HORIZON

The Berenberg Capital Market Outlook · Wealth and Asset Management

TURN FOR THE BETTER

If the US-China trade dispute does not escalate again, global growth should pick up slightly in 2020. However, political uncertainty will remain high.

LIMITED POTENTIAL

In the event of an economic upturn and a partial settlement in the trade dispute, equities should benefit initially from their relative attractiveness and investor inflows, despite the rally in 2019. Disappointments could emerge later in 2020.

SELECTIVITY AND TACTICAL POSITIONING

A repeat of the strong performance of nearly all asset classes in 2019 is unlikely. Active management, selectivity and tactical positioning will become more important.

Q1 | 2020

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FOREWORD

Prof Dr Bernd Meyer
Chief Investment Strategist

Dear reader,
One year ago, interest rate and recession fears dominated the markets. Equity markets had largely priced in a looming recession. That was an exaggeration. Although the economy weakened, no recession materialised. For that reason and thanks to the massive support of central banks, nearly all asset classes and especially equities made substantial gains in 2019. And this despite great political uncertainty.

The situation today is virtually the opposite of the situation a year ago. Equity markets are pricing in an economic recovery. While we expect a turn for the better as long as trade tensions are not massively ramped up again, there are hardly any reasons to expect a boom. The economic cycle is now more than ten years old and there are few catch-up effects. There is almost full employment and consumer spending is strong. It makes more sense to watch out for the risk of potential weakening here. Business investment is being held back by low profit growth, persistent uncertainty and rising labour costs. Political uncertainty remains high, not least of all due to the US Presidential election in November 2020. The potential for additional monetary stimulus is limited and not much can be expected in the way of fiscal stimulus either, particularly not in the United States in the run-up to the election. Moreover, equity valuations are already ambitious considering the consensus profit expectations for 2020. And profit expectations will probably be downgraded further. Global profit growth in the mid-single-digit range at best seems realistic. This means that the expansion will continue, but equity markets have only limited potential from the standpoint of fundamentals.

On the other hand, investors have no alternative to equities in the medium to long term. The relative valuation of equities is still very attractive, especially considering that investor positioning is not aggressive on average. Investor inflows into equities only began to pick up in the last few months. Markets are supported by this circumstance. If it comes to an orderly Brexit and a (temporary) detente in the trade dispute, which currently seems likely, and if economic data signal the turn for the better that we anticipate, equity markets could well rise further at first – subject to the risk of an excessive rally that would invite disappointments. A volatile sideways movement seems to be the most probable scenario in the run-up to the elections in the United States. Active management, selectivity and tactical positioning will probably become even more important in 2020.

In the Insights Interview, Matthias Born, Head of Investments and Head of Portfolio Management Equities, discusses the key ingredients of successful stock selection and the application of his team's expertise to multi-asset strategies.

Wishing you all the best for 2020,

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LIMITED POTENTIAL DESPITE STRONGER GROWTH

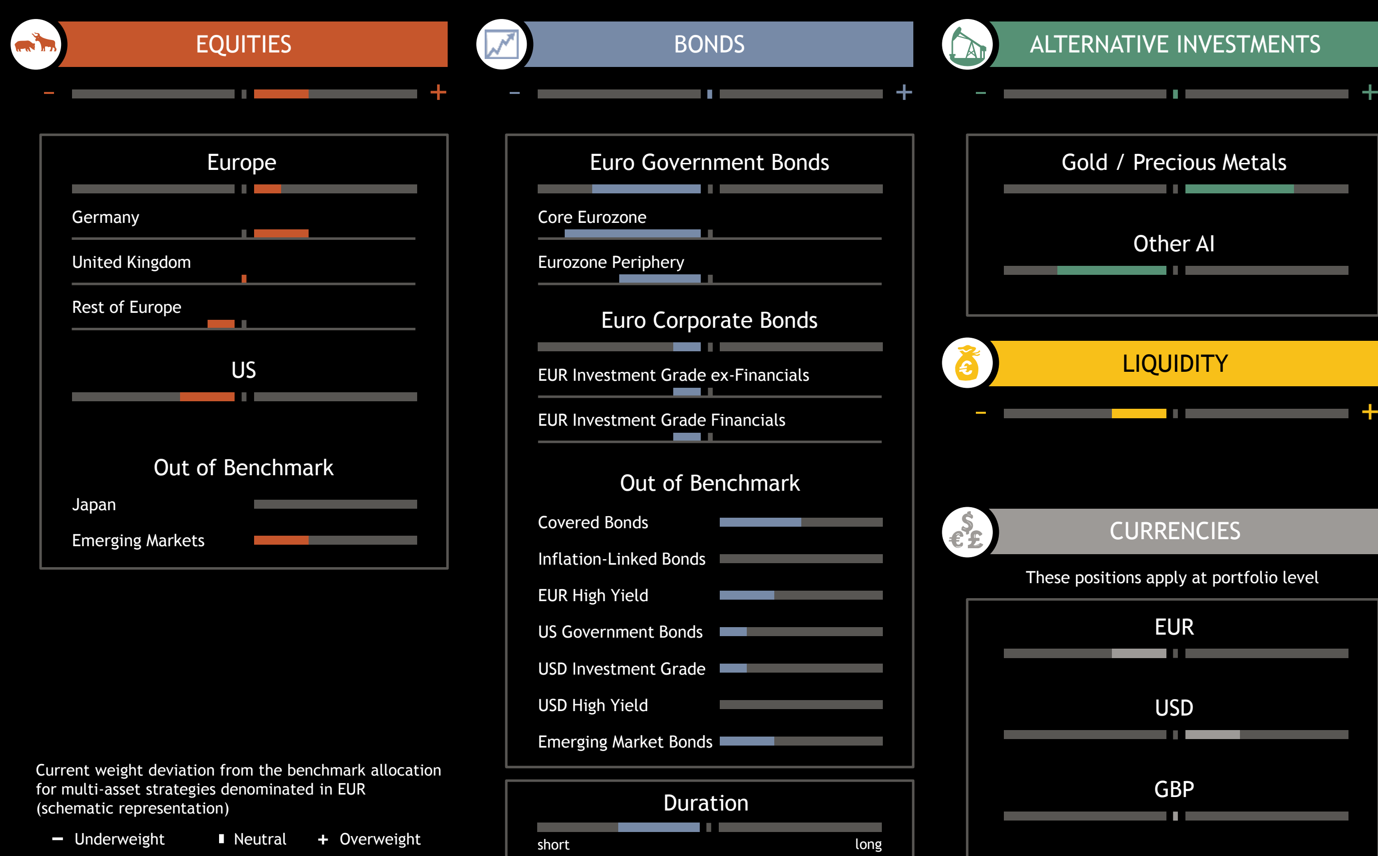
IN A NUTSHELL

- Global economic growth will probably pick up slightly in 2020 amidst persistently high political uncertainty.
- Equity markets have largely priced in an economic recovery and profit expectations are still too high. Based on fundamentals, there is only potential for single-digit growth.
- Limited growth, low inflation, low central bank interest rates and renewed bond purchases by the ECB will limit the rise of bond yields.
- Given further signs of economic stabilisation, equities should benefit further from the redeployment of capital from safe haven investments. This would increase the risk of sharp corrections in reaction to negative surprises.

Portfolio positioning at a glance

We completely closed out our equity underweight, mainly by increasing our exposure to UK equities, at the start of the fourth quarter. We then built up a slight overweight by means of emerging market equities. Due to stock selection, however, our portfolios exhibit an even higher sensitivity to equity markets. This cautiously optimistic positioning will be appropriate in the short term. Accelerating growth and the partial deal in the trade dispute should help the markets rise further even though much is already priced in.

Within equities, we prefer emerging-market countries and Europe, which would benefit the most from a stabilisation of global growth. We are still underweighted in safe government bonds and high-quality corporate bonds due to low yields. We are keeping the duration relatively short. A growth stabilisation in the first months of the new year would probably cause safe bond yields to rise further. This would present an opportunity to build up additional positions for the remainder of the year. We prefer riskier bond segments for now, but are sticking with our gold position as a portfolio hedge. Gold could benefit from a weaker US dollar and is still supported by low real interest rates.



2019 review: central banks step on the gas, markets catch up

2019 was a very good year for investors despite mostly disappointing economic data and great political uncertainty. All asset classes posted substantial gains, including strong double-digit gains for oil, equities, gold and EM government bonds. The market losses in the fourth quarter of 2018 resulting from overblown interest rate and recession fears set the stage for the strong market gains in 2019. Although the economy weakened, no recession materialised. Markets had considerable recovery potential for this reason. Markets also benefited from strong central bank support. More than 50 central banks across the world lowered interest rates. The US Federal Reserve lowered interest rates three times and ended quantitative tightening so that its balance sheet expanded again (see the chart on the following page). Interest rate fears dissipated. The ECB also lowered its deposit facility rate again and resumed its bond purchases.

As growth slowed and inflation remained weak, safe bond yields declined substantially, with German bund yields falling to a record low in negative territory in the summer. This development supported all investment alternatives. In the fourth quarter, riskier investments benefited from hopes for stabilising and accelerating growth in 2020, an orderly Brexit and at least a partial deal in the trade dispute between China and the United States. Safe bond yields rose again while bonds and gold shed some of their gains since the beginning of the year. The US dollar weakened in the fourth quarter but is still higher in the year to date.

Only a weak economic recovery is probable in 2020

Financial conditions have improved markedly thanks to monetary policy and positive market performance. This is supporting the economy. Our economists expect a modest acceleration of growth assuming that the trade dispute does not escalate again. Leading economic indicators support this expectation. It is likely, however, that the recovery will only be moderate given that political uncertainty remains high, the only limited stimulus measures in China will not help the global economy as much as in previous cycles, hardly any catch-up effects can be expected in the labour market and consumer spending, and low profit growth coupled with political uncertainty is weighing on business investment. Moreover, there is only limited potential for additional monetary policy stimulus and not much can be expected from fiscal policy either, especially considering that the positive effects of the US tax reform are fading.

Political uncertainty remains high

Hopes for a significant easing of political uncertainty in 2020 are likely to be disappointed. Although Boris Johnson's election victory should lead to an orderly Brexit on 31 January 2020, the subsequent negotiations on trade relations with the EU, to be completed by the end of 2020, harbour new risks. The difficulty in reaching a partial, "Phase 1" deal in the trade dispute between the United States and China shows that further significant easing can hardly be expected, especially considering that the trade dispute is only the current arena of a new global geopolitical rivalry.

All asset classes except cash with positive performance in 2019, led by oil, equities and gold

Total return	Year-to-date (YTD) and in Q4 (in %, in EUR)		12-month periods of the last 5 years (in %, in EUR)					CAGR*	Std. dev.*
	YTD (31/12/18-16/12/19)	Q4 (30/09/19-16/12/19)	16/12/18 16/12/19	16/12/17 16/12/18	16/12/16 16/12/17	16/12/15 16/12/16	16/12/14 16/12/15	16/12/14 16/12/19	16/12/14 16/12/19
Brent	35.9	10.9	19.6	6.1	-3.3	27.7	-39.6	-1.1	34.9
S&P 500	33.4	5.4	27.0	3.1	7.4	16.5	22.9	15.0	15.8
Stoxx Europe 50	27.6	5.1	23.9	-7.7	9.5	1.8	9.0	6.8	15.1
DAX	27.0	7.9	23.4	-17.1	14.9	8.9	9.5	7.0	17.2
MSCI EM	18.5	6.6	16.5	-7.3	18.6	16.0	1.9	8.6	15.6
Gold	18.4	-2.0	20.9	2.5	-1.6	10.5	2.7	6.7	12.0
EM Sovereigns	16.8	-0.8	15.2	-0.6	-1.9	14.4	20.5	9.1	8.6
US Sovereigns	8.2	-2.1	7.8	4.5	-9.5	5.1	15.4	4.3	7.9
EUR Corporates	6.6	-0.2	6.6	-1.9	3.5	4.4	-0.5	2.4	2.0
EUR Sovereigns	3.5	-1.1	3.8	-0.4	1.2	1.8	1.7	1.6	1.9
USDEUR	2.9	-2.2	1.4	3.9	-11.0	4.4	14.6	2.3	8.2
Eonia	-0.4	-0.1	-0.4	-0.4	-0.4	-0.3	-0.1	-0.3	0.0

Time period: 16/12/2014-16/12/2019.
Source: Bloomberg * CAGR = annualized return (in %, in EUR); Std. dev. = Annualised standard deviation (in %, in EUR).

Ultimately, China's ascent raises the spectre of global technological and military dominance and competing societal models: liberal democracy versus authoritarian surveillance state. The future of Hong Kong must also be viewed in this context. Violent suppression of the pro-democracy protests in Hong Kong would be a great risk for the markets.

The Presidential election in the United States on 3 November of next year will be at the centre of political uncertainty in 2020. Even the Democrat primaries beginning in February will probably move markets. If a rather left-leaning Democrat candidate wins the primaries, markets would have to fear a rollback of President Trump's tax reform in the event of a Democrat victory in November. However, a Democrat President with Democrat majorities in the Senate and House of Representatives is unlikely. And that would be a good thing because an analysis of equity markets since 1928 shows that stock market performance has been much weaker in the six months after the election if Congress is united as opposed to divided. Presidents are more likely to take more extreme decisions in the absence of a counterweight in one of the two chambers of Congress. Otherwise, stock market performance in election years is not different on average from that in non-election years (centre chart). It can only be observed that the stock market only trends sideways on average in the six months before the election when the sitting President is a Republican. It does not seem far-fetched to think this could also happen in 2020.

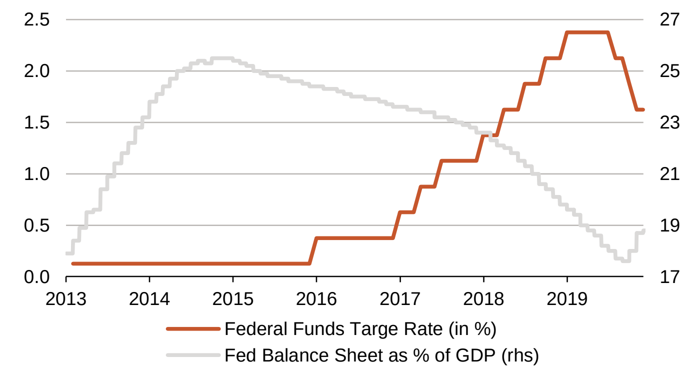
Equity markets are already pricing in a growth recovery

We expect only single-digit gains for equities in 2020 given that equity markets have already largely priced in an economic recovery in 2020 after their very good performance in 2019. However, with the partial deal reached in the trade dispute and if economic data improve, equities could initially rise further with the support of inflows to equity investments and the typically advantageous seasonality. European and emerging-market equities in particular would benefit in that case. An excessive rally followed by a correction is easily conceivable. But since disappointments could emerge at any time at the current level of valuations, overly aggressive positioning should be avoided now. In the bond market, we prefer credit risks going into next year, i.e. corporate bonds or emerging-market bonds, over safe government bonds with longer durations because safe bond yields are likely to rise a little at first in our core scenario.

Prof Dr Bernd Meyer, Chief Investment Strategist

Reversal of US monetary policy provided support in 2019

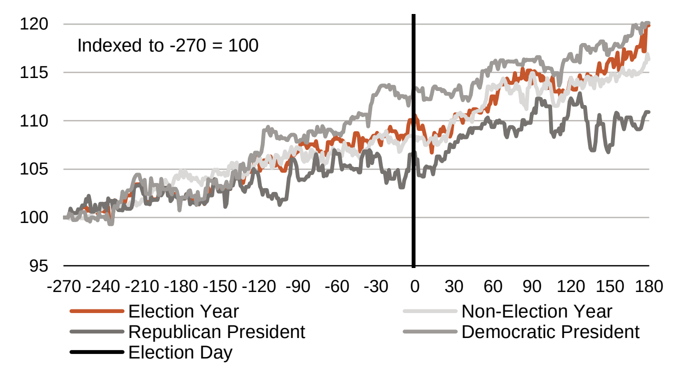
After years of rising interest rates and quantitative tightening, the US central bank lowered its base interest rate three times and expanded its balance sheet



Time period: 01/01/2013–30/11/2019.
Source: Bloomberg, own calculations.

Stock market performance typically not remarkable in election years

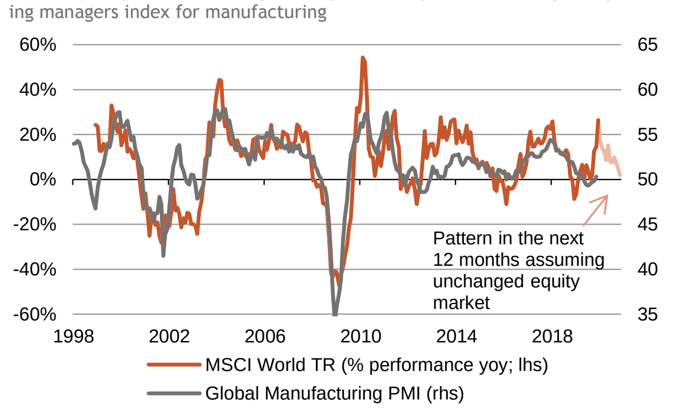
Median S&P 500 performance in the 270 (180) calendar days before (after) the election. Non-election years centred around the average election date in November



Time period: 01/01/1928–30/11/2019.
Source: Bloomberg, own calculations.

Stock market is already pricing in a significant economic recovery

Year-on-year performance of global equities compared with the global purchasing managers index for manufacturing



Time period: 30/11/1998–30/11/2020.
Source: Bloomberg, own calculations.

BOTTOM IN SIGHT

IN A NUTSHELL

- Economy: first signs of a turn for the better.
- Slow recovery of global trade and manufacturing if trade tensions are not massively ramped up again.
- ECB and Fed to remain expansive, but will not increase stimulus in 2020.

Divided economy

A series of political crises knocked the economy off stride in Europe and east Asia last year. Above all, the trade tensions instigated by the United States and China's growth weakness are weighing on the sentiment of companies. In Europe, the Brexit turmoil has contributed to the general uncertainty of companies.

A similar pattern has emerged on both sides of the Atlantic. Whereas manufacturing has fallen into crisis and businesses have scaled back capital expenditures in view of the uncertainty surrounding the future of world trade, private consumption has remained strong. Housing construction and higher government expenditures have also supported domestic economies.

The divide between largely strong domestic demand and sputtering external trade cannot go on forever. Either the external trade shocks will fade or the weakness of export-oriented manufacturing will continue and increasingly spill over to other parts of the economy.

There have been growing signs of a turn for the better in 2020 in the last few months. US President Donald Trump announced fresh punitive tariffs against China in August and has already imposed some of them. This step further clouded manufacturing sentiment in many parts of the world. By contrast, the last three months have been rather calm. The "Phase 1" trade agreement, agreed in principle by both sides, could significantly reduce the dispute. In the absence of new bad news, the sentiment of many manufacturing enterprises has brightened somewhat since October.

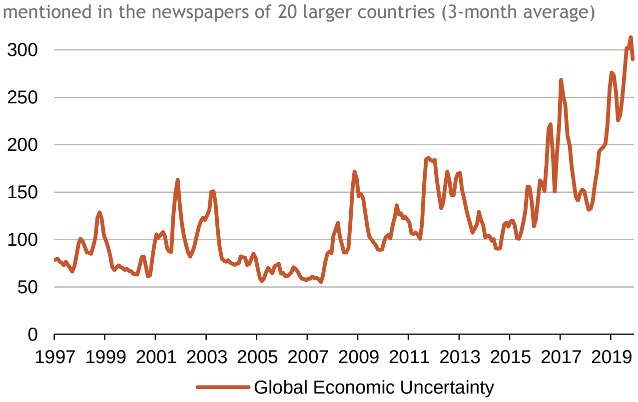
Progress in sight

We expect this nascent trend to continue in 2020:

1. Although the United States and China will continue to be geostrategic rivals for a long time, the two sides still have an interest in not letting their trade war spiral out of control. The damage to both sides has become evident. Even if they only reach a small partial deal in the best case, they will presumably not re-escalate their dispute to a degree that would damage the global economy further. President Donald Trump's incentive to reach new deals in the 2020 election year, instead of endangering US economic growth with a further escalation and lessening his re-election chances, will probably increase. The mere absence of bad news could

Has economic policy uncertainty peaked?

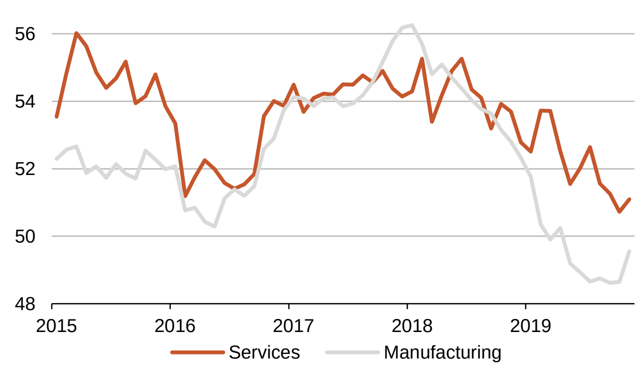
This index measures the frequency with which economic policy uncertainty is mentioned in the newspapers of 20 larger countries (3-month average)



Time period: 01/01/1997-30/11/2019.
Source: Policyuncertainty.com.

Business expectations in industrialised nations: turn for the better?

Purchasing managers index for manufacturing and services (50 = no change)



Time period: 01/01/2015-30/11/2019.
Source: Markit.

well be enough for companies to take a more positive view of the future again and ramp up their investments somewhat. Global trade and manufacturing could then slowly recover.

2. Although China's economy will remain weak, numerous small monetary and credit policy steps will probably suffice to prevent a collapse. The weak export business will probably recover a bit in the coming year. After contracting in 2019, the economically important automobile market in China will likely bottom out soon.
3. In all probability, the United Kingdom will avoid a hard Brexit without a follow-on agreement. After Boris Johnson clearly won the election on 12 December, the country will leave the EU on 31 January. Even though a comprehensive agreement on future relations with the EU will presumably not be reached before the end of the planned transition period on 31 December 2020, there could still be enough time to reach an agreement on trade in goods.

Political risks in the eurozone

The political situation in Italy remains uncertain. But considering that the current government is pursuing a halfway sound budget policy and even the opposition under right-wing populist Matteo Salvini cannot really have an interest in pushing the country's financial system to the edge of ruin by waging a massive budget fight with Brussels, which would lead to higher risk premiums for Italian bonds, we expect that Italy will be able to avoid a full-blown financial crisis in 2020 as well.

In Germany, the SPD could possibly withdraw from the grand coalition, triggering new elections. But even a black-green coalition would hardly change the basic tenor of policy. Nevertheless, investors must be wary of the possibility that a green-red-red coalition could also take power. In that case, Germany could face an economically damaging wave of regulation similar to the imposition of rent caps in Berlin.

In France, Macron's reforms are beginning to bear fruit. The number of new business start-ups has risen by almost 50% in the last three years. If Macron sticks to the reform course as expected, France could embark on a new golden decade of high trend growth of the kind that Germany has experienced in the last 10 years.

Central banks pivot

Wage pressure is rising only slowly in the United States and Europe. For that reason, core inflation rates are either very low, at around 1% in the eurozone, or in line with the targeted rate of around 2% in the United States. Central banks can afford to continue their very expansive monetary policy in 2020. On the other hand, the fiscal stimulus that Boris Johnson is planning in the United Kingdom could force the BoE to raise interest rates once in 2020.

Dr Holger Schmieding, Chief Economist

Growth and inflation forecasts

	GDP Growth (in %)						Inflation (in %)					
	2019		2020		2021		2019		2020		2021	
		∅**		∅**		∅**		∅**		∅**		∅**
USA	2.3	2.3	1.9	1.8	2.2	1.9	1.8	1.8	2.2	2.1	2.3	2.0
Eurozone	1.2	1.1	1.0	1.0	1.5	1.2	1.2	1.2	1.3	1.3	1.6	1.4
Germany	0.5	0.5	0.6	0.7	1.5	1.2	1.3	1.4	1.3	1.4	1.6	1.5
France	1.3	1.3	1.3	1.2	1.7	1.3	1.3	1.3	1.7	1.3	1.7	1.3
Italy	0.2	0.2	0.5	0.5	1.0	0.6	0.7	0.7	1.1	0.8	1.4	1.1
Spain	2.0	2.0	1.8	1.7	1.8	1.6	0.8	0.8	1.3	1.1	1.5	1.4
UK	1.3	1.3	1.8	1.0	2.1	1.5	1.8	1.8	2.0	1.9	2.3	2.0
Japan	1.1	0.9	0.9	0.3	0.9	0.8	0.5	0.6	1.0	0.8	1.5	0.8
China	6.2	6.1	5.9	5.9	5.6	5.7	2.9	2.8	3.7	2.8	2.2	2.1
World*	2.4		2.4		2.5			3.0		3.0		3.0

* Berenberg data on actual exchange rates, not purchasing power parity because PPP would give more weight to the fast-growing emerging-market countries.
** Average, Bloomberg consensus as of 16/12/2019.

OPPORTUNITIES IN EUROPE

IN A NUTSHELL

- Analysts will probably need to downgrade their profit estimates further. We expect only moderately rising corporate profits in 2020.
- High valuations have already priced in many positive factors. We do not expect valuations to rise further.
- We prefer European equities, which should benefit from modest growth acceleration, the more cyclical composition of the index and the subdued positioning of international investors.

2019 was a surprisingly good year for equities

Recession fears dominated equities markets at the start of 2019, the trade dispute escalated in May and the probability of a no-deal Brexit rose sharply in the summer. Nevertheless, equity markets had their best year since 2009 from the standpoint of a euro investor. US equities outperformed with very strong gains, followed by European and Japanese equities. By contrast, Asian emerging-market countries gained only slightly more than half as much as the S&P 500, as they were weighed down by disappointing Chinese economic data and the ongoing trade conflict. The rally in US stock markets was buoyed by the Fed's pivot from restrictive to expansive monetary policy. US markets were also supported by massive share buyback programmes. And yet corporate profits in the United States and Europe stagnated.

Corporate profits will probably only rise moderately in 2020

Only modestly accelerating global economic growth coupled with low inflation will continue to limit the nominal sales growth of companies in 2020. An expansion of profit margins is not to be expected due to the negative effect of the high debt of US companies in conjunction with modestly rising bond yields, wages and tariffs. The consensus expectation of margin expansion appears to be unrealistic. We believe it will be necessary to further downgrade profit expectations for 2020, especially for Europe. In the best case, global corporate profits can be expected to rise year on year by 4-7% in 2020. The consensus expectation is currently still around 9%.

Valuations should not rise

As a result of the declining profit expectations of analysts, the pricing out of political risks and the pricing in of an economic recovery, valuation metrics have risen well above their historical averages since the beginning of the year. US equities are now almost as expensive as they were at the end of 2017 when the US tax reform became more concrete and the market anticipated positive profit estimate revisions on the part of analysts. This time, the market is hoping for a prolonged de-escalation of the trade dispute and an economic recovery. If these positive catalysts fail to materialise, the market at current valuation levels will be vulnerable to a sharper pullback. We do not expect the relatively expensive valuation levels, particularly of US equities, to rise further in 2020. All things considered, we therefore anticipate only a limited rise in equity prices in 2020.

Strong gains for all equity regions in 2019 – global equities with strongest calendar year performance since 2009

Total return	Year-to-date and in Q4 (in %, EUR)		12-month periods of the last 5 years (in %, EUR)					P/B*	Div.*	P/E*
	YTD (31/12/18-16/12/19)	QTD (30/09/19-16/12/19)	16/12/18 16/12/19	16/12/17 16/12/18	16/12/16 16/12/17	16/12/15 16/12/16	16/12/14 16/12/15	16/12.19	16/12.19	16/12.19
MSCI EM Eastern Europe	34.6	9.3	29.7	4.6	4.0	39.7	20.8	1.0	6.0	7.4
S&P 500	33.4	5.4	27.0	3.1	7.4	16.5	22.9	3.5	1.9	19.5
Stoxx Europe Small 200	29.7	9.5	27.1	-9.5	17.3	0.8	19.6	2.0	2.6	18.4
Euro Stoxx 50	29.1	5.9	25.4	-10.8	12.0	3.4	9.1	1.7	3.3	15.8
Stoxx Europe Cyclicals	28.4	10.1	25.7	-14.0	13.1	8.3	7.9			
Stoxx Europe 50	27.6	5.1	23.9	-7.7	9.5	1.8	9.0	2.0	3.8	15.8
Russell 2000	27.4	6.3	20.3	-2.8	0.9	26.1	17.0	2.0	1.7	32.3
DAX	27.0	7.9	23.4	-17.1	14.9	8.9	9.5	1.6	2.9	15.8
MSCI UK	24.7	8.0	22.8	-6.4	5.0	5.0	7.4	1.7	4.6	14.0
Topix	23.1	5.6	17.3	-6.1	9.5	11.4	27.9	1.2	2.3	14.8
Stoxx Europe Defensives	21.8	3.5	17.9	2.4	6.4	-2.3	11.4			
MSCI EM Asia	19.5	7.4	17.1	-8.7	22.7	12.7	5.6	1.7	2.4	15.2

Time period: 16/12/2014-16/12/2019.
Source: Bloomberg. * P/B = price/book value ratio; Div. = dividend yield (%); P/E = price-earnings ratio. Values based on estimates for the next 12 months.

Chances for outperformance in Europe

Within the equity regions, we prefer Europe. Besides the cheaper valuations, this preference is supported by the fact that Europe usually performs better than the rest of the world, and especially the United States, when global growth accelerates, due to the more cyclical composition of equity indices in Europe. Moreover, many international investors have a Europe underweight due to the many years of underperformance, so that the positioning of market participants offers catch-up potential. The chances for a value rally are good in the short term. Value stocks are very inexpensive compared to growth stocks and can also be expected to benefit from rising bond yields. However, considering that the acceleration of global economic growth and thus the rise in interest rates will probably only be limited, we think that growth stocks will continue to perform better due to the higher and more stable profit growth rates. We also still see potential for British mid-caps, which are more focused on the domestic market than their large-cap peers and will therefore suffer less from any sterling strength. They will likely also benefit from a pick-up of the domestic economy and the fiscal stimulus announced by the British government. Outside of Europe, we mainly like emerging-market equities due to their relative attractiveness, an end of US dollar strength and their widening growth differential. A risk to our modestly positive view of equity markets would be a further escalation of the trade dispute, which we do not consider probable in view of the approaching US elections, but cannot rule out either.

Ulrich Urbahn, Head Multi Asset Strategy & Research

WHAT IS ON COMPANIES' MINDS?

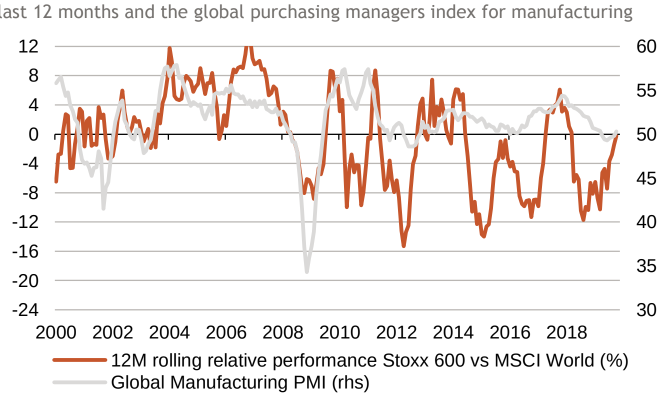
Reality in China, dreams of the future in Europe

The United States is still the world's biggest economy, but number-two China is rapidly catching up. Retail sales were one of the first sectors in which digitalisation broke through: today, e-commerce in China is the world's biggest online market, accounting for nearly 20% of Chinese consumer spending. Half of all Chinese are customers of Alibaba, the country's biggest tech company and online seller. China's digital future is also plain to see in the world of finance. Ant Financial, in which Alibaba holds a 33% stake, was recently valued at USD150bn and is now as big as Citigroup, the third-largest bank in the United States. Payment transactions in China were revolutionised by Alipay and Tencent's Tenpay years ago: now more than 60% of all online and offline payments are made through one of these two apps. The growth of the technology sector and the strong positioning of some firms are not the only reasons why China is an extremely exciting but also complicated market. One thing is certain, however: Chinese companies will play a bigger role on the world stage than ever before.

Matthias Born, CIO Equities

Global growth acceleration tends to be good for Europe

Rolling relative performance between Stoxx Europa 600 and MSCI World in the last 12 months and the global purchasing managers index for manufacturing

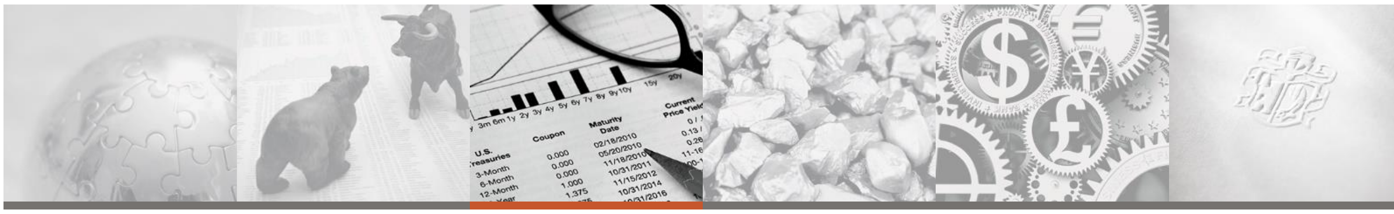


Time period: 28/02/2000–30/11/2019.
Source: Bloomberg, Berenberg.

Forecast overview: European equities offer more potential

	Currently			∅*
Index forecasts	**16/12/2019**	**30/06/2020**	**31/12/2020**	**in 12 months**
S&P500	3,191	3,150	3,250	3,380
Dax	13,408	13,300	13,900	14,110
EuroStoxx 50	3,773	3,700	3,850	3,980
MSCI UK	2,152	2,250	2,300	2,319
Index potential (in %)				
S&P500	-	-1.3	1.8	5.9
Dax	-	-0.8	3.7	5.2
EuroStoxx 50	-	-1.9	2.0	5.5
MSCI UK	-	4.5	6.9	7.7

* Average, consensus, as of 16/12/2019.
Source: Bloomberg, Factset, Berenberg.



2020 WILL BE DIFFERENT

IN A NUTSHELL

- European government bond yields have bounced off record lows; a further rise is possible at first.
- High current income makes corporate bonds attractive at first, but caution should be exercised later.
- Emerging-market bonds are attractive, but growing heterogeneity requires selectivity.

On and on it goes … also in 2020?

We are nearing the close of a generally strong year for bonds. Will this be repeated in 2020? Most probably not, or at least not to the same extent and not in every segment of the market. We expect modestly falling prices for safe government bonds, opportunities for corporate bonds at least in phases, and fundamentally attractive emerging-market bonds.

Government bonds: are record-low yields behind us now?

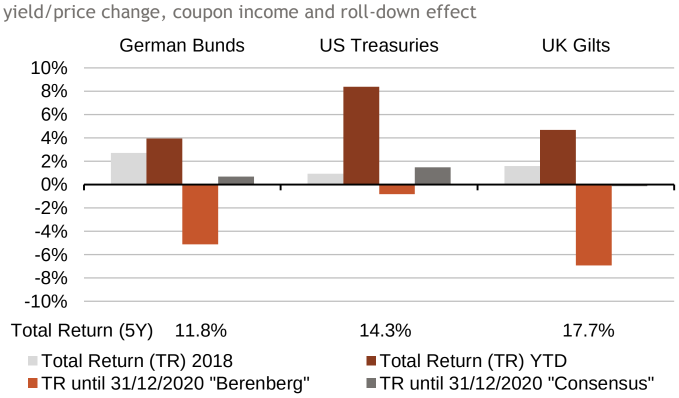
Yields of European government bonds have risen appreciably from the record lows of last summer. Whereas 10-year German bunds yielded only -0.71% in August, the yield rose to over -0.22% at times in the following weeks. Comparable movements occurred in the government bond yields of other Eurozone countries. Under certain conditions, this trend could initially continue at the start of 2020. For example, if macroeconomic indicators improve, investors' risk appetite and demand for bonds offering safety will decline. In that case, tactical buying opportunities could arise in the first half of the year before uncertainties related to the looming US election and the further course of economic growth trigger volatility. In our opinion, monetary policy will remain unchanged: we do not expect a (further) interest rate cut either in Europe or in the United States. In the worst case, central banks would nonetheless pursue a more expansive course. The greatest of all risks will still be US trade policy as escalating conflicts would quickly increase investors' demand for safety and lead to considerably lower yields.

Corporate bonds: diminishing confidence as the year progresses

Despite numerous bleak forecasts, bonds performed very well in 2019. Hybrid and contingent convertible bonds topped the ranking of European bonds with double-digit price gains (+12.5% and +17.5%, respectively). Investment-grade bonds have also made solid gains to date (+6.5%). Where will bonds go from here? Supported by ECB bond purchases and the expectation of less new issuance activity, we anticipate a positive start to the year with moderately narrowing risk spreads. At the same time, we must remember that the economic cycle is most probably now in its final third and many analysts expect worsening credit metrics. In addition, valuations in many credit segments are no longer excessively attractive after the recovery rally (see graph). Assuming a friendly start to the year accompanied by moderately rising interest rates, it would make sense to give preference to more spread-sensitive segments offering high current income. In the early part of the year, we prefer selectively picked subordinated

Safe government bonds: Berenberg more cautious than consensus

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



Time period: 16/12/2014-16/12/2019.
Source: Bloomberg, own calculations. iBoxx government bond indices (7-10 years. TR).

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

Comparison of Berenberg and consensus forecasts, values at mid-year and year-end 2020

	16/12/2019	30/06/2020		31/12/2020	
	Currently		∅*		∅*
USA					
Base interest rate	1.50 - 1.75	1.50-1.75	1.60	1.50-1.75	1.55
10Y US yield	1.87	2.15	1.86	2.20	1.93
Eurozone					
Base interest rate	0.00	0.00	0.00	0.00	0.00
10Y Bund yield	-0.28	-0.10	-0.40	0.30	-0.31
UK					
Base interest rate	0.75	0.75	0.80	1.00	0.75
10Y Gilt yield	0.82	1.30	0.81	1.70	0.95

*Average. Consensus as of 16/12/2019.
Source: Bloomberg.

and European high-yield bonds, as well as corporate bonds with BBB ratings for more defensive mandates. In the later course of the year, we plan to become more cautious and build up positions in higher-quality bonds with a somewhat longer duration instead of the above-named credit segments.

Emerging-market bonds: differentiation to become more important

After a strong showing in the first half of the year, emerging-market bonds denominated in both local and hard currencies consolidated over the course of the second half, although without giving up much in the way of performance. This development was mainly driven by the US-Chinese trade conflict and burgeoning political risks, particularly in Latin America. A closer look at the positive annual performance reveals that it was mostly attributable to expansive central bank policy. At the present time, however, particular attention must be paid to idiosyncratic risks, especially in the case of local-currency bonds and countries with lower credit ratings. Prominent examples of such countries include Argentina, Chile, Lebanon and Ecuador. For this reason, we currently prefer less volatile hard-currency bonds to their local-currency counterparts. Potential investments should be carefully differentiated, not only at the level of countries and companies, but also at the level of regions, in order to better account for the growing heterogeneity of this segment. We are currently avoiding the Latin America region and looking out for opportunities in the Africa region and Asia instead. Generally speaking, however, both hard-currency and local-currency emerging-market bonds are still attractive, particularly compared to the possible alternatives. We consider the current risk spreads for hard-currency government bonds to be fair and those for hard-currency corporate bonds – especially those with better average ratings and shorter durations –to be attractive. If political country risks remain high or if international trade conflicts are escalated again, we would prefer the segment of corporate bonds due to the better risk/return ratio.

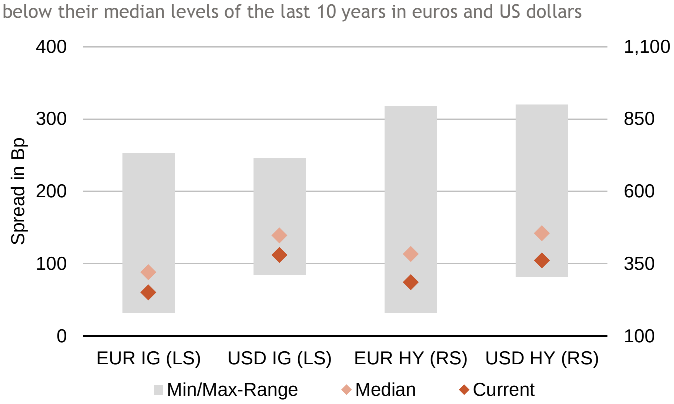
Conclusion: duration is not an option

Investors who wish to earn positive income on bonds should base their decisions on risk spreads instead of falling yields and long durations in 2020. At least at the start of the year, therefore, subordinated and high-yield corporate bonds should be considered for portfolio diversification. Moreover, emerging markets are still an attractive segment, although it will be more important than recently to perform careful analysis and strictly differentiate between acceptable risks and risks that should be avoided. By contrast, the segment of safe government bonds is subject to the risk of value losses; at any rate, they should deliver positive contributions by way of portfolio diversification if economic worries arise or political risks worsen, leading to increased demand for safe-haven investments.

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

Corporate bonds: risk spreads closer to the bottom end

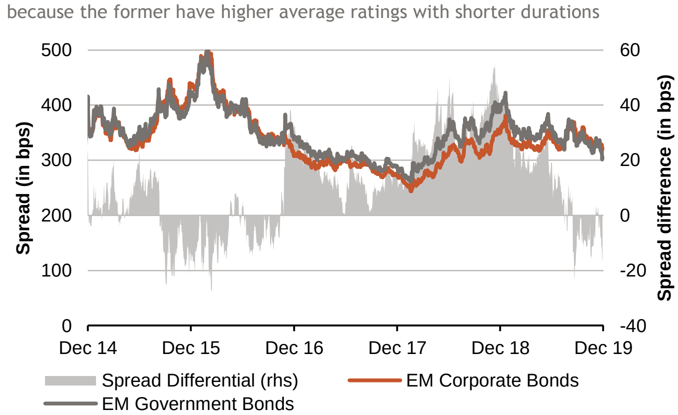
Risk spreads in the investment-grade (IG) and high-yield (HY) segments are both below their median levels of the last 10 years in euros and US dollars



Time period: 16/12/2009-16/12/2019.
Source: Bloomberg.

Emerging markets: corporates more attractive than governments

When risk spreads are similar, we prefer corporate bonds to government bonds because the former have higher average ratings with shorter durations



Time period: 16/12/2014-16/12/2019.
Source: J.P. Morgan, Bloomberg.

INDUSTRIAL METALS POISED TO CATCH UP

Crude oil under pressure despite OPEC cuts

Constant alternation between optimism and pessimism about the trade dispute and speculation concerning the OPEC meeting in December caused crude oil to trend slightly upwards in the past quarter. However, the now decided production cuts will probably not be enough to prevent an oversupply in the first half of the year. That is because demand growth will not keep up with production increases in the United States, Brazil and Norway even assuming a moderate economic recovery. OPEC will therefore continue to play the role of swing producer and may well have to order further cuts to balance supply and demand. On the other hand, an escalation of Middle East tensions could trigger significant price increases given that energy markets currently appear to be blind to the conflicts smouldering there and are pricing in no geopolitical risks whatsoever.

Gold takes a breather

The gold rally of the preceding months paused in the fourth quarter. The precious metal lost some of its appeal due to the higher risk appetite of investors and higher bond yields. Moreover, the already extreme net-long positioning of speculative investors and record ETF holdings are limiting further upside price potential. That said, the downside potential is also limited. The price of gold is supported by globally dovish monetary policy and low levels of real interest rates, as well as an expected weakening of the US dollar. Furthermore, the central banks of emerging-market countries such as Russia, China and India will use the lower prices as buying opportunities in order to "de-dollarise" their reserves. As a result, gold will continue to serve as an attractive diversifier in 2020, mainly due to its function as a hedge against economic-policy and political risks.

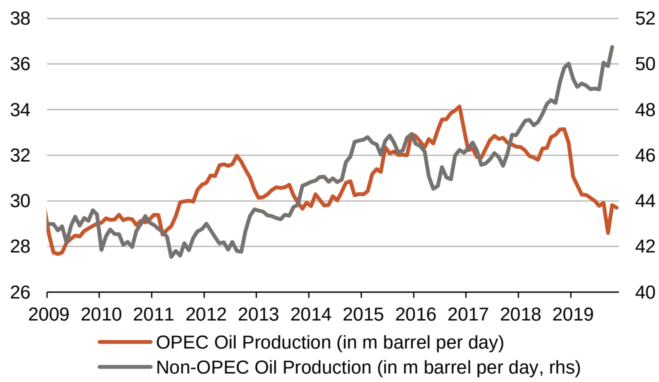
Industrial metals have catch-up potential

The trade dispute, disappointing economic data and surplus capacities on the supply side made industrial metals the worst asset class in 2019. This did not change in the fourth quarter. Unlike cyclical stocks, the metal markets did not reward the more conciliatory tone between the United States and China and the signs of a coming economic recovery. Instead, they have remained sceptical. Industrial metals would have catch-up potential if the optimistic expectations in the equity markets materialise. We see opportunities especially in copper due to the support given by structural trends such as the expansion of renewable forms of energy, low inventories and a strained supply situation.

Ludwig Kemper, Analyst Multi Asset Strategy & Research

Non-OPEC countries increase their production

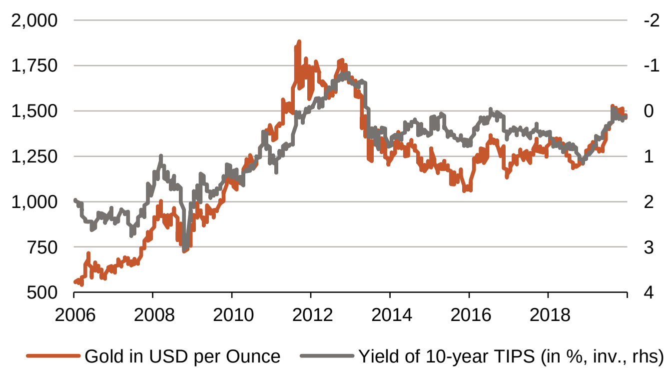
OPEC must continue to act as the swing producer to prevent an oversupply and therefore a drop in crude oil prices



Time period: 01/01/2009–30/11/2019.
Source: Bloomberg.

Gold price supported by low real interest rates

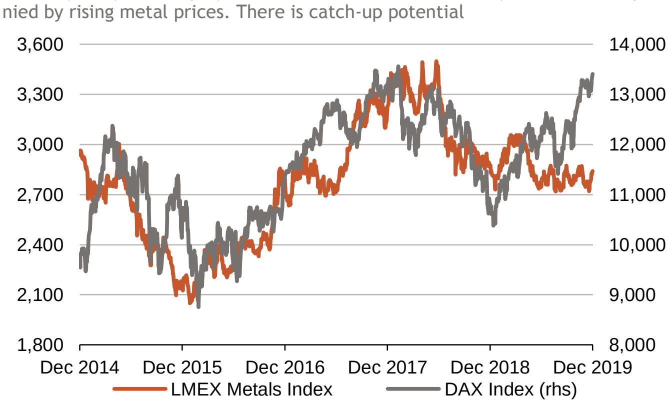
Thanks to the dovish monetary policy of central banks, real interest rates should remain at low levels, supporting the price of gold



Time period: 01/01/2006–30/11/2019.
Source: Federal Reserve, Bloomberg.

Investors are still sceptical about industrial metals

The rally of cyclical equity indices such as the DAX has not yet been accompanied by rising metal prices. There is catch-up potential



Time period: 16/12/2014–16/12/2019.
Source: Bloomberg.

NEW TREND IN THE NEW YEAR?

No strong trends

The year 2019 was full of economic imponderables and monetary policy surprises. However, there were no striking trends in the currency market. The US dollar gained over the course of the year, although the increases of slightly more than 2% on a trade-weighted basis and around 2.9% against the euro were not exactly remarkable.

US dollar will probably come under some pressure

The US currency benefited in 2019 from the relatively robust US economy, higher interest rates compared to the eurozone and the dollar's quality as a safe haven for investors. Given that risks – trade conflict and Brexit – will subside and the economy in Europe will regain its footing, in our opinion, the dollar will come under some pressure and the euro will rise moderately. This trend reversal could even happen in the first quarter. Apart from a very brief interruption, the euro-dollar exchange rate has remained just below the 200-day moving average since May 2018. If the exchange rate breaks out above the 200-day moving average, this could be the long-expected signal for a trend reversal in the currency market.

In all probability, the ECB will not take any additional expansive measures in the next few months, meaning that the euro has already processed all exchange rate-weakening factors. After the previous three rate cuts, the Fed will pause for now and base its future monetary policy on economic data.

British pound: course set for a soft Brexit

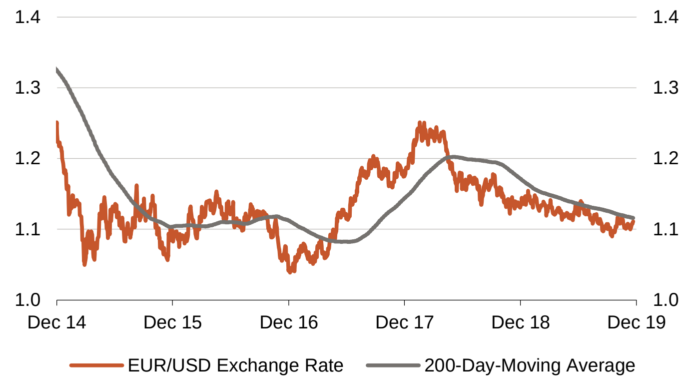
The currency market has priced out a hard Brexit. Sterling has appreciated considerably against the euro. As soon as a contractually regulated departure has been completed and all remaining doubts have been cleared away, the British currency could rise further, by one to two cents, to around 0.83 pounds per euro.

The Bank of England (BoE) has held off on changing interest rates in the last few months and is currently in "wait-and-see" mode. After the electoral victory of the Conservatives and an orderly exit from the European Union on 31 January 2020, the BoE will probably keep interest rates steady at first. It will raise interest rates later in the year, presumably in the third quarter. This is probable because, first of all, Boris Johnson is planning a fiscal stimulus and, second, British consumers will open up their wallets once the Brexit uncertainties have dissipated. These two developments will be conducive to higher inflation rates, making it likely that the central bank will tighten its monetary policy.

Dr. Jörn Quitzau, Senior Economist

EUR/USD: trend reversal in the new year?

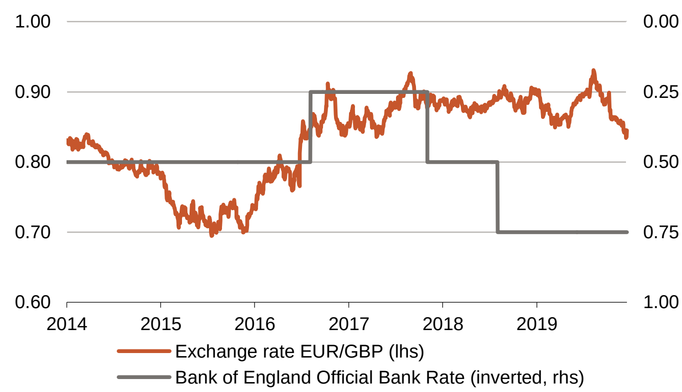
The euro has stabilised around the level of 1.10 US dollars per euro. An end of economic weakness in the Eurozone should lead to a trend reversal



Time period: 16/12/2014–16/12/2019.
Exchange rate in US dollars. Source: Bloomberg.

EUR/GBP: hard Brexit is priced out

The currency market has anticipated an orderly Brexit. The BoE will continue to proceed cautiously, but will probably raise the base interest rate next year



Time period: 01/01/2014–16/12/2019.
Exchange rate in GBP. Base interest rate in %. Source: Bloomberg.

Exchange rate forecasts

The euro will rise again when the burden of political risks is lifted

	16/12/2019	30/06/2020		31/12/2020	
Exchange rate forecast	**Currently**		∅*		∅*
EUR/USD	1.11	1.13	1.13	1.15	1.16
EUR/GBP	0.84	0.83	0.85	0.83	0.85
EUR/CHF	1.09	1.12	1.11	1.14	1.12
EUR/JPY	122	119	120	121	120
Change against the euro in %					
USD	-	-1.4	-1.4	-3.1	-3.9
GBP	-	0.7	-1.7	0.7	-1.7
CHF	-	-2.2	-1.4	-4.0	-2.2
JPY	-	2.6	1.8	0.9	1.8

*Average. Consensus as of 16/12/2019.
Source: Bloomberg.

INTERVIEW WITH MATTHIAS BORN

Mr Born, you are Head of Investments and Head of Portfolio Management Equities at Berenberg. What are your responsibilities?

As Head of Investments, it is my responsibility to design our offering of investment solutions in a way that is competitive and client-focused. The key success factors are performance, product range and team culture. We have invested in our investment teams and reorganised our investment processes in the last two years. We can now build on this. Besides the strategic development of the platform, I also focus on equities, of course. I have been a passionate equity fund manager for 18 years. I constantly discuss current developments and positions with my own team and naturally also with the multi-asset managers.

What is the nature of your collaboration with the asset management team of the Multi-Asset Division?

The goal of our collaboration is to make efficient use of synergies and create added value for our clients. For example, the equities team attends meetings of the Investment Committee in which the market outlook and investment ideas spanning all asset classes are discussed. Naturally, we also contribute our equities expertise to asset management mandates. In this respect, our clients also benefit from our boutique character and short decision paths.

You also continue to work as a portfolio manager, of course. What does your typical workday look like?

The basis of our work is to read and thoroughly analyse company reports and the research reports of colleagues and other brokers. In addition, we make a point of visiting companies and attending conferences and management meetings. I then discuss the impressions and insights gained from these meetings with my colleagues – either in person or using our digital research management tool. And, of course, I visit clients as well, both current and prospective.

You are obviously passionate about equities. What moved you to pursue the career of a portfolio manager? Germany is not exactly known for its equities culture.

My father worked at Dresdner Bank and my stepfather always invested his money in equities and so there was a certain early influence from my family. At school, I participated in the Stock Market Learning contest on a regular basis and then I took an advanced course in economics. While I was studying business administration at college, I founded an investment company with fellow students, which invested the money of friends and family

in equities. I made the final decision as an intern at DIT, the investment fund company of Dresdner Bank.

How has your profession changed over the years?

Regulation, digitalisation and passive competition have been especially important. When I began my career, research reports still came in by fax and I personally delivered my order slips to the trading desk. Machine learning will have a major impact on our work in the future, including our investment processes and in automation. For this reason, we have formed an Innovation & Data team to work on these innovations. Regulation and passive competition cut into our profitability.

Given the expertise you have accumulated over many years, what was your best private investment and what was your worst? What did you learn from this mistake?

The best was Aixtron, which I bought when it first issued shares and sold before the new market segment collapsed. Otherwise, the best investments have generally been those which I was prepared to hold for a long time. There are various stocks in my fund that I have held for more than a decade, such as LVMH, SAP and Kerry. The biggest mistakes were those investments for which I was overly influenced by exuberant optimism or trends. My own investment funds and those of my colleagues make up the biggest part of my private portfolio. I can best judge how the investment strategy is faring and have the necessary conviction with these funds.

What is the secret of your success as an equity portfolio manager?

Diligent analysis, but also courage and discipline. It is important to not shy away from risk and also to have the courage to admit your shortcomings – no one can know everything. And you need discipline in your investment process. It was important in the fourth quarter of 2018 to remain calm and not sell at the wrong time. We were successful in that regard.

How is that reflected in your investment philosophy?

A focused portfolio for which the benchmark only serves as general orientation. That means I take high single stock risks, but balance them by investing in strong business models. We strive to be invested for the long term in all our equity strategies. The foundation is always fundamental analysis of companies. This analysis is focused on the sustainability of the business model and growth.

What specific criteria do you apply in selecting stocks?

It is crucial for us, for the company, to have clear competitive advantages that support permanently high profitability. Also, we only invest in companies that benefit from structural growth drivers.

The absolute magnitude of growth is not the only thing we look at; we are more interested in the predictability and stability of growth. Finally, you cannot afford to disregard the company's valuation, of course. Investing in high-quality companies only makes sense if they are undervalued by the market. In this context, however, it is also important to assess the valuation in conjunction with the attractiveness of growth.

What role does ESG play in our investment approach?

ESG is a crucial aspect of all our investment strategies. We try to invest in high-quality companies that grow faster than the market over very long time periods. For this to happen, the sustainability of both the business model and the growth must be assured. For example, we were never interested in companies that derive their competitive advantages from exploiting their workers. For this reason, I would say that ESG has always been an integral aspect of our approach even though we did not call it that. This is also shown by MSCI's very good AA ESG rating of the Berenberg European Focus Fund.

Why should an investor prefer active funds to passive ETFs?

Because an ETF tracks the average performance of an index, investors who invest in such funds can only achieve average returns at most, virtually by definition. Investors in active funds have a chance at beating average returns. The latter makes sense particularly in Europe, in my opinion. Unlike the case in the United States, structurally less attractive sectors in Europe, such as banks and autos, make up a much larger share of the indices. With our focused portfolios, we can concentrate on truly exciting investment ideas.

How satisfied are you with the performance of your equity funds since you began working at Berenberg in October 2017?

Since the funds' inception in October 2017, our Europe and Eurozone funds have clearly outperformed not only the benchmark, but also most of our competitors. The funds have performed especially well in 2019 so far. We have ranked in the top 6% and top 1%, respectively, of the peer group since the beginning of the year. Above all, the strategy of investing independently of the benchmark and counting on a focused portfolio of high-growth, high-quality stocks has proved to be successful. Our investors also benefit from the relatively small size of the funds, which gives us greater flexibility than our competitors. And our other equity funds are also at the top of their peer groups. We can be very satisfied with that.

BRIEF BIOGRAPHY

Matthias Born joined Berenberg as CIO Equities in October 2017. He has been the head of the entire investment platform since October 2019. Mr Born began his career with Allianz Global Investors (AGI) in 2001. In 2007, he took over the AGI flagship fund Concentra and since 2009 he has managed one of the most successful teams for European equities, with responsibility for client funds of well into the double-digit billions. He has received multiple awards from investment fund rating firms for his outstanding performance in the German and European equities market.

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IMPORTANT NOTICES

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