HORIZON

The Berenberg Capital Market Outlook · Wealth and Asset Management

2024 STARTS POSITIVELY

Equity markets have moved on from the recession versus soft landing debate and are already pricing in a very favourable long-term outlook for the economy and corporate earnings. For further upside, equities need higher earnings.

RATE CUTS DESPITE ECONOMIC RECOVERY

With a global economic recovery on the horizon and the first interest rate cuts in the second quarter, long-term bond yields are unlikely to fall much, yield curves will steepen, market breadth will increase, and small caps and commodity prices will recover.

MAINTAINING BALANCE

The risks to this favourable scenario are manifold: stubborn inflation, geopolitics, too optimistic sentiment, high investor positioning and the US elections. A balanced positioning after the strong start to the year is therefore advisable.

Q2 2024

BERENBERG
PARTNERSHIP SINCE 1590

FOREWORD

Prof Dr Bernd Meyer
Chief Investment Strategist

Dear readers,
Equity markets have had a surprisingly positive start to the year. After a bumpy first two to three weeks with losses of up to two percent, despite rising bond yields and diminishing expectations of interest rate cuts, there were strong price gains – remarkably driven by higher equity valuations. The robust US economy and positive fourth-quarter earnings reports in the US provided support. The results from major technology stocks have rekindled the AI euphoria. Equity markets thus appear to have moved on from the recession versus soft landing debate and are already pricing in a very favourable long-term economic and earnings outlook. This is the only way to reconcile the simultaneous rise in real yields and equity valuations. However, market breadth remains low.

How likely is this positive outlook? The risk of a hard landing for the US economy has diminished in the short term. The initially unlikely scenario that inflation can be brought down without triggering a recession is looking increasingly likely. There have been recent positive economic surprises in the US, the eurozone, Japan and China. Our economists are cautiously optimistic that the global economy will recover beginning in the second quarter. In addition, market expectations for interest rates and inflation have now become much more realistic. For 2024, only half as many rate cuts by the Fed and the ECB are priced in now than at the beginning of the year. We believe that the scope for longer-term rate cuts is limited given the structural drivers of inflation, but we expect the Fed and the ECB to cut rates towards the end of the second quarter. If this happens against the backdrop of a recovering economy, long-term bond yields are unlikely to fall much and yield curves will steepen again. A further sharp rise in valuations, especially for US equities, is then unlikely. Equity markets will therefore need higher earnings to realise further potential. If the global economy recovers and interest rates start to fall, market breadth should increase and (especially European) small caps and commodity prices should recover. Read the interview with our small and micro-cap fund manager, Peter Kraus, on page 14.

However, there are many risks to this scenario (such as more persistent inflation, geopolitics). Even if it materialises, there are likely to be several obstacles along the way (such as too optimistic sentiment, high investor positioning, US elections). In the second quarter, the typically positive April seasonality and the first interest rate cuts by the Fed and the ECB, possibly in June, could continue to support markets, even if the upside potential appears limited. Then the summer seasonality and uncertainty ahead of the US elections are likely to lead to higher volatility from mid-year. Similarly high risk-adjusted return expectations across asset classes and the prevailing uncertainty make balanced positioning at the asset class level more important than before. We believe the opportunities lie beneath the surface.

CONTENT

EQUITY MARKETS PRICING IN FAVOURABLE PROSPECTS

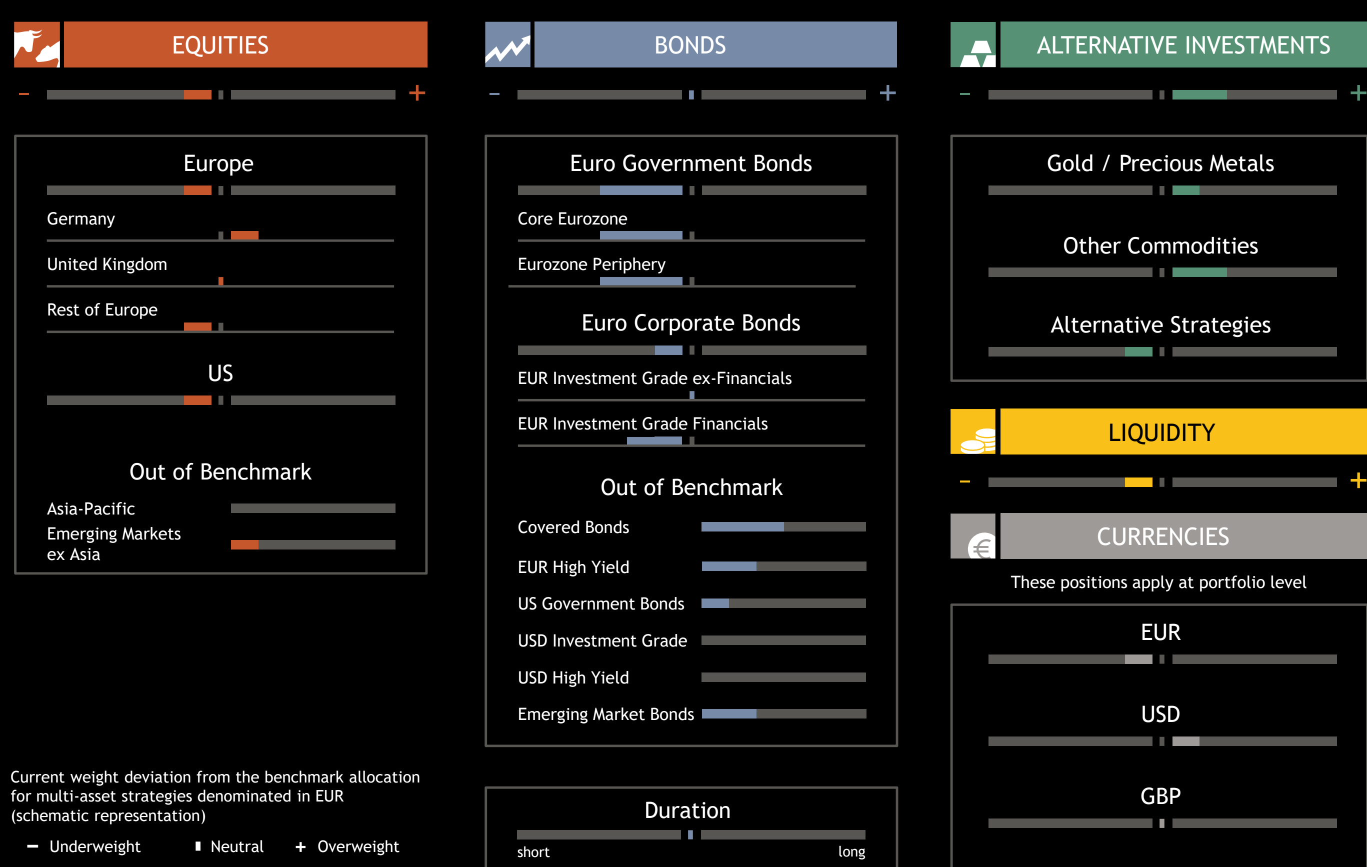
IN A NUTSHELL

- Easier financial conditions have given the US economy a boost. The likelihood that the global economy will recover from the second quarter onwards has increased.
- The first rate cuts in an already recovering economy would not be comparable with those in previous cycles. Longer-term bond yields are unlikely to fall much and equity valuations are likely to rise only slightly at best.
- Sentiment and positioning currently make markets more vulnerable to corrections. We see only moderate upside potential for equities and expect market breadth to increase.
- Comparable return expectations across asset classes and high uncertainty favour balanced portfolios.

Portfolio positioning at a glance

Looking in the rear-view mirror, we started the year with an overly defensive positioning. Although we had increased our equity weighting in US equities at the beginning of November, we closed this position at the beginning of January after making substantial gains. The expected weakness in growth before a rebound has not yet materialised. With the strong gains, equity markets are now pricing in a very positive outlook for the economy and corporate earnings. However, without a correction of the optimistic sentiment and high positioning, we remain balanced in view of the many risks to this positive scenario.

Below the surface, our strongest convictions are in precious and industrial metals, broadly diversified US equities (new positioning since mid-March), European small caps, covered bonds, subordinated bank bonds, catastrophe bonds, local currency emerging market bonds and a position that would benefit from a steeper US yield curve. Our focus on quality and growth equities should also benefit from falling interest rates. With low investor positioning and strong demand from China, gold remains attractive despite all-time highs in the face of falling central bank rates.



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

– Underweight ▮ Neutral + Overweight

First quarter: easier financial conditions support the economy

The significant easing of financial conditions by the capital markets in November / December 2023 (such as lower interest rates and risk premiums) have given the US economy in particular new momentum. US bank lending standards have also been eased considerably and, despite quantitative tightening, net liquidity in the US has been supportive due to the reduction in the reverse repo facility. Since the beginning of the year, however, economic surprises have also turned positive in the eurozone, China and Japan. By contrast, US inflation is proving to be more persistent. As a result, the interest rate cuts priced in by the markets at the end of the year have been more than halved. Bond yields rose again, with 10-year Bund and US Treasury yields up by more than 40 basis points – 10-year US real yields climbed to 2%. As a result, many bond segments have been negative since the beginning of the year. The US dollar strengthened slightly. However, economic optimism dominated in equities and oil – the markets are pricing in positive earnings and economic developments in the long term, which would be consistent with higher real yields.

Economic recovery carries risk of higher rates for longer

Consensus forecasts for global economic growth in 2024 have been rising since the beginning of the year, led by the US (chart, top of page 5). In February, the global manufacturing PMI rose above the critical 50 level for the first time since August 2022. A global economic recovery is taking shape. Against this backdrop, and with US growth above potential, a resurgence in inflation remains a key risk for markets. Short-term inflation dynamics have already picked up somewhat recently. This could weigh on the economy and equity markets again, like the phase from end-July to end-October 2023 (middle chart, page 5). At that time, however, the Fed had raised interest rates again, which is now unlikely given that the current federal funds rate is significantly higher in real terms, even with more persistent inflation. However, a renewed rise in US 10-year real yields to 2.5% would likely necessitate further rate hikes – unless this reflects solid growth prospects, in which case it should not be a major problem for equity markets.

Rate cuts despite economic recovery = stable bond yields

If inflation continues to fall for the time being, as our economists' baseline scenario suggests, central banks are likely to start cutting interest rates in June, despite the emerging economic recovery. However, long-term bond yields are unlikely to fall by much. With structurally higher inflation and rising government debt, the risk premium for holding long-term bonds, the "term premium", should normalise somewhat and the yield curve should steepen again. Longer term, we see limited scope for interest rate cuts without a recession. In addition to structural factors such as demographics, the energy transition, reorganisation of supply chains and the arms race, a Trump presidency with potentially higher tariffs, a return to lower immigration, further inflationary pressures from de-globalisation and a strong fiscal expansion should not be overlooked. Also in view of the high US budget deficit, we believe a high proportion of real assets and inflation protection in portfolios remains important.

Positive economic surprises in Q1 boosted oil and equity markets and weighed on bonds. Gold and the US dollar rose.

Total return	YTD and in 2023 (in %, in EUR)		12-month periods of the last 5 years (in %, in EUR)					CAGR*	Std.-dev.*
	YTD (31/12/23-18/03/24)	2023 (31/12/22-31/12/23)	18/03/23 18/03/24	18/03/22 18/03/23	18/03/21 18/03/22	18/03/20 18/03/21	18/03/19 18/03/20	18/03/19 18/03/24	18/03/19 18/03/24
Brent	16.5	-4.1	29.1	-11.6	106.7	84.7	-52.7	15.6	40.4
S&P 500	10.3	22.3	31.2	-7.5	24.7	51.1	-9.8	15.6	21.1
Stoxx Europe 50	7.6	15.1	20.1	4.7	14.1	42.1	-21.2	9.9	16.6
DAX	7.1	20.3	21.4	2.5	-2.5	75.0	-27.6	9.0	20.5
Gold	6.3	9.7	6.5	7.2	19.3	7.0	18.4	11.6	13.4
MSCI EM	3.6	6.3	10.0	-9.6	-8.1	58.9	-21.1	2.7	16.9
EM Sovereigns	1.7	6.9	7.1	-3.8	1.2	8.7	-4.4	1.6	8.5
USD/EUR	1.5	-3.0	-1.9	3.6	7.8	-8.4	3.9	0.8	7.2
Euro Overnight Deposit	0.8	3.3	3.7	0.6	-0.6	-0.5	-0.4	0.5	0.1
US Sovereigns	-0.4	0.7	-3.1	-2.2	5.3	-9.5	15.0	0.7	7.0
EUR Corporates	-0.4	8.2	6.0	-8.1	-5.2	9.0	-3.3	-0.5	3.9
EUR Sovereigns	-1.0	6.0	2.3	-7.4	-3.2	3.3	-0.1	-1.1	3.8

Time period: 18/03/2019-18/03/2024.
Source: Bloomberg * CAGR = annualised return (in %, in EUR); Std. dev. = annualised standard deviation (in %, in EUR).

Moderate equity potential with greater market breadth

The improved economic outlook has not yet been reflected in significant upward revisions to earnings estimates. As a result, the gains have been almost entirely the result of rising valuations, particularly in the case of US equities. Without upward revisions to earnings expectations, further upside is likely to be limited, even if interest rates are lowered. However, profit margins are under pressure from wage growth and interest rates. Strong productivity growth (e.g. through AI, shorter supply chains, automation, sufficient energy) is therefore essential.

Contrary to our expectations, market breadth has remained low so far this year. Equity-weighted indices have underperformed market-cap-weighted indices (bottom chart). AI euphoria has once again boosted a few large companies, and interest rate sensitivity is evident beneath the surface. However, if the picture of imminent first rate cuts solidifies despite signs of economic recovery, market breadth should increase and (European) small caps and commodity prices should recover. In the US, the relative performance of the equally weighted index that we allocated to via an ETF in March has stabilised recently.

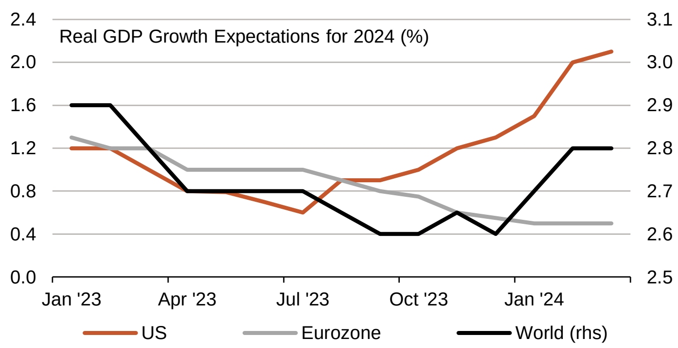
Sentiment and positioning increase market vulnerability

The synchronisation between equities and bonds has diminished significantly, bond volatility has fallen and equity volatility is low. Systematic investors have therefore continued to build equity positions and are now highly positioned. Investor sentiment is bullish. In addition, according to surveys and analysis, cash ratios of US mutual funds are below average. Equity markets are therefore more vulnerable to a correction. However, in the absence of a trigger, the typically positive seasonality in April and the prospect of interest rate cuts in June could see equities continue to rise, driven by laggards that are likely to outperform as we move into the summer. Equally weighted indices and small caps are likely to catch up. However, setbacks are likely in the third quarter at the latest, during the typically weak summer and in the run-up to the US elections. Given the many risks, this argues for a broad, balanced positioning. Our expectation of steeper yield curves and little change in long-term yields argues against an increased duration positioning. If the economy recovers, high-quality corporate bonds will remain attractive despite lower risk premiums. Given the strength of the US economy and a possible Trump victory, the US dollar is unlikely to weaken much for the time being.

Prof Dr Bernd Meyer, Chief Investment Strategist

Economic outlook brightens, led by the US

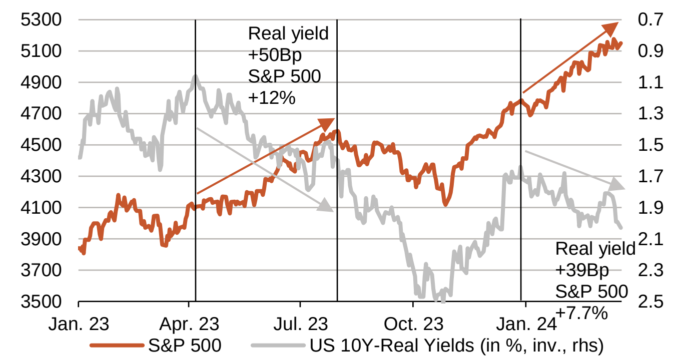
Bank economists' consensus forecasts for global economic growth in 2024 are rising. Forecasts for the eurozone are stabilising



Time period: 01/01/2023-18/03/2024.
Source: Bloomberg, own calculations.

Stocks and real yields are rising! Does this fit together this time?

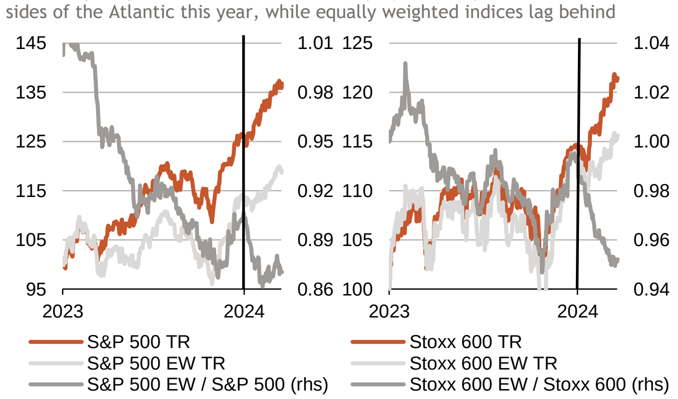
Higher real yields could weigh on equities again, unless they reflect strong economic and earnings growth rather than restrictive monetary policy



Time period: 01/01/2023-18/03/2024.
Source: Bloomberg, own calculations.

Low market breadth – few stocks drive equity markets!

A few large-cap stocks continue to drive equity market performance on both sides of the Atlantic this year, while equally weighted indices lag behind



Time period: 01/01/2023-18/03/2024; EW denotes equally weighted indices.
Source: Bloomberg, own calculations.

INFLATIONARY PRESSURE EASES, RATE PIVOT AHEAD

IN A NUTSHELL

- US: more growth than expected.
- Europe: stagnation in winter, upturn in spring.
- Inflationary pressure decreases – but not permanently to 2%.
- Monetary policy: Fed and ECB cut interest rates from June.

US: Fiscal policy supports economy despite high interest rates

Despite the Fed's vigorous rate hikes, the US economy continues to perform better than expected. Even the interest rate-sensitive housing sector, which initially slumped by 20%, is slowly emerging from the trough. Thanks to a still robust labour market, consumer spending remains strong. Companies have also not cut back on their investments despite higher financing costs. Thanks to high reserves, they are less dependent on credit than before. Moreover, unlike in previous cycles, they have not built up excess capacity in recent years. Therefore, they do not need to compensate for this with lower investment.

The most important reason for the sustained high growth in the US is fiscal policy. First, tax incentives for green (and some other) investments are counteracting tight monetary policy. Second, the government is massively increasing its own spending, by 4.5% in real terms in the final quarter of 2023 compared with the previous year. Thanks to high federal subsidies, the states and municipalities were even able to increase their investments by 16.3%.

Of course, significant risks remain. This is because monetary policy has a lagged effect. It could therefore slow down the economy this year, even though the US (and Europe) had already reached the interest rate peak in autumn 2023. However, fiscal policy is likely to remain expansionary in the election year of 2024. We have raised our forecast for US growth this year from 2.2% to 2.4% after 2.5% last year. After a good start to the year, we continue to expect growth to slow somewhat in the spring and summer before regaining momentum in late 2024 following an initial easing of monetary policy.

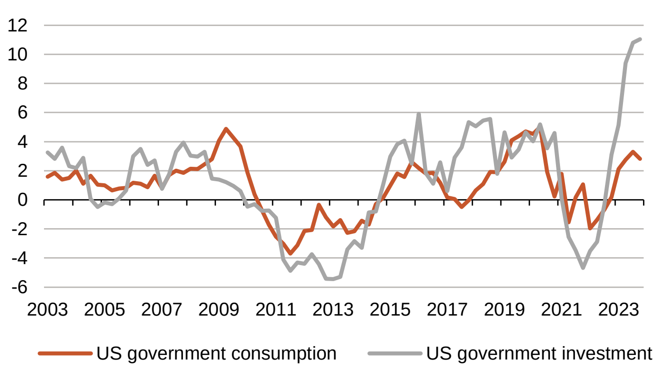
Mixed outlook for Europe

Two very different forces are shaping the outlook for the European economy in the months ahead. First, the continent has weathered the second winter after the Putin shock well. As we approach the end of the regular heating season, gas storage levels are still exceptionally high at 60%. As a result, the wholesale price of natural gas is only about half of what it was a year ago. In addition, consumer incomes have been rising faster than prices since the spring of 2023, thanks to falling inflation, a broadly stable labour market and higher wage growth. Consumers therefore have more money in their pockets in real terms – i.e. after inflation.

In contrast, the manufacturing sector remains in recession. Weak global trade is particularly affecting countries such as Germany that specialise in exporting goods. This effect is exacerbated by a pronounced inventory correction. Many companies had taken

Fiscal tailwind: US government spending

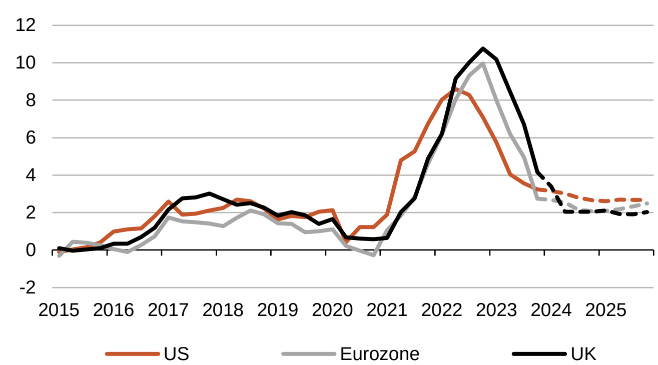
Year-on-year increase in %; price-adjusted total spending



Time period: Q1 2003-Q4 2023.
Source: BEA.

Inflation: the pressure is easing

Year-on-year increase in consumer prices in %



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

advantage of the end of the pandemic-related bottlenecks in the supply chain in 2022 to build up stocks of raw materials and finished goods. As demand has weakened, they have been reducing their inventories since spring 2023. For the time being, they are therefore producing less than they are selling.

However, there are now increasing signs that this inventory correction may soon be over. The rise in the purchasing managers' indices suggests that the manufacturing sector will be able to grow from the spring onwards.

Europe: new momentum in spring

After stagnating over the winter, the eurozone is poised for a rebound in spring. Once the economy has regained some momentum following the end of the inventory correction, many companies will start to invest again to restructure supply chains and replace scarce labour. Although China will remain structurally weak, exports to the country should recover slightly. All in all, China should grow by around 3-4% in 2024, although the official growth target of 5% will probably only be achieved with statistical tricks. With better news from the manufacturing sector, consumer spending in the eurozone should also pick up in the spring. Driven by rising domestic demand, the eurozone economy could return to slightly above trend growth of 1.3% in the autumn. Southern Europe will continue to outperform Germany thanks to the reforms of recent years and a more expansionary fiscal policy. We expect the UK to perform similarly to the eurozone.

The big inflation surge is over

Price pressures have eased considerably on both sides of the Atlantic. Core inflation rates (excluding volatile energy and food prices) are likely to fall further in the coming months. However, with domestic demand remaining robust, we do not expect US inflation to fall to 2%. Instead, there are increasing signs that it will stabilise at around 2.5% or slightly higher.

With many energy prices falling and the sharp rise in food prices coming to an end, eurozone inflation could fall to around 2% in autumn. But as the recovery takes hold, companies will regain pricing power in 2025. In the longer term, persistently high wage growth will continue to push up prices for labour-intensive services. As the costs of climate protection will also have an impact, we expect inflation in Europe to rise back to 2.5% over the course of 2025.

Central banks: first interest rate cuts in June

The Fed would like to avoid a significant rise in unemployment. For many US central bankers, an inflation rate of around 2.5% is acceptable. The Fed is therefore likely to start cutting its key rate again from June 2024, probably from the current 5.5% to 4.75% by the end of 2024 and to 4% by mid-2025. We also expect the first interest rate cuts in the eurozone (and the UK) from June 2024 in view of falling inflation rates.

Dr Holger Schmieding, Chief Economist

Growth and inflation forecasts

	GDP growth (in %)						Inflation (in %)					
	2024		2025		2026		2024		2025		2026	
		∅**		∅**		∅**		∅**		∅**		∅**
USA	2.4	2.1	1.7	1.7	2.0	2.0	2.9	2.7	2.7	2.4	2.7	2.3
Eurozone	0.7	0.5	1.6	1.4	1.5	1.4	2.4	2.3	2.3	2.1	2.5	2.0
Germany	0.1	0.2	1.4	1.1	1.3	1.3	2.2	2.6	2.2	2.2	2.4	1.9
France	0.7	0.7	1.7	1.3	1.6	1.6	2.6	2.6	2.4	2.0	2.6	1.9
Italy	0.8	0.5	1.3	1.1	1.2	1.1	1.6	1.7	2.1	2.0	2.3	1.8
Spain	1.9	1.5	2.1	1.9	2.1	1.7	2.7	2.8	2.4	2.2	2.6	2.1
UK	0.4	0.4	1.6	1.2	1.7	1.6	2.4	2.6	2.0	2.1	2.3	2.1
Japan	0.6	0.7	1.1	1.1	1.1	0.9	2.0	2.2	1.9	1.7	1.7	1.7
China	4.3	4.6	3.8	4.3	3.9	4.1	1.0	0.8	2.0	1.6	2.0	1.8
World*	2.3	-	2.5	-	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 18/03/2024.

MODERATE UPSIDE POTENTIAL

IN A NUTSHELL

- Equity indices should still have moderate upside potential until the end of the year. However, further significant increases in valuations are unlikely, especially in the US.
- Small caps offer more potential, also supported by increasing M&A activity.
- Our focus is on high-quality growth stocks with high earnings growth rates. We continue to find value regions such as Latin America attractive for diversification reasons.

Favourable start to the year

Continued robust US macro data and positive economic surprises for Japan and the eurozone have led to a continuation of the bull market in equities, supported by eased financial conditions and a solid earnings season. However, rising real yields due to increasing inflation risks and the pricing out of central bank rate cuts were, at least superficially, ignored by the market. In contrast to the year-end rally, however, market breadth has declined again. Interest-rate-sensitive small caps have lagged their large cap counterparts so far this year.

Mixed revisions to earnings expectations

Although the Q4 reporting season has surprised on the upside overall, changes in earnings expectations for 2024 are mixed. Japan in particular is benefiting from the weak yen and has received the largest positive earnings revisions. In the case of US equities, the AI winners in particular have seen their earnings estimates rise, with the result that aggregate EPS estimates for the S&P 500 have risen at least slightly. By contrast, negative earnings revisions dominated in Europe and emerging markets. With interest rates and wages still high and commodity prices on the rise again, we continue to believe that corporate earnings will struggle to surprise on the upside this year.

Further valuation expansion in the US limited

The recent bull market has been strongly driven by valuations, despite rising interest rates, which is rather unusual. The forward P/E for the S&P 500 is now back at just under 21 (90th percentile over the past 10 years), well above the historical average of 17. In addition to hopes of higher long-term profits from the AI revolution, one driver has been the continued inflows into US technology – the only equity sector to see massive inflows in recent months, thanks to the AI euphoria. In addition, systematic strategies have continued to increase their equity exposure, especially risk-parity strategies, due to the falling correlation between equities and bonds. Given the already high positioning of non-fundamental investors, we believe that the potential for a significant rise in valuations is limited, even in the event of central bank rate cuts. By contrast, other segments such as European equities and small caps are cheap relative to their own history. If our economists are right and European growth accelerates from the second quarter of 2024, not only earnings but also valuations of European companies should rise.

It has been a good start to the year for most equity regions - Japan leads YTD, followed by the EuroStoxx 50 and the S&P 500

Total return	YTD and in 2023 (in %, in EUR)		12-month periods of the last 5 years (in %, in EUR)					P/B*	Div.*	P/E*
	YTD (31/12/23-18/03/24)	2023 (31/12/22-31/12/23)	18/03/23 18/03/24	18/03/22 18/03/23	18/03/21 18/03/22	18/03/20 18/03/21	18/03/19 18/03/20	18/03/24	18/03/24	18/03/24
MSCI Japan	11.5	16.2	24.9	-2.6	-3.9	46.7	-12.4	1.5	2.2	16.7
Euro Stoxx 50	10.5	22.2	25.7	6.8	2.8	65.4	-27.7	2.0	3.3	13.8
S&P 500	10.3	22.3	31.2	-7.5	24.7	51.1	-9.8	4.2	1.5	20.9
Stoxx Europe 50	7.6	15.1	20.1	4.7	14.1	42.1	-21.2	2.5	3.4	14.8
DAX	7.1	20.3	21.4	2.5	-2.5	75.0	-27.6	1.5	3.2	12.6
Stoxx Europe Cyclicals	6.4	22.4	26.1	-4.6	7.0	79.5	-32.3			
MSCI EM Asia	4.7	4.3	7.9	-8.8	-11.8	61.2	-15.0	1.6	4.2	12.7
Stoxx Europe Defensives	3.4	9.8	14.0	0.5	16.7	31.1	-18.9			
MSCI USA Small Caps	2.6	14.1	18.2	-10.7	6.1	107.7	-33.0	1.8	1.7	19.4
MSCI UK	2.3	10.2	12.5	-1.0	18.2	45.1	-32.6	1.7	4.1	11.3
Stoxx Europe Small 200	1.5	12.3	11.8	-13.6	2.6	75.2	-27.4	1.4	3.4	12.9
MSCI EM Latin America	-3.7	28.5	25.9	-6.5	22.8	46.6	-44.5	1.5	6.2	9.0

Time period: 18/03/2019-18/03/2024.
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.

Market breadth likely to increase as year progresses

We see opportunities mainly below the surface. For example, we like healthcare companies, which are benefiting from several megatrends such as the ageing population and digitalisation. We believe small caps with healthy balance sheets have catch-up potential. This is supported by favourable valuations, increasing M&A activity and stabilising interest rates. Our focus remains on high-quality European growth stocks, which should benefit from their above-average earnings growth rates. We like "value" regions such as Latin America for diversification, as a cyclical play and because commodity stocks, which are relatively well represented in the index, have risen significantly less than commodities themselves. At the same time, the US equity market should remain relatively supported despite its high valuation. In addition to the stronger US economy, lower energy costs and more innovative companies, this is mainly because the mega-caps are still the most supported by non-fundamental inflows (ETFs, options, buybacks). Overall, we see only moderate upside potential for equity indices until the end of the year due to positioning and valuation. The probability of a pullback over the summer has increased significantly, in line with typical seasonality. This is especially true as the US presidential election campaign enters its hot phase. This will naturally lead to some volatility in the markets.

Ulrich Urbahn, Head of Multi Asset Strategy & Research

WHAT IS ON COMPANIES' MINDS?

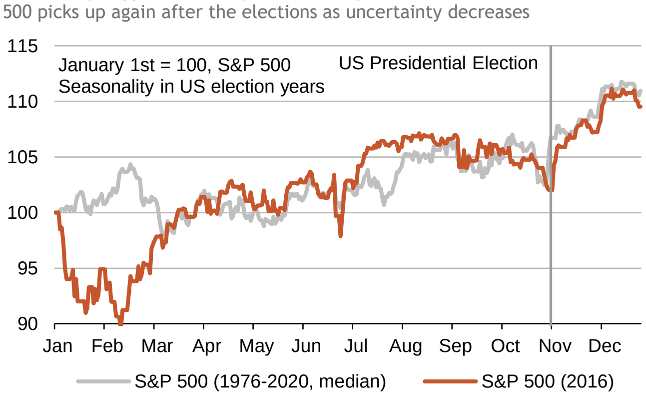
New dynamics in many sectors

In our discussions with companies at conferences and one-on-one meetings, decision-makers were largely optimistic. Healthcare companies such as Novo Nordisk and Eli Lilly point to continued dynamic growth in obesity treatments. In the life sciences sector, although inventories are being reduced, a turnaround in customer ordering behaviour has yet to materialise, while the financing environment in the biotech sector appears to be slowly improving. On the other hand, we are hearing from the private equity sector that fundraising remains difficult, but that well-established strategies with a strong track record are still in demand. Disinvestments are likely to pick up again this year. The storage market is showing the first signs of recovery, driven by strong demand from the artificial intelligence sector. Companies in the automotive sector are also cautiously optimistic as inventories have been well reduced. Demand for electric cars is expected to increase in Europe, especially in the southern countries. After a short period of weakness in the luxury market, the fourth quarter saw a significant increase in demand, which continued into early 2024.

Matthias Born, CIO Equitites

Volatility likely to increase over the summer

Seasonality suggests volatility in the run-up to the US elections, before the S&P 500 picks up again after the elections as uncertainty decreases



Time period: 01/01/1976-31/12/2020.
Source: Bloomberg, own calculations.

Forecast overview: moderate upside potential

Berenberg and consensus forecast in comparison, values at the end of 2024 and mid-2025

	Current			Ø*
Index forecasts	**18/03/2024**	**31/12/2024**	**30/06/2025**	**In 12 months**
S&P 500	5,149	5,300	5,500	5,604
DAX	17,933	18,500	20,000	20,397
Euro Stoxx 50	4,983	5,100	5,400	5,346
MSCI UK	2,214	2,300	2,400	2,614
Index potential (in %)				
S&P 500	-	2.9	6.8	8.8
DAX	-	3.2	11.5	13.7
Euro Stoxx 50	-	2.4	8.4	7.3
MSCI UK	-	3.9	8.4	18.1

* Average, consensus bottom-up as of 18/03/2024.
Source: Bloomberg, Factset, Berenberg.

ATTRACTIVE PROSPECTS IN HETEROGENEOUS BOND MARKETS

IN A NUTSHELL

- After a weak start to the year for government bonds, UK local-currency bonds look set to recover.
- In European corporate bonds, we avoid high yield, while bank bonds offer selective entry opportunities.
- In emerging markets, falling interest rates make the local currency bond segment particularly attractive.

Heterogeneous markets offer varying opportunities

The bond year 2024 got off to a mixed start. Positive economic surprises have been met with headwinds in the form of rising yields, which individual bond segments have been able to counter to varying degrees. Heterogeneity is likely to characterise the remainder of the year, and while we do not retract our "The good times are not over" slogan from the previous issue of "Horizon", we emphasise below that differentiation within the sub-markets under consideration is essential.

Safe government bonds: mixed outlook for the rest of the year

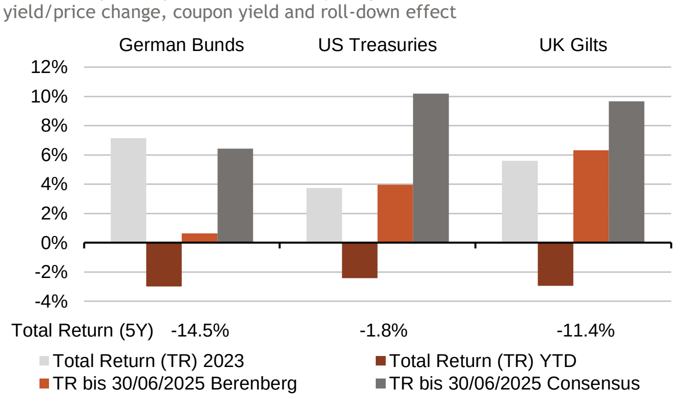
After the sharp fall in yields in the final weeks of last year, the past quarter has been characterised by a countermovement. However, the corresponding price losses have led to a positive message: the most difficult phase of the year is probably already behind us. As current yield levels have moved much closer to our forecasts, the outlook for the coming months is at least partly promising. For UK government bonds in particular, we see good opportunities for a clearly positive performance in the 10-year maturity segment. We are more cautious about German government bonds, which do not have as much to offer in the way of downside protection as their Anglo-Saxon counterparts, given their comparatively low basic interest rate (see chart below left). We continue to expect the major central banks to act in a supportive manner by lowering their key interest rates over the course of the year. In fact, we now expect the European Central Bank to take one more step than at the beginning of the year.

Corporate bonds: hands off the high-yield segment

We were already very sceptical about the valuation of European high yield bonds at the end of 2023. While the investment-grade segment was still offering reasonable risk premiums, high-yield was already looking expensive on the back of a possible recession in Europe. However, the surprisingly positive economic data since the beginning of the year and continued solid corporate results mean that an imminent recession now seems less likely. This explains the positive start to the year for high-yield bonds (+1.8%), despite a significant rise in interest rates. Even though the economic outlook has improved, we remain sceptical given the historically high valuation of this sub-segment and prefer more defensive investment-grade bonds with reasonable yields of around 3.8%. Investors are currently concerned about the credit exposure of German financial institutions such as Deutsche Pfandbriefbank, as well as of savings banks and Landesbanken. As a result, risk premiums on European financial bonds (see chart below left) have

For safe government bonds, the worst is over

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



Time period: 18/03/2019-18/03/2024.
Source: Bloomberg, Berenberg 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 the end of 2024 and mid-2025

	18/03/2024	31/12/2024		30/06/2025	
	Current		∅*		∅*
USA					
Key interest rate	5.25-5.5	4.50-4.75	4.55	4.00	3.85
10Y US yield	4.33	4.50	3.82	4.50	3.67
Eurozone					
Key interest rate	4.50	3.40	3.19	3.00	2.80
10Y Bund yield	2.46	2.60	2.11	2.80	2.10
Great Britain					
Key interest rate	5.25	4.00	4.30	3.50	3.55
10Y Gilts yield	4.09	4.00	3.59	4.00	3.56

* Average, consensus as of 18/03/2024.
Source: Bloomberg.

recently widened relative to non-financial bonds. Although we do not consider the situation for these institutions to be life-threatening at present, we would refrain from making any new commitments for the time being. In the short term, however, senior bonds issued by "national champions" such as France, the UK or Spain could offer interesting entry points.

Emerging markets: rate cuts support local currency bonds

Strong labour market data and recent higher-than-expected consumer prices suggest that the US central bank could leave its key interest rate at the current level for longer than had been expected at the start of the year. The number of interest rate cuts priced in by the market for 2024 has been revised from six at the time to three at present, and the US government bond curve shifted upwards by 25 to 35 basis points as a result. In response, the local yield curves in numerous emerging markets also came under pressure. Is the latter fundamentally justified? A look at the inflation figures for emerging markets that raised interest rates very early on provides no evidence of this – on the contrary, the flattening of inflation in emerging markets is a clear trend. While in December just two of the ten countries we analysed in detail from this perspective had already seen inflation fall to the respective central bank target, this figure had already risen to four in January. From a fundamental perspective, local interest rates should therefore fall rather than rise, which would support bond prices. In fact, some emerging-market central banks have already started to cut interest rates, including Brazil, Chile, Poland and Hungary. In Central America, Mexico should soon follow suit. We therefore currently see very attractive opportunities for investors looking to benefit from interest rate cuts in emerging markets. We remain optimistic about local currency bonds in particular and, from a regional perspective, favour those countries where real interest rates are high and the economy is fundamentally on the right track. Furthermore, we do not expect any negative surprises in connection with the forthcoming elections in some emerging markets, which means that there should be no disruption from this side either.

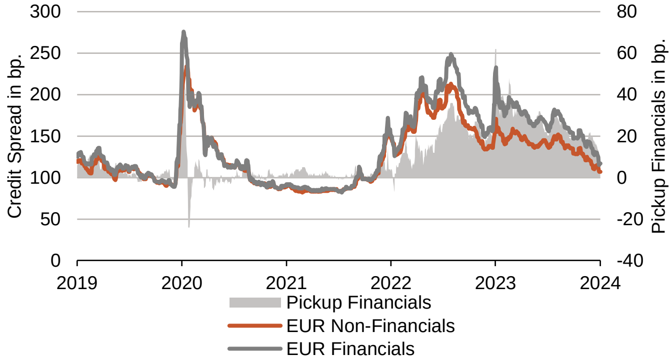
Conclusion: it is worth taking a closer look

There are opportunities and risks in all three of the segments discussed above, so it is worth taking a closer look. In the safe-haven government bond market, UK gilts in local currency are particularly attractive, while German bunds and US securities are less so. If you want to invest in corporate bonds, we believe you should focus on the investment-grade sector. National banking champions also offer interesting opportunities. Also, in emerging markets, it is local currency securities that are benefiting from the central banks' interest rate pivot – a trend that should continue.

Martin Mayer, Senior Portfolio Manager Multi Asset
Christian Bettinger, Head Fixed Income Euro & Emerging Markets
Wei Lon Sung, Head Fixed Income Emerging Markets

Financial bonds still pay a significant excess premium

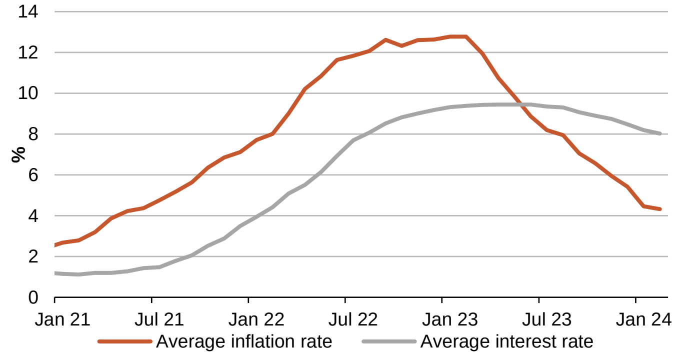
Despite the decline that has already started, we expect the excess spread of the financial sector over non-financial bonds to narrow further



Time period: 18/03/2019-18/03/2024, risk premiums in basis points.
Source: ICE, Berenberg calculations.

Emerging markets: the trend towards lower rates is gathering pace

Inflation is falling sharply in selected countries* that started raising interest rates early. Interest rates are now following the downward trend



Time period: 01/01/2021-29/02/2024, Source: Bloomberg, Berenberg calculations, * Countries: Brazil, Chile, Colombia, Mexico, Peru, Poland, Hungary, South Korea, Czech Republic, Romania.

OPPORTUNITIES PREVAIL

Oil continues to move sideways despite positive developments

Crude oil (Brent) has recently stabilised above the USD80 per barrel mark after the significant weakness in the fourth quarter of last year. Tailwinds have come from two directions. On the one hand, many shipping companies are now diverting their oil tankers to the much longer route around the Cape of Good Hope because of the attacks by the Houthi rebels in the Red Sea. This not only increases transport costs, but also ties up more supply on the world's oceans. On the other hand, the increasingly positive economic surprises around the world point to better demand. However, supply also remains ample. OPEC+, which has considerable spare capacity, has, out of necessity, extended its voluntary cuts until the end of June. However, compliance by members has already weakened recently. In addition, non-OPEC production is likely to continue to rise this year, albeit at a slightly lower rate than in 2023. Overall, the oil price is likely to be volatile and move sideways in the coming months. Geopolitical escalations or a stronger recovery in China offer the potential for positive surprises.

Gold not “crowded” despite all-time high

Gold suddenly broke out in the first quarter and climbed to new all-time highs, even though there was no fundamental trigger. On the contrary, real yields and the US-dollar, both of which normally weigh on gold, are higher today than at the start of the year. At the same time, ETFs have had steady outflows and are therefore not responsible for the bull run. Hence, the breakout is likely to be driven primarily by technical factors. Despite this strong movement, the upside risks for gold predominate, even though it has historically trended sideways in a soft landing. In addition to central bank demand, private investor demand in China appears to be picking up noticeably due to the real estate crisis. At the same time, investor positioning in the West has considerable upside in the event of a hard landing or geopolitical escalation in the Middle East. Only a sharp rise in rates remains a risk for gold.

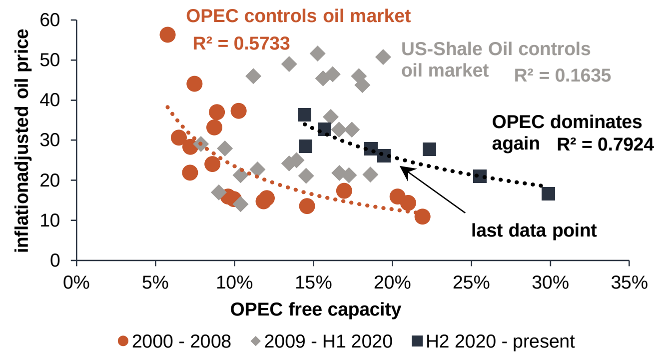
Metals outlook positive despite ongoing weakness in manufacturing

The LME base metals index has traded sideways since the beginning of the year. Although the economic outlook has brightened considerably, manufacturing activity is still subdued. With no sign of a significant increase in supply, even though demand growth for the green transformation is gaining momentum, prices are likely to rise (sharply) sooner or later. However, a recovery in the manufacturing sector is necessary before prices can rise substantially in the short term.

Ludwig Kemper, Multi Asset Strategy & Research

Oil: OPEC dominates market, but high capacities weigh on oil price

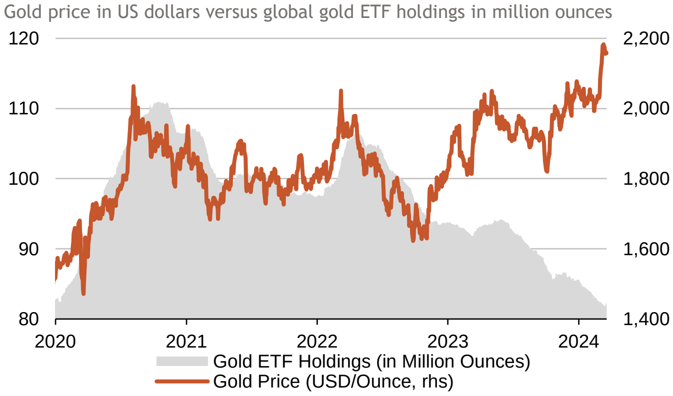
OPEC spare capacity versus inflation-adjusted oil price, depending on who dominates the oil market. Lower capacity = higher prices



Time period: 01/01/2000-31/12/2023, semi-annual data.
Source: Bloomberg, Berenberg calculations.

Gold: Price is rising, although ETF holdings continue to fall

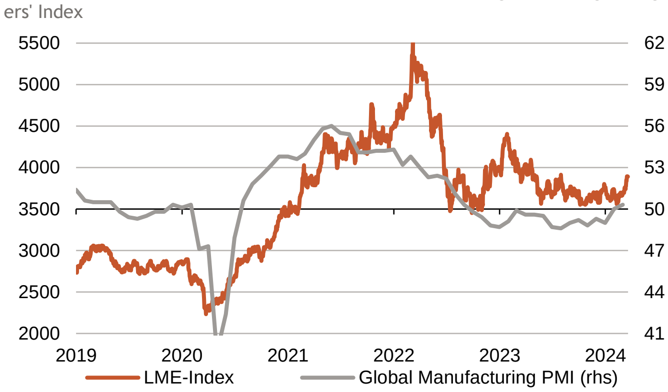
Gold price in US dollars versus global gold ETF holdings in million ounces



Time period: 01/01/2020-18/03/2024.
Source: Bloomberg, Berenberg calculations.

Metals: Waiting for rising industrial activity

LME Industrial Metals Index versus the Global Manufacturing Purchasing Managers' Index



Time period: 01/01/2019-18/03/2024.
Source: Bloomberg, Berenberg calculations.

LONG-TERM DOLLAR STRENGTH – EURO CATCHES UP

Focus on central banks and the economy

The euro has recently regained some ground. Since mid-February, the currency has appreciated moderately against the strong dollar, recently reaching a rate of USD1.09 per euro – close to the level of USD1.10 that we expect by mid-year. Whether the euro area economy recovers as expected, and when and by how much interest rates will fall, will be important for future developments.

After the latest policy meeting on 7 March, ECB President Christine Lagarde signalled very clearly that the bank intends to wait until June before possibly cutting interest rates. We expect the ECB, the US Federal Reserve and the Bank of England to begin their rate cuts later in the second quarter, close to each other. The exact sequence of the first rate cuts could cause short-term volatility in the currency markets. In the long run, however, it should be insignificant.

Over the medium term, US key rates are likely to be about one percentage point higher than in the eurozone. However, given the higher starting level, we expect the Fed to cut rates more than the ECB over the next twelve months – by 150 basis points versus 100 basis points.

The US economy has been more dynamic than other economies in recent years, which has also helped the dollar. If, as we expect, the eurozone is able to emerge from its spring stagnation, there is some upside potential for the euro. It could rise slightly to USD1.12 by the end of the year. However, this would not be a real high for the euro. If nothing intervenes, it could rise further towards USD1.15 by the end of 2025 (and USD1.20 by the end of 2026).

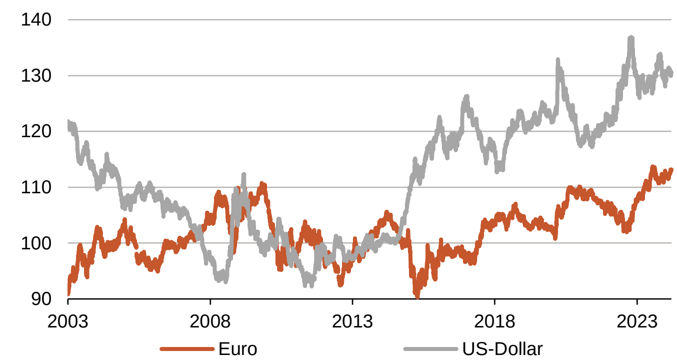
The euro also gained some ground against the Swiss franc in February. Although the current exchange rate of 0.96 euros per franc is still very low by historical standards, we expect little further upside potential for the time being. Low inflation in Switzerland mitigates the competitive disadvantage of the strong franc for Swiss companies.

We also do not expect any major changes in the exchange rate of the euro against sterling. The economic trend is similar to that in the eurozone.

Dr Salomon Fiedler, Economist

The dollar has already been strong for several years

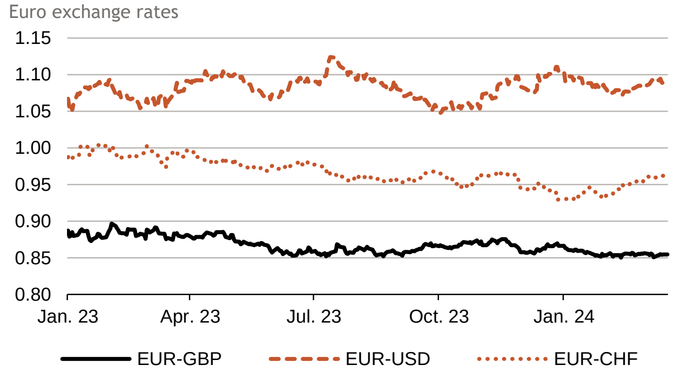
Nominal effective exchange rates



Time period: 01/01/2003-18/03/2024.
Euro and dollar against trading partner currency baskets. Source: JPM.

The euro has recently regained some ground

Euro exchange rates



Time period: 01.01.2023-18.03.2024.
Source: FT.

Exchange rate forecasts

Berenberg and consensus forecast in comparison, values at the end of 2024 and mid-2025

	18/03/2024	31/12/2024		30/06/2025	
Exchange rate forecast	**Current**		∅*		∅*
EUR/USD	1.09	1.12	1.10	1.13	1.09
EUR/GBP	0.85	0.85	0.87	0.85	0.85
EUR/CHF	0.97	0.96	0.98	0.96	0.96
EUR/JPY	162	157	156	156	160
Change against the euro (in %)					
USD	-	-2.9	-1.2	-3.8	-0.3
GBP	-	0.5	-1.8	0.5	0.5
CHF	-	0.5	-1.5	0.5	0.5
JPY	-	3.3	4.0	4.0	1.4

* Average, consensus as of 18/03/2024.
Source: Bloomberg.

INTERVIEW WITH PETER KRAUS

Mr Kraus, you are Head of Small Cap Equities at Berenberg. What is the appeal of small caps and why should investors invest in them?

There are many reasons for the long-term outperformance of small caps. Traditionally, small and medium-sized companies grow faster than large companies. Small caps also benefit from greater innovation and entrepreneurial dynamism. Less regulatory pressure, a stronger local presence in times of nearshoring and a higher likelihood of being acquired by other companies also help. Fundamentally, there is a large number of companies to choose from in the small cap sector: Over 90 per cent of companies at European and international level are micro or small caps. In addition, smaller companies receive significantly less attention from external analysts. This is unjustified, as this segment contains many concealed global market leaders with above-average growth ("hidden champions").

You and your team manage the Berenberg European Small Cap and Micro Cap Fund and the Berenberg International Micro Cap Fund. What characterises the investment approach of your funds and how do they differ?

In all three strategies, we focus on the smallest but most exciting companies in future-oriented sectors such as technology, healthcare and industry, and generally hold these companies for many years. The Berenberg European Small Cap fund focuses on European companies with a market capitalisation of EUR1bn-4bn, while the Berenberg European Micro Cap fund focuses on European companies with a market capitalisation of between EUR100m and EUR1bn. Our investment horizon is generally more than five years.

Our newest product is the Berenberg International Micro Cap. With this new concept, we invest in small companies in niche markets such as Australia, New Zealand, Israel, Singapore and South Korea, as well as in undiscovered companies in efficient markets such as the US/Canada and Japan. The EUR900m average weighted market capitalisation of a portfolio company in the Berenberg International Micro Cap Fund is significantly lower than that of a US competitor at EUR3bn. The fund also offers diversification benefits to existing clients. The historical correlation to the European Small Cap is relatively low at around 0.74. All team members are invested in our three funds and we have strict capacity limits for our small and micro cap products.

What factors do you consider when selecting stocks? Is this selection process different from that for large caps?

We focus on high-quality companies with attractive long-term growth drivers. We look for three things: an excellent competitive position, strong management teams and very attractive financial ratios (including high profit margins and returns on capital, strong balance sheets). The companies we favour have benefited from their strong pricing power, especially in this inflationary environment, have performed well in a difficult macroeconomic environment and have often emerged stronger. Our portfolios focus on global leaders in the growth sectors of technology, healthcare and industry. The stock universe is very large compared to large caps and is also under-covered by analysts. As a result, stock selection is generally more complex, but the opportunities over the longer term are greater.

Small caps have performed disappointingly over the past two years, both in absolute terms and relative to large caps. Can you explain the reasons for this?

An almost toxic combination of an inflationary shock and economic slowdown, together with extremely restrictive central bank policies and one of the biggest bond market sell-offs in 50 years, led to significant valuation declines for growth and quality companies, and small caps in particular. Of course, small caps in particular had significantly outperformed large caps in previous years and were trading at a premium. However, with inflation rates already falling sharply, the end of the interest rate hike cycle and the first signs of an economic recovery, we are confident that the headwind from falling valuations is behind us. Reliable growth, high profitability and returns on capital, and strong balance sheets are coming back into focus.

Which sectors and regions are of particular interest in the small cap space at the moment?

Our conviction remains unchanged: breakthrough innovations in technology (e.g. software, semiconductor equipment) or healthcare (e.g. medical devices, diagnostics) offer the highest potential for long-term earnings growth. This is what drives stock prices.

Given this rather optimistic outlook, what risks do you see?

There are always risks and uncertainties in the short term – such as a weak economic recovery, continued central bank hawkishness, geopolitical tensions, etc. That is why you should invest for the long term if possible. After all, significantly above-average earnings growth has always been reflected in rising share prices over the longer term.

How do you position your funds to take advantage of the expected turnaround? How do you ensure robustness to be well positioned in the event of less favourable developments?

We have not allowed the difficult market environment of the past 18 months to distract us from our long-term investment approach. For example, there are still no traditional banks, insurers or property companies in the portfolio. On the other hand, we have continued to take advantage of opportunities that have arisen on the downside, for example in the semiconductor sector and in medical technology and diagnostics companies. We are convinced that our companies will continue to grow profitably over the long term and emerge stronger from crises, thanks to their strong balance sheets, high profitability, attractive returns on equity and high barriers to entry in their respective niche markets. We therefore consider our portfolios to be well positioned: The average portfolio company has a return on equity of more than 20%, no net debt and medium-term sales and earnings growth rates of 10-15% and 15-20% respectively. On average, the earnings per share of our holdings double every four to five years.

How do you assess the potential of technology trends such as artificial intelligence or renewable energy for small and micro cap companies?

Everyone's talking about AI. We can clearly see that this is a new trend with probably great potential. Unlike the Dotcom bubble of 1998-2000, we are now dealing with profitable and fast-growing companies. We have a number of fantastic companies in our portfolios, particularly in the semiconductor equipment sector, which are benefiting significantly from this trend. We are more cautious when it comes to renewable energies – often (too) high debt levels, low returns on capital, strong competition and regulatory uncertainty make us wary. However, we are invested in a number of companies that offer energy efficiency technologies.

SHORT VITA

Peter Kraus has been Head of Small Cap Equities at Berenberg since 2017. He and his team manage three small and micro cap equity funds as well as other international small and micro cap mandates. Previously, he was a fund manager for European micro and small/mid caps at Allianz Global Investors, where he made a significant contribution to the success of the small cap team. He was responsible for the management of European small cap funds as well as for the acquisition and management of international institutional mandates and was honoured with several awards.

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IMPORTANT NOTICES

Date: 22 March 2024

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