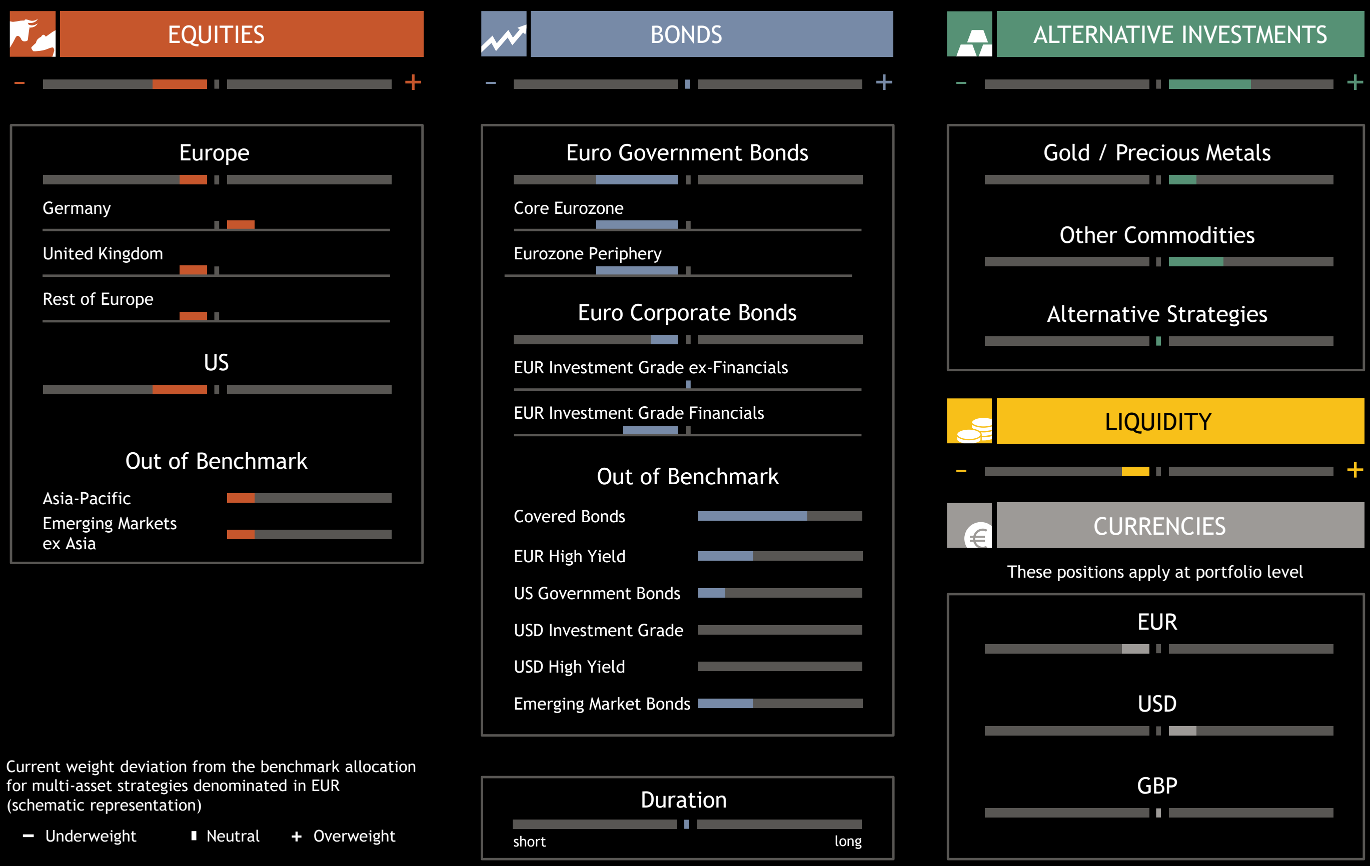
MORE VOLATILITY WITH US ECONOMIC SLOWDOWN

IN A NUTSHELL

- Robust US growth, liquidity withdrawal and strong issuance drove US real yields to their highest level since 2009. This slowed down equities and bonds at the same time. They showed strong synchronisation. Commodities recovered.
- Positive economic impulses are not likely in the fourth quarter. Despite a later and possibly only mild US weakness, its extent is likely to become the central issue.
- Bond yields are unlikely to rise much more. Commodities have less potential after the recovery, and equities seem capped for now with the risk of a more significant correction. The back and forth of recent months continues.

Portfolio positioning at a glance

We have been slightly underweight equities since the end of February and moderately underweight since the second quarter. That was too early. US equities performed positively until July. Still, at least for the last few months, the underweighting has been good. We continue to feel comfortable with this positioning. To increase the equity position, we would need either a more significant correction or a foreseeable economic upswing on both sides of the Atlantic coupled with lower inflation. We have increased the duration on the bond side to neutral in view of the economic risks and the foreseeable end of interest rate hikes. We have also exited some riskier bond positions in favour of safer ones, such as covered bonds, as risk premiums could widen again if the economy weakens. Overall, we have reduced credit risk in favour of interest rate risk. Nevertheless, emerging market bonds, especially in local currency, remain attractive. Cyclical commodities no longer have significant catch-up potential after the recent recovery. We have slightly reduced the position tactically. However, they remain strategically interesting as a diversifier in an environment of elevated inflation (volatility) and due to the structural demand from the energy transition. Gold also remains overweighted in view of the increased risks.



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

− Underweight ▮ Neutral + Overweight

Third quarter: "High(er) for longer" narrative boosted real yields and slowed down equities and government bonds

The developments from the second quarter initially continued in Q3. Thanks to a robust US economy, US equities and their valuations continued to rise, ignoring high and rising real interest rates as they have since May (top chart, p5). The picture turned in August. With the US economy still robust, oil and industrial metal prices rising again and core inflation still high, the markets priced out the expected rapid interest rate cuts by the US central bank. Nevertheless, the yield curve steepened. This is because the real yield on 10-year inflation-indexed US government securities climbed to almost 2%, the highest level since 2009, driven also by strong issuing activity (budget deficit) and the withdrawal of liquidity (QT). This weighed on equities and bonds at the same time – equities and government bonds returned to a positive correlation, equity markets lost about 5 % from the peak, higher-valued technology stocks suffered particularly and commodity prices recovered – the markets experienced a small "revival" of the developments of 2022. However, the increase in equity volatility remained limited, so that highly positioned systematic investors only sold off equities to a limited extent. There was no volatility spike that would have triggered a wave of selling by systematic investors and thus a more significant correction.

US data turns — US economy sets for landing

The economic downturn in the US has so far been a long time coming – unlike in the eurozone or China, economic data there continued to surprise on the upside in the third quarter (middle chart, p5). But in the US, too, signs of an economic slowdown are mounting. Not least, monetary policy has reached a restrictive level in recent months, with a positive real central bank rate of more than 1.5% (Fed rate of 5.25–5.50% versus consumer price inflation of 3.7% in August). The US unemployment rate has risen from a low of 3.4% in May to 3.8% in August. Even though the participation rate rose somewhat in parallel, the labour market is showing signs of cooling. Against this background, for Europe as well, no recovery is to be expected in the coming months. But after the wave of massive disappointments since spring, the negative surprises are likely to subside. Likewise, there are no clear signs of positive economic impulses from China as long as there are no stronger stimulus measures. For markets, this means that there are unlikely to be any positive signals from the economy in the fourth quarter and the question of the strength of the US slowdown is likely to be in focus.

Bonds from safe issuers could benefit

Against this backdrop, safe havens such as government bonds are likely to outperform risk assets in Q4. As long as inflation does not firm up again, which is a risk given the significant rise in commodity prices, bond yields should rise little, if at all, while the current yield is already attractive. Should the US economy weaken more markedly, safe haven bonds should benefit more significantly – this is an attractive asymmetric yield profile, especially as speculative investors have strong short positions in US Treasuries and 10-year US Treasuries have a real yield of almost 2%. However, investors from the euro area should not forget the currency risk. The US dollar remains heavily overvalued and is likely to depreciate significantly over the medium to longer term. Alternatively,

Déjà vu? Third quarter tougher, but so far without major correction in equities; oil, industrial metals and the US dollar recovered significantly

Total return	YTD and in Q3 (in %, in EUR): YTD (31/12/22-20/09/23)	Q3TD (30/06/23-20/09/23)	12-month periods of the last 5 years (in %, in EUR): 20/09/22 20/09/23	20/09/21 20/09/22	20/09/20 20/09/21	20/09/19 20/09/20	20/09/18 20/09/19	CAGR* 20/09/18 20/09/23	Std.-dev.* 20/09/18 20/09/23
S&P 500	15.8	1.0	8.0	5.5	34.9	4.9	11.3	12.4	21.7
Brent	14.5	27.6	8.8	80.3	75.7	-40.1	-8.4	13.6	40.8
DAX	13.3	-2.3	24.6	-16.3	15.4	5.2	1.1	5.1	20.8
Stoxx Europe 50	12.4	0.5	20.0	1.5	19.6	-5.5	9.9	8.6	16.9
Gold	6.3	2.8	8.5	11.0	-8.7	19.7	34.3	12.1	13.1
MSCI EM	3.5	0.5	-2.0	-9.1	17.2	3.0	7.9	3.0	17.2
EM Sovereigns	2.9	1.0	-1.3	-6.3	5.4	-3.9	20.0	2.4	8.5
EUR Corporates	2.8	0.7	2.2	-14.6	1.8	0.7	5.8	-1.1	3.8
Euro Overnight Deposit	2.0	0.7	2.3	-0.5	-0.6	-0.5	-0.4	0.1	0.1
EUR Sovereigns	1.3	-0.3	-0.9	-10.8	0.1	0.2	5.3	-1.4	3.6
USDEUR	0.4	2.3	-6.5	17.6	1.0	-6.9	6.9	2.0	7.2
US Sovereigns	-0.5	-0.2	-8.0	2.1	-1.1	1.2	17.9	2.1	7.0

Time period: 20/09/2018-20/09/2023

Source: Bloomberg * CAGR = annualised return (in %, in EUR); Std. dev. = annualised standard deviation (in %, in EUR).

hedging the currency will cost. However, the real yield on 10-year Bunds is just positive at 0.2%. High-quality covered and corporate bonds offer more yield and we prefer these in Europe. Risk premiums have generally narrowed considerably, so the risk of rising spreads exists. Shorter maturities are to be preferred here. Interest rate duration should therefore be built up via safe bonds. Overall, we prefer bonds to equities, but a strong absolute overweight does not seem obvious, also in view of the continued high interest rate volatility.

Upward breakout of equities unlikely for now

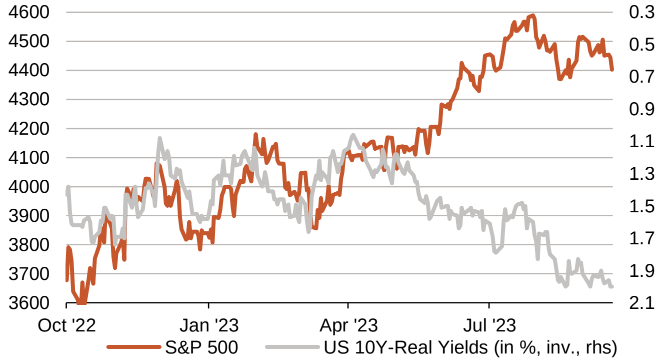
Valuations of US equities in particular are significantly elevated by historical standards – despite high bond yields. The optimistic earnings estimates for 2024, driven by a strong expected widening of profit margins, also make positive surprises difficult. Admittedly, producer price inflation is currently coming down faster than consumer price inflation, a classic margin driver. But consumers are becoming more cautious. A more pronounced economic slowdown is more likely to lead to a reduction in profit expectations. Support from equity fund inflows remains very limited and systematic, risk-based investment strategies are highly positioned in equities. This suggests a continuation of the back and forth of the last two to three months with the risk of a more significant correction should a volatility spike trigger a sell-off by systematics. It is conceivable that with the economic outlook for 2024 at the end of the year, investors' gaze will already shift to a possible global upswing in 2024 – especially if the US economy has cooled down more significantly by then and inflation is lower. In our view, however, this has become less likely.

The expected environment suggests that investors should again pay more attention to the quality of corporate earnings and structural earnings growth. This, combined with stable or falling bond yields, should allow quality and growth stocks to outperform in relative terms again in the fourth quarter (bottom chart). Without an investor focus on economic recovery, however, small caps are likely to continue to struggle for the time being despite attractive valuations.

Prof Dr Bernd Meyer, Chief Investment Strategist

Equity markets do react to high and rising real yields

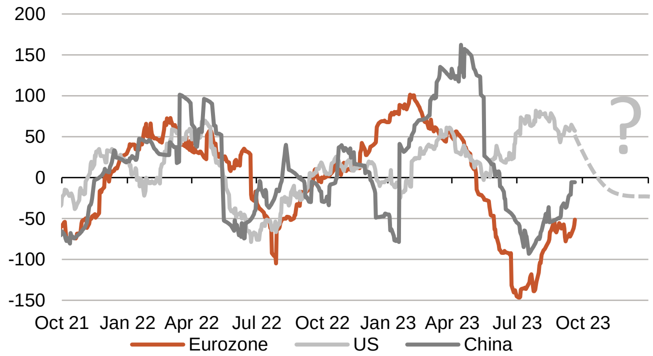
Stock markets initially continued to rise since May despite rising real yields. This was not sustainable. High real yields put the brakes on from August onwards.



Time period: 01/10/2022-20/09/2023
Source: Bloomberg, own calculations

US economy sturdier than expected in Q3. Will Q4 turn the tide?

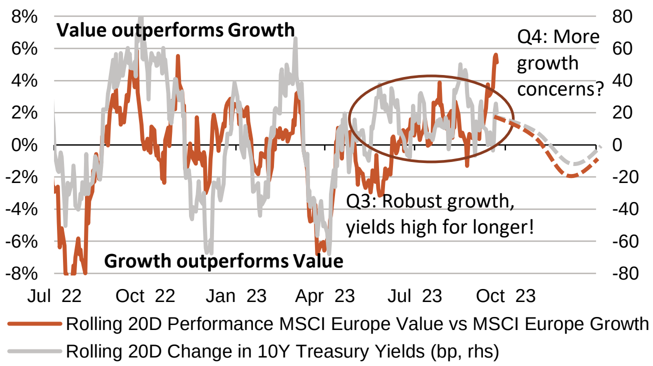
US economic data significantly exceeded the consensus, especially at the beginning of the third quarter. Data from Europe and China continued to disappoint.



Time period: 01/10/2021-20/09/2023
Source: Bloomberg, own calculations

Potential growth revival in Q4 after value outperformance in Q3

Relative development of value stocks compared to growth stocks in Europe and development of yields on American government bonds.



Time period: 01/07/2022-20/09/2023
Source: Bloomberg, own calculations

INVENTORY CORRECTION WEIGHS ON GLOBAL ECONOMY

IN A NUTSHELL

- The global economy is losing considerable momentum.
- US: soft landing ahead, new momentum in mid-2024.
- Europe: stagflation until spring 2024.
- Inflationary pressure continues to decline – but not to 2%.
- Central banks: The end of the interest rate cycle has been reached.

A divided economy

In large parts of the world, the wind is blowing in the manufacturing sector's face. Because consumers had to forgo services more than goods during the pandemic, they now have more pent-up demand for travel, dining out and other services than for goods. The result is an unusual gap between robust demand for services and pronounced weakness in manufacturing. In addition, many companies around the world had used the end of the pronounced supply chain bottlenecks in late 2022 and early 2023 to build up inventories of inputs and finished goods. Faced with weakening demand from the US, China and Europe, they are now reducing their inventories again. So, for the time being, they are producing less than they are selling.

Yet it often takes only two to three quarters for these companies to sufficiently clear their inventories. We expect the manufacturing sector to bottom out by the end of 2023 and a new upswing to start shortly thereafter.

Soft landing in the US

Despite the Fed's forceful reversal of interest rates, the US economy continues to hold up better than expected. Housing construction, which is particularly sensitive to interest rates, seems to be slowly stabilising after a 23% slump compared to the beginning of 2021. The labour market is losing more and more momentum. As a result, private consumer wage growth is also declining. But thanks to a sharp drop in inflation, consumers' purchasing power, which is derived from their disposable incomes after deducting inflation, is rising. This supports private consumption.

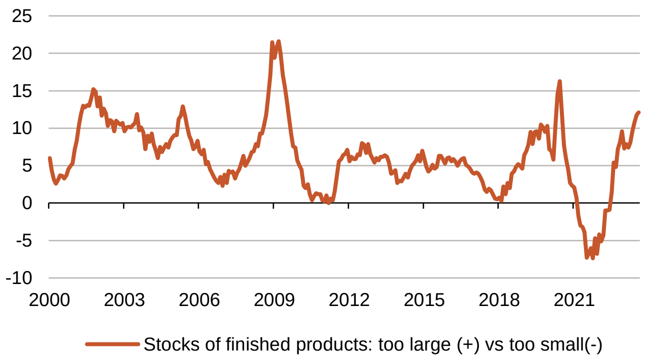
Instead of a mini-recession at the turn of the year, we now expect a soft landing for the US, ie a phase of weak growth far below the trend rate of just under 2%, but no longer a decline in economic output. The global weakness in manufacturing affects the US less than Europe. From mid-2024, a less tight interest rate policy should strengthen the economic upward forces. In view of structurally high demand for housing, residential construction is also likely to pick up again from spring 2024. Fiscal policy is also contributing to the growth in demand. We therefore expect the US economy to reach an annualised growth rate of 2% again in mid-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 inflation on the decline, a stable labour market and higher wage increases,

Inventory correction in the euro area

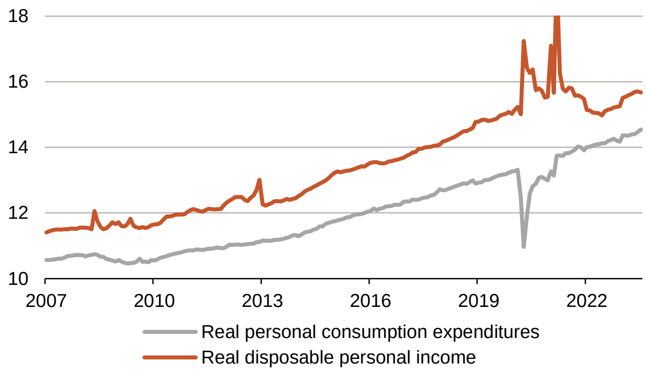
Too much or too little in stock? Balance of answers in percentage points



Survey of euro area industry; "We assess our stocks of unsold finished goods as ...", balance of responses in ppt, + means "too large", - "too small"; seasonally adjusted monthly data.
Time period: 01/01/2000-05/09/2023. Source: European Commission

US households: real disposable income and consumption

Trillion USD, in 2012 prices



Seasonally adjusted annualised monthly data.
Time period: 01/01/2007-05/09/2023. Source: BEA

consumer incomes have been rising more strongly than prices since the second quarter. In real terms – ie after deducting inflation – consumers have more money in their pockets again. This has already been reflected in lively travel activity in the summer. On the other hand, the manufacturing sector is in recession. The weak world demand for goods as well as the inventory correction is hitting countries that specialise in exporting goods, like Germany, particularly hard. After stagnating in the summer, economic output in the eurozone is expected to decline somewhat in the final quarter.

Europe: Tailwind from home – headwind from overseas

Nevertheless, there are signs of a new upswing in the coming year. We expect the inventory correction in the manufacturing sector to come to an end by the end of 2023. Many companies are currently holding back on investments in view of the great uncertainties. As soon as the economy regains some momentum, they will spend more next year to restructure supply chains and replace scarce labour. Although China will remain structurally weak, exports to China are likely to pick up slightly next year. Finally, China should grow at around 3-4% in 2024. Then, by mid-2024 at the latest, with the US economy returning to normal growth, the economy in Europe could also regain the momentum of the period before the Russian attack on Ukraine began. For the UK, we expect a similar course as for the eurozone.

Inflation continues to decline

Price pressures continue to ease on both sides of the Atlantic, faster in the US than in Europe. As the US labour market continues to lose momentum, wage pressures there are slowly decreasing. By contrast, wages in the eurozone are likely to rise by at least 5% in 2023, before wage growth then falls back to around 4% in the course of 2024. In the US and Europe, inflation rates will tend to fall further. The somewhat higher oil prices interrupt this only briefly. The peak of food price inflation has passed. As transport costs have fallen, price pressures in this area will also ease with weak demand for goods. However, higher wage growth in Europe will continue to push up prices for wage-intensive services, so that inflation in Europe is likely to settle at around 2.5% from Q4 2024 instead of the around 1.5% in the years before the pandemic. For the US, we also expect inflation rates close to 2.5% for 2024 and 2025.

Central banks - interest rate peak (almost) reached

The less robust labour market in the US and the weaker economy will presumably prevent the US Fed and the ECB from further (noticeably) raising their already high key interest rates. As soon as the phase of economic weakness has sufficiently dampened inflationary pressure, the Fed will then lower interest rates again somewhat from spring 2024, while the ECB will probably not ease its interest rate policy in the coming year in view of inflation remaining above 2%.

Dr Holger Schmieding, Chief Economist

Growth and inflation forecasts

	GDP growth (in %)						Inflation (in %)					
	2023		2024		2025		2023		2024		2025	
		∅**		∅**		∅**		∅**		∅**		∅**
USA	2.1	2.0	1.2	0.5	1.7	2.2	4.1	4.1	2.7	2.6	2.3	2.3
Eurozone	0.4	0.5	0.8	0.8	1.7	1.5	5.6	5.6	3.0	2.7	2.3	2.1
Germany	-0.5	-0.3	0.6	0.6	1.6	1.5	6.2	6.1	2.8	2.9	2.2	2.1
France	0.7	0.8	1.1	0.9	1.7	1.4	6.0	5.7	3.7	2.7	2.5	2.1
Italy	0.7	0.8	0.5	0.6	1.2	1.2	6.2	6.2	2.5	2.4	2.2	1.9
Spain	2.2	2.2	1.4	1.5	2.1	2.0	3.7	3.5	3.3	2.8	2.3	1.9
UK	0.3	0.4	0.8	0.5	1.7	1.5	7.4	7.5	2.7	3.1	2.0	2.1
Japan	1.8	1.8	1.0	1.0	1.1	1.0	3.1	3.1	2.0	1.9	1.5	1.4
China	4.7	5.1	3.8	4.5	3.6	4.5	0.5	0.6	2.0	1.9	2.2	2.0
World*	2.3	-	2.2	-	2.4	-	-	-	-	-	-	-

* 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 22/09/2023

INCREASED RISK OF A MODERATE SETBACK

IN A NUTSHELL

- Warning leading indicators, rising interest rates, a strengthening US dollar and the oil price recovery should put pressure on optimistic consensus earnings estimates.
- The increasing withdrawal of liquidity is likely to put a cap on valuations in the coming months.
- After the sideways market in Q3, we see an increased risk of a setback. However, the downside potential should be limited as many investors are already cautious.

Equity rally did not continue in Q3

The third quarter has shown that the upside potential for equities is currently limited. This is mainly because a lot of positives have already been priced in and many investors have been forced into the market after the strong H1 equity market performance, so there have been fewer and fewer incremental buyers. The negative economic surprises in China and Europe led to an underperformance of local equity markets. US equities held up marginally better thanks to AI enthusiasm and a robust US economy to date – in euro terms, they also benefited from the USD appreciation in Q3.

Unrealistic profit expectations for 2024

During the Q2 reporting season, many US retailers gave a negative outlook. US consumer sentiment is beginning to dim. The resumption of student loan payments in October, the beginning of a slowdown in the labour market and the erosion of excess pandemic savings pose significant downside risks to consumers later this year and are likely to weigh on private consumption. However, this does not yet seem to have reached analysts' earnings estimates. The consensus expects earnings growth of just under 10% for the developed markets in 2024, driven primarily by an expansion of profit margins in the US. For the emerging markets, the consensus expects an even stronger recovery in 2024 after a profit recession this year. However, still elevated wage inflation and rising corporate funding costs, together with arguably declining pricing power due to disinflation and the absence of a strong China recovery to date, are likely to limit earnings growth – especially for a large share of cyclical companies as well as small caps. It is likely to be difficult for companies to outperform the optimistic forecasts in 2024.

US equities almost priced for perfection

Despite higher real interest rates and liquidity withdrawal, US equity valuations have widened this year. The forward P/E ratio for the S&P 500 has risen from 17 to over 20 since the beginning of the year, with higher 10Y Treasury yields. As a result, US equities are now again expensively priced relative to their own history. Other segments such as European equities and small caps are relatively cheaply priced compared to their own history. There are several reasons for the increased valuation discrepancy between the US and the rest of the world.

For example, US companies are likely to be the main beneficiaries of AI. Many valuation-insensitive strategies, such as systematic strategies, 401k plans, option investors and share buyback programmes, are also mainly in US equities, partly because the US has

Equity markets treaded water in the third quarter - US equities benefited from USD appreciation

Total return	YTD and in Q3 (in %, in EUR): YTD (31/12/22-20/09/23)	Q3TD (30/06/23-20/09/23)	12-month periods of the last 5 years (in %, in EUR): 20/09/22 20/09/23	20/09/21 20/09/22	20/09/20 20/09/21	20/09/19 20/09/20	20/09/18 20/09/19	P/B* 20/09/23	Div.* 20/09/23	P/E* 20/09/23
MSCI EM Eastern Europe	18.5	-3.1	36.0	-83.7	44.5	-21.6	25.0	1.0	6.0	7.1
S&P 500	15.8	1.0	8.0	5.5	34.9	4.9	11.3	3.9	1.6	20.3
Euro Stoxx 50	15.3	-2.6	26.5	-12.0	25.4	-6.1	7.9	1.8	3.6	12.1
MSCI Japan	15.3	4.3	14.8	-15.6	27.1	-0.3	4.2	1.4	2.3	16.0
DAX	13.3	-2.3	24.6	-16.3	15.4	5.2	1.1	1.4	3.5	11.4
Stoxx Europe 50	12.4	0.5	20.0	1.5	19.6	-5.5	9.9	2.3	3.5	13.5
Stoxx Europe Cyclicals	11.6	-0.2	20.1	-14.6	33.3	-4.2	-1.4			
Stoxx Europe Defensives	11.6	4.7	16.7	3.0	15.2	-4.1	11.6			
MSCI UK	9.4	3.2	12.6	9.0	27.2	-20.2	4.7	1.7	4.2	10.8
Stoxx Europe Small 200	5.5	-0.2	11.8	-26.2	34.2	1.1	1.6	1.4	3.3	14.0
MSCI USA Small Caps	5.2	-1.7	-1.6	0.6	47.9	-8.4	1.7	1.7	1.7	21.0
MSCI EM Asia	2.4	0.4	-2.8	-10.6	14.1	12.6	5.4	1.5	2.4	14.8

Time period: 20/09/2018-20/09/2023
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 largest and most liquid market in the world. However, the triple burden of the recent dollar appreciation, higher interest rates and oil prices is likely to have an increasing impact on the US, especially since the ongoing withdrawal of liquidity is not conducive to valuations either.

Increased risk of setbacks in the coming months

The still-low market breadth does not signal a high level of investor conviction and, along with restrictive central bank policies and negative leading economic indicators, continues to call for caution. Within the equity regions, China and Europe could surprise most positively. Both regions have already priced in a lot of negativity. However, if, contrary to expectations, China was to recover more strongly, this would catch many investors on the wrong foot. The strong outperformance of US equities over European equities since Q2 2023 could at least pause. Recent economic data in Europe has surprised more negatively than in the US, and this could reverse – not least because Europe faces fewer headwinds from the currency and higher interest rates. Overall, we see both upside (fundamental) and downside (many discretionary investors expect a setback) potential for equities as limited. A moderate setback followed by a volatile sideways movement seems most likely to us.

Ulrich Urbahn, Head of Multi Asset Strategy & Research

WHAT IS ON COMPANIES' MINDS?

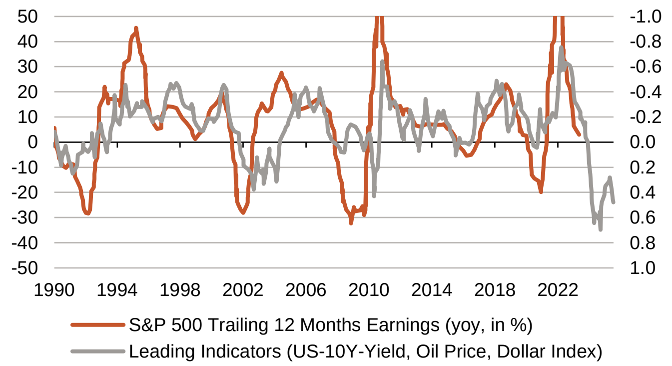
Gloomy sentiment

In our discussions with companies, business leaders are currently more cautious and expect a slowdown in H2. While this weakness in the construction sector was already evident in many companies in the last quarters, it was more broadly visible in the past quarter. A slowdown is also emerging in the automotive industry. Car suppliers are reporting lower call-offs and the Chinese market is recovering more weakly than expected, leading to further price pressure, especially for electric vehicles. Increased price pressure has also been a topic in the payments industry recently and can ultimately be attributed to increased cost sensitivity on the part of customers. The pharmaceutical industry, on the other hand, has seen positive developments in anti-obesity drugs. The SELECT study by Novo Nordisk shows success in weight reduction and heart disease prevention. In other areas, too, the pharmaceutical companies are extremely optimistic with an innovative product pipeline. In the field of renewable energies, project developers report difficulties that can be attributed to the increased refinancing and manufacturing costs. Overall, it can be said that although the increased interest rate level is leaving its mark everywhere, the well-positioned companies are doing much better.

Matthias Born, CIO Equitites

Macro headwinds for (US) corporate earnings

Development of US corporate profits versus macro model estimate for profits, which uses interest rates, oil prices and the dollar as input variables



Time period: 01/01/1990-31/08/2023
Source: TheFelderReport.com, Berenberg

Forecast overview: limited upside potential

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

	Current			∅*
Index forecasts	**22/09/2023**	**30/06/2024**	**31/12/2024**	**In 12 months**
S&P 500	4,320	4,600	4,750	5,130
DAX	15,557	17,300	18,000	19,514
Euro Stoxx 50	4,207	4,700	4,800	5,071
MSCI UK	2,199	2,350	2,400	2,575
Index potential (in %)				
S&P 500	-	6.5	10.0	18.8
DAX	-	11.2	15.7	25.4
Euro Stoxx 50	-	11.7	14.1	20.5
MSCI UK	-	6.8	9.1	17.1

* Average, consensus bottom-up as of 22/09/2023
Source: Bloomberg, Factset, Berenberg

A DIFFERENTIATING LOOK IS WORTHWHILE

IN A NUTSHELL

- High-rated government bonds promise positive returns, in local currencies especially in the Anglo-Saxon region.
- We like European corporate bonds defensively; at the short end, secure covered bonds offer similar yields.
- In emerging markets, we favour the local currency segment and see corporate bonds in the lead.

Still good opportunities in an exciting environment

The lowering of the US credit rating from AAA to AA+ by the rating agency Fitch had a knock-on effect on the bond market at the beginning of August. Since Standard & Poor's has been awarding this (second-best) rating since 2011, the US Treasury is now only awarded the highest credit rating by Moody's among the major agencies. In addition, fears of recession and inflation continue to be important topics, although no clear signals have yet emerged in either area. Global key interest rate prospects and adequate yield levels, on the other hand, generally give reason for confidence.

Safe government bonds: Look ahead — land in sight

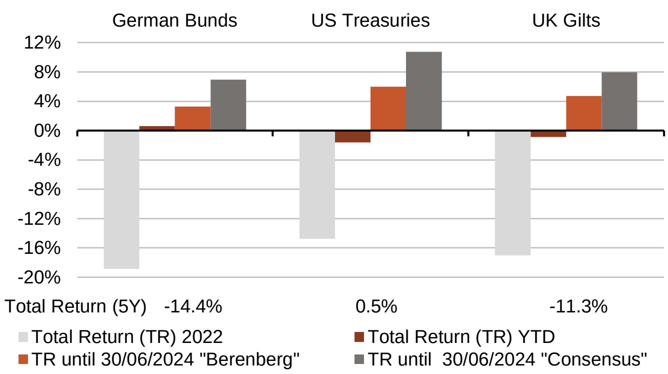
Yields of sovereigns with strong credit ratings rose for a long time in the third quarter as well, with UK gilts in the 10-year segment developing positively in contrast to German and US securities. Since the beginning of the year, however, they have performed the weakest in a comparison of the three currency areas (see figure below left). The European Central Bank raised its key interest rate by a total of 50 basis points in July and September, the US Fed in July and the Bank of England in August by 25 basis points each. In the US and the euro area, the phase of interest rate hikes is thus likely to be behind us. Our economists expect the BoE to leave the key interest rate at 5.25% until a first cut in Q2 2024. In the coming year, all three central banks are likely to turn the interest rate screw in the opposite direction. For 2024, the combination of expected yield movements and current interest offers an overall positive return perspective. Despite the higher supply of US Treasuries, US and UK government bonds were ahead of German Bunds in local currency until the middle of the year.

Corporate bonds: It doesn't always have to be full throttle

Who would have thought? Despite the threat of recession and persistently high inflation, the riskier European high-yield bonds (+6.6%) have clearly outperformed investment grade paper (+2.7%) so far this year. However, a look at the valuation shows that the risk premiums in the high-yield segment still seem just about fair in a long-term comparison. In the event of a recession, they would even be considered very ambitious. In contrast, the risk premiums in the investment grade segment are more attractive. With average yields of around 4.4%, we continue to prefer this more defensive variant of corporate bonds. Here, the vast majority of issuers continue to convince with solid balance sheets and generous liquidity reserves. In terms of sector selection, we concentrate on defensive industries and avoid cyclical ones such as chemicals. Financial bonds were able to noticeably reduce the underperformance they had built up since March compared to non-financial bonds. This positive trend as well as continued very robust

Safe sovereign bonds consistently with positive earnings prospects

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



Time period: 22/09/2018-22/09/2023
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 mid-year 2024 and year-end 2024

	22/09/2023	30/06/2024		31/12/2024	
	Current		∅*		∅*
USA					
Key interest rate	5.25-5.50	5.00-5.25	5.05	4.25-4.50	4.30
10Y US yield	4.44	4.30	3.66	4.30	3.57
Eurozone					
Key interest rate	4.50	4.25	4.15	4.00	3.60
10Y Bund yield	2.74	2.80	2.35	2.90	2.31
Great Britain					
Key interest rate	5.25	5.00	5.35	4.00	4.65
10Y Gilts yield	4.24	4.30	3.87	4.20	3.67

* Average, consensus as of 22/09/2023
Source: Bloomberg

quarterly results confirm our overweight in European banks and insurance companies. As long as interest rate volatility remains at high levels, we prefer short-dated bonds between one and three years. At the short end, AAA-rated covered bonds offer almost the same yields as lower AA-rated corporate bonds (see chart below left). Here it makes sense to take risk out of the portfolio and add collateralised Pfandbriefe instead.

Emerging markets: Tailwind for corporate bonds

Although risk premiums on emerging market government and corporate bonds in hard currencies have widened somewhat recently, they are still near their lows for the year (see chart below right). Currently, the total return on hard currency bonds is more influenced by the volatility of US yields than by changes in risk premiums. We expect activity in the primary markets for government securities to increase. The focus is likely to be on investment grade countries, as yields on lower quality issuers remain high. On the corporate side, we continue to see limited new supply, with 2023 recording the lowest level of monthly issuance compared to the past decade. This should give corporate bonds a tailwind over government bonds. Inflation rates are likely to have peaked in many emerging markets, which has priced in impending monetary easing and positive performance from interest rate duration in the local currency segment. Although the spread between local and US interest rates is expected to narrow further, emerging market bonds should withstand this factor as well as the recent appreciation of the US dollar. We prefer local currency securities to their hard currency counterparts and expect Latin America to outperform Asia, Eastern Europe, Africa and the Middle East at the regional level. In terms of credit quality, we consider the investment grade segment more attractive compared to high yield and accordingly prefer a more defensive positioning.

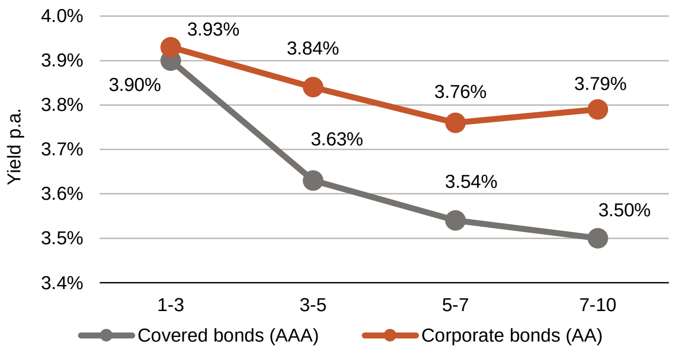
Conclusion: Bonds continue to offer good opportunities

We also see interesting opportunities for the coming months in all the bond segments discussed. However, a distinction must be made. Safe government bonds are particularly attractive in the respective local currencies outside the euro area, and in European corporate bonds we focus on defensive versus cyclical sectors and on good credit ratings as well as short maturities, whereby the addition of covered bonds is recommended. We also prefer the investment grade segment in emerging markets, where local currency bonds and the corporate segment are to be preferred over the government segment. A closer look within the bond classes is worthwhile.

Martin Mayer, Senior Portfolio Manager Multi Asset
Christian Bettinger, Head Fixed Income Euro
Zinzile Dube, Portfolio Manager Fixed Income EM

Covered and corporate bonds almost equally yielding

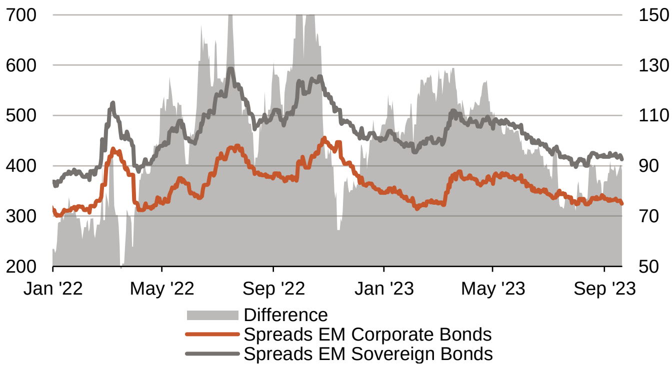
On the euro curve, covered bonds in the short maturity segment yield almost as much as corporate bonds with a better rating



Time of observation: 20/09/2023, AAA/AA = average ratings in the respective segment
Source: Bloomberg, own calculations

In emerging markets, we prefer corporate bonds

The risk premiums (spreads) of government bonds have narrowed compared to those of corporate bonds since the spring - we prefer the latter



Time priod: 01/01/2022-20/09/2023, left scale: spreads (in basis points), right scale: spread difference (in basis points). Source: Bloomberg, own calculations

COMMODITIES ARE – AND REMAIN – CYCLICAL

Oil price recovery here at last! It gets more difficult from here

After the disappointing first half of the year, oil had a brilliant start to the third quarter. Thanks to the special OPEC+ cuts, rising demand in China, a strong travel season and extremely pessimistic investor positioning, Brent gained more than 25% and is thus clearly in positive territory since the beginning of the year. Although the fundamental starting position is good, it is difficult to find further incrementally positive drivers. On the demand side, the weak autumn seasonality is starting in the West and much of the catch-up effects have materialised in China. On the supply side, OPEC+ has extended its special cuts until the end of the year, but further tightening seems unlikely. At the same time, exports from Iran are rising despite US sanctions, and if Iraq settles its dispute with Turkey over Kurdish oil exports, these should also rise. Overall, the upside potential from this seems more limited, although the current supply deficit and low inventories clearly limit downside risks.

Gold's shine depends on central banks

Gold climbed towards USD1,980 an ounce at the start of the third quarter on hopes of an end to Fed rate hikes. Cooler June inflation data and the fall of the US dollar to a 15-month low helped the rally. However, the turnaround came in mid-July, and in August gold fell below 1,900 for the first time since March this year, driven by rising real interest rates – the 10Y TIPS rose to 2% for the first time since 2009 – and a resurgent US dollar. Looking ahead, a sustainable upward trend depends largely on the decisions of the central banks. In the event of an interest rate pause, the fundamental upside potential is likely to remain limited for the time being. However, in view of the already reduced positioning of ETF and futures investors and the massive gold purchases by central banks of various emerging markets in the course of the dedollarisation, gold does not seem susceptible to major setbacks.

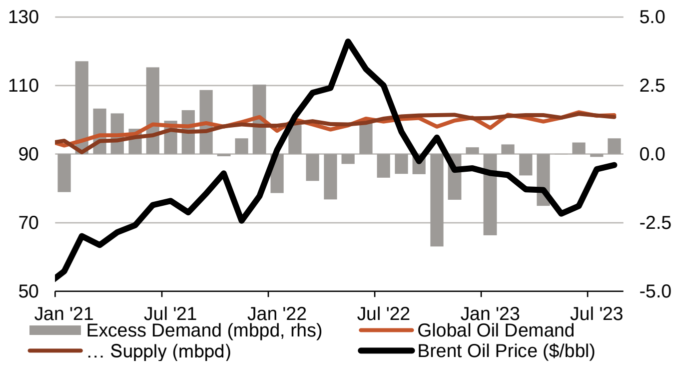
Fundamental upside potential for metals intact in the long term

With a gain of 1.3%, the industrial metals complex is almost unchanged since the beginning of the third quarter. The question of economic robustness in the West, but above all the uncertainty about the Chinese economic recovery, caused the metal markets to fluctuate sideways between hope and disappointment. 'All Quiet on the Eastern Front' still applies: major Chinese economic stimuli are still missing. In the short term, China's weakness remains a thorn in the flesh, but in the long term the decarbonisation trend with low inventories offers fundamental upside potential.

Philina Kuhzarani, Analyst Multi Asset Strategy & Research

Oil finally recovers thanks to supply shortage

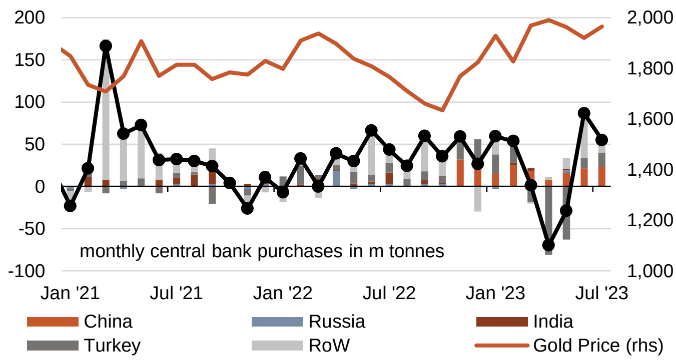
Oil price development versus global demand overhang



Time period: 01/01/2021-31/08/2023
Source: Bloomberg, EIA, own calculations

Gold: Central banks buy gold countercyclically

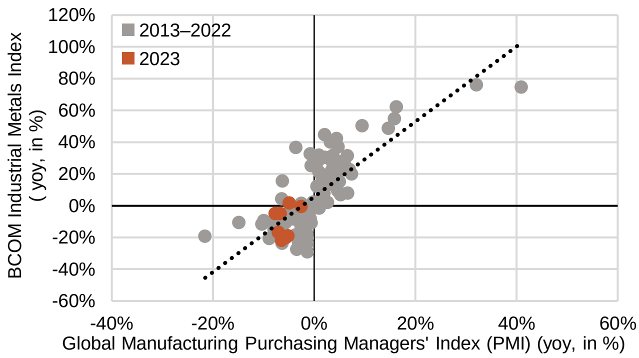
Monthly gold central bank purchases, in million tons



Time period: 01/01/2021 - 31/07/2023
Source: Bloomberg, own calculations

Metals: Weakening industry puts industrial metals under pressure

Change in the BCOM Industrial Metals Index versus the change in the Global Purchasing Managers' Index for industry, year-on-year, in %.



Time period: 01/01/2017-31/08/2023
Source: Bloomberg, own calculations

EURO/US DOLLAR: TAILWIND FOR THE US DOLLAR

Monetary policy outlook strengthens the US dollar

After a positive outlier to over 1.12 US dollars per euro in July, the euro subsequently came under pressure and fell to below 1.07 by mid-September. The main reason for this euro weakness is a reassessment of the economic situation on both sides of the Atlantic and the resulting change in the monetary policy outlook. The economy in the eurozone is developing sluggishly. Germany, the largest economy in the eurozone, is proving to be a brake. In view of the weak economy, the pressure on the European Central Bank (ECB) to tighten the key interest rate even further is decreasing. The September rate hike is likely to mark the end of the rate hike cycle. In contrast, the US economy is proving to be surprisingly robust despite the strong tightening of monetary policy. The widely feared recession is unlikely to materialise. A soft landing is now likely. This in turn reduces the likelihood of significant interest rate cuts by the Fed in the coming year, which would have been likely in the event of a more severe recession to stimulate the economy. Even a further interest rate hike is not completely ruled out. The bottom line is that in recent weeks the currency market has priced in that the ECB will tighten less and the Fed will ease less next year. The US interest rate advantage would thus not dwindle so quickly.

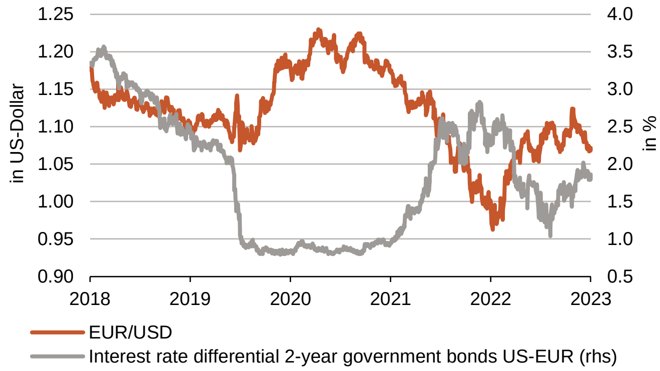
For the time being, the economic framework conditions do not speak in favour of the euro. However, if market players turn their attention to the possible economic revival in the eurozone in the spring towards the end of the year, sentiment could turn in favour of the euro again. In this case, the exchange rate could be somewhat higher again at the turn of the year.

The euro remains on the defensive against the Swiss franc. Since March, the euro has been trading consistently below parity. At around 0.96 francs per euro, the gap to parity is now considerable. Besides being a safe haven, the franc benefits from the policy of the Swiss National Bank (SNB). It has committed itself to a policy of a strong franc in order to fight inflation – with success: since June, Switzerland's inflation rate has been below the 2% mark again. In this respect, it is questionable how long the SNB will stick to its policy of a very strong franc. As a result, the euro could gain at least slightly against the franc next year.

Dr Jörn Quitzau, Senior Economist

EUR/USD: Interest rate differential speaks for the US currency

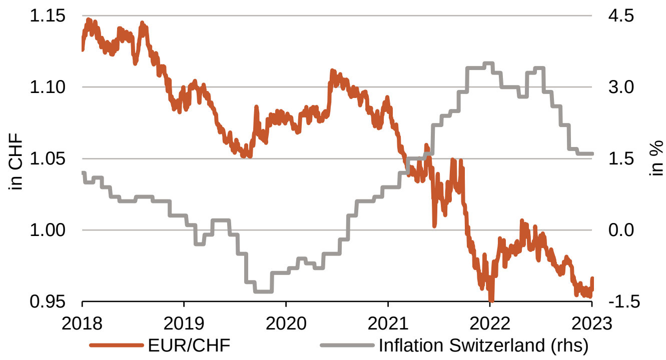
The US dollar benefits from higher interest rates. The current monetary policy outlook argues for a continued interest rate head start



Time period: 20/09/2018-20/09/2023
EUR in US dollars; interest rate differential in %. Source: Macrobond

EUR/CHF: Strong franc dampens inflation

The Swiss National Bank has been pursuing a strong franc policy for months. The strong currency dampens the inflation rate



Time period: 20/09/2018-20/09/2023
Euro in Swiss francs; inflation in %. Source: Macrobond

Exchange rate forecasts

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

	22.09.2022	30/06/2024		31/12/2024	
Exchange rate forecast	**Current**		∅*		∅*
EUR/USD	1.07	1.12	1.12	1.15	1.14
EUR/GBP	0.87	0.86	0.87	0.85	0.87
EUR/CHF	0.97	0.98	0.98	0.98	1.00
EUR/JPY	158	159	150	161	146
Change against the euro (in %)					
USD	-	-4.9	-4.9	-7.4	-6.6
GBP	-	1.1	0.0	2.3	0.0
CHF	-	-1.4	-1.4	-1.4	-3.4
JPY	-	-0.7	5.3	-1.9	8.2

* Average, consensus as of 22/09/2023
Source: Bloomberg

INTERVIEW WITH FELIX STERN

Mr Stern, you have been a portfolio manager for more than 23 years, focusing on government and corporate bonds and short-term bonds in the euro area. What fascinates you about your work?

The complex and multi-layered nature of bond markets fascinates me. In addition, the number of factors to be considered in bond management is more complex compared to other asset classes. For example, topics such as the overarching credit rating, sector and maturity structure, and country and currency risks have to be considered against the background of expected economic and political developments and under the influence of central banks. Once the basic strategic framework is in place, the issuers and their creditworthiness must be analysed and the appropriate bonds added to the portfolio.

What does your day-to-day work look like in concrete terms?

We continuously monitor and evaluate the current news situation and developments in the European and US bond markets as well as the issuers in our investment universe. Based on our risk systems, we determine whether there is a need for action with individual issuers or in the overarching maturity and credit rating management. Then we take a look at the new issue business. They often offer a premium over outstanding bonds of the same issuer or other issuers in the same industry with similar credit ratings. The rest of the day is dominated by analytical topics, such as credit assessment through dialogue with issuers. We also focus on the appropriate tactical and strategic direction and how we can best implement it in our client mandates, taking into account individual requirements. In addition, we are constantly developing our investment processes and analysis tools and regularly attend client meetings.

Interest rates are back, and bonds are in the focus again. What can you earn with shorter-dated euro bonds at the moment, and where are the risks? And what does the inverse yield curve mean for investors?

In the euro bond segment, we currently have a special situation in which short-dated bonds have a significantly higher yield than their long-dated counterparts. While the short end is essentially shaped by current inflation and central bank policy, the long end is rather dominated by long-term inflation expectations. A similarly

pronounced inversion of the yield curve was last observed after the German reunification.

Investors who prefer a rather short-term interest rate risk are therefore benefiting from the current situation. Depending on the risk premium and the bond sector, yields of between 3-5% percent can be achieved with a good credit rating, ie in the investment grade sector. However, the real interest rate is currently still negative. In addition, there is a risk that if the yield curve normalises and key interest rates fall, reinvestment could be at significantly lower interest rates.

Investors who currently opt for a longer-term alternative on the bond market are also currently exposed to negative real interest rates. Over the investment horizon, however, the chance of a positive real return increases. In the medium term, a level of inflation is again emerging that is below the yields currently achievable on the bond market. Moreover, the question of reinvestment will only arise in a few years. Until then, investors benefit from a currently attractive entry yield and possible higher price gains on their bond investment in the event of future yield declines.

How do the funds you manage differ from one another? What do you specifically look for when selecting bonds?

The funds we manage differ in their investment horizon. The **Berenberg Euro Floating Rate SGB**, for example, covers an investment horizon of three to twelve months. It focuses on bonds whose interest rates are largely dependent on the development of money market interest rates. The **Berenberg Euro Enhanced Liquidity** is suitable for investors with a short- to medium-term investment horizon. It has a higher expected value than fixed-term deposits and participates in the development of credit risk premiums and short-term capital market interest rates. In addition, we actively manage the duration. Our most recent product is the **Berenberg Euro Target 2028**, which was launched in 2023. The fund is a classic defined term fund with a final maturity in mid-2028. The investment horizon is five years.

The target return of the new Berenberg Euro Target 2028 defined term fund is between 4.5-5% percent before costs per year. What distinguishes a defined term fund?

Defined term funds are a good solution for investors who want to combine the payoff profile of a bond with the advantages of a broadly diversified portfolio investment. They are structured in such a way that all bonds have a final maturity within a predefined maturity – for example in 2028. The bonds are generally intended to be held until final maturity and the portfolio turnover is kept low. At the end of the maturity, the bonds are redeemed together with the final coupon payments. Investors with smaller investment amounts thus get a broadly diversified portfolio and for institutional investors the accounting effort is noticeably reduced compared to individual investments.

What are the special features of the Berenberg Euro Target 2028 Fund?

The Berenberg Euro Target 2028 offers investors the opportunity to secure the current interest rate and spread environment in the medium term and to preserve the chance of a positive real return for the next five years. It is broadly diversified, plannable and clearly structured. In the fund portfolio, we focus on euro-denominated corporate and financial bonds with a maturity until the end of 2028 and invest predominantly in investment-grade bonds. We deliberately avoid subordinated bonds, bonds with maturities beyond 2028 and foreign currency bonds. In addition, our investors can benefit from ongoing monitoring of the new issue markets during the term. We identify attractively valued new issues with a final maturity in 2028 and include them in the fund. As a rule, the bonds in the fund are to be held until final maturity. However, the fundamental situation of individual issuers and bonds may deteriorate in the meantime. In this respect, it is important to recognise these at an early stage and to act decisively. The central element of the Berenberg Euro Target 2028 is therefore our risk management.

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

The current cycle of rate hikes in Europe is coming to an end, and growth concerns may increasingly become the focus of the ECB. We are probably also close to the highs in yields in this cycle, and it is not unlikely that yields could fall again in the coming quarters. Credit spreads remain attractively priced and are already pricing in an economic slowdown to some extent. The combination of both factors, ie attractive credit risk premiums plus high risk-free interest rates, shows that it is exciting to consider investing in the bond sector right now.

SHORT VITA

Felix Stern started in portfolio management at Berenberg over 23 years ago. Today, Mr Stern is Senior FI PM and is responsible for balanced euro bond strategies with a special focus on short and medium maturities. As a specialist for defensive bond sectors as well as short-dated bond concepts, he is now responsible for special and public funds from Berenberg. The trained industrial clerk completed his German Diploma in business economics from the Fernuniversität in Hagen while working and also acquired a degree as CCrA - Certified Credit Analyst (DFVA).

PUBLISHING INFORMATION

PUBLISHER

Prof Dr Bernd Meyer | Chief Investment Strategist

AUTHORS

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

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

Zinzile Dube | Portfolio Manager Fixed Income EM
manages mutual funds and strategies focused on EM hard currency and local currency bonds

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

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

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

IMPORTANT NOTICES

Date: 25 September 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