REFLEXIONS Q3-19

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Executive Summary

Dear ladies and gentlemen,

The tension between risks and opportunities in the capital markets has become increasingly tangible. The impending trade and economic war between the United States and China is a major contributor to the heightened perception of risk. Further, the political hazards that have smouldered for some time already, such as Brexit, additionally burden the sentiment.

On the other hand, the most important central banks are sending very positive signals for the capital markets. Moderate to low inflation numbers enable them to pursue increasingly expansive monetary policies. Above all, we expect the US Fed to enact two interest rates cuts this year. In addition, the European and Chinese central banks are injecting additional liquidity into the economy and capital markets. The altered monetary policy has already influenced the government bond yields considerably on both sides of the Atlantic. The current decline in yields has dimmed the outlook for future returns in the bond market. It is more important than ever to seize selective opportunities in this segment.

Overall, the mixture of positive and negative signals results in a balanced assessment of the equity markets. Regionally speaking, US equities are still our first choice. However, the global growth slowdown, coupled with the escalating trade war between the United States and China, has somewhat dampened our current outlook for emerging market equities. In consideration of the uncertainties in the Eurozone, we devote special attention to the Swiss equity market in this issue. Our guest contributor and specialist for Swiss equities, Sven-Erik Schipanski, explains the opportunities and risks in our local market.

As another special topic, we take up the already commenced US presidential election campaign. In an early preview, our equity strategist Till Christian Budelmann assesses the positive or negative implications for future economic developments as they relate to each candidate.

Falling yields are fundamentally positive for gold. Especially considering the slowing economic growth momentum, gold is still advisable as a diversification element and could benefit from rising prices.

Complementing our written commentaries, we are pleased to illustrate a summary of our capital market view on the next page.

With best wishes for an interesting read,
Sincerely,

Maximilian Hefele
Head of Asset Management

House view – capital markets

Bank View	- -	-	o	+	++
Equities	○	○	●	○	○
North America	○	○	○	●	○
Consumer Discretionary	○	○	●	○	○
Consumer Staples	○	●	○	○	○
Energy	○	○	○	●	○
Financials	○	○	○	●	○
Health Care	○	○	○	●	○
Industrials	○	○	○	●	○
Information Technology	○	○	●	○	○
Materials	○	○	●	○	○
Real Estate	○	○	●	○	○
Communication Services	○	○	●	○	○
Utilities	○	○	●	○	○
Europe	○	○	●	○	○
Consumer Discretionary	○	○	●	○	○
Consumer Staples	○	○	●	○	○
Energy	○	○	●	○	○
Financials	○	○	○	●	○
Health Care	○	○	●	○	○
Industrials	○	○	○	●	○
Information Technology	○	○	○	●	○
Materials	○	●	○	○	○
Real Estate	○	○	●	○	○
Communication Services	○	○	●	○	○
Utilities	○	○	○	●	○
Emerging Markets	○	●	○	○	○

Bank View	- -	-	o	+	++
Fixed Income	○	●	○	○	○
Denomination US Dollar	○	○	○	●	○
Duration	○	○	●	○	○
Sovereigns	○	○	○	●	○
Corporates Non-Financial	○	○	●	○	○
Corporates Financial	○	○	●	○	○
Senior	○	○	●	○	○
Subordinated Debt	○	○	●	○	○
Corporate High Yield	○	○	●	○	○
Denomination Euro	○	●	○	○	○
Duration	○	●	○	○	○
Sovereigns	○	●	○	○	○
Core	○	●	○	○	○
Peripheral	○	●	○	○	○
Corporates Non-Financial	○	○	●	○	○
Corporates Financial	○	○	●	○	○
Senior	○	○	●	○	○
Subordinated Debt	○	○	○	●	○
Corporates High Yield	○	○	●	○	○
Emerging Markets	○	○	○	○	●
Hard Currency	○	○	○	○	●
Local Currency	○	○	●	○	○

Bank View	- -	-	o	+	++
Alternative Investments	○	○	○	●	○
Commodities	○	○	○	●	○
Energy	○	○	○	●	○
Industrials Metals	○	○	●	○	○
Precious Metals	○	○	○	●	○
Hedge Fund Strategies	○	○	●	○	○
Long/Short	○	○	●	○	○
Relative Value	○	○	○	●	○
Macro	○	○	●	○	○
Event Driven	○	○	●	○	○
Convertibles	○	○	○	●	○
Real Estate	○	○	●	○	○

Monetary policy supports the economy

Dr Holger Schmieding
Chief Economist

- **Economy: Global trade and manufacturing weaken further**
- **The new trade dispute between China and the United States has delayed a renewed upturn of manufacturing**
- **China applies stimulus, central banks support the economy**

The industrial recession continues for the time being

A series of political crises and political shocks has knocked the economy off stride in Europe and East Asia. In addition to the trade tensions stoked by the United States, the growth weakness in China continues to weigh on business sentiment. While there were many signs of an imminent end to the manufacturing recession from March to May, the unexpected escalation of the trade war between the United States and China in early May has heightened the risk that the manufacturing recession could last throughout the summer. We must be prepared for more bad news in the short term.

The economy in the Western world exceeded expectations in the early part of the year, due in part to exceptional effects such as the mild Winter in much of Europe and the late Easter holiday. This year, a larger than usual number of holidays fell in April (thus in the second quarter), instead of in March. The second quarter numbers in Europe will likely be proportionally worse.

After the strong performance in 2018 and the good start to 2019, the US economy is currently losing momentum. Substantial slowing can be observed especially in manufacturing, due to the trade dispute with China. On the other hand, the solid growth of consumers' real incomes suggests that the US economy can expand at a rate of around 2.5% in 2019.

In nearly all countries of the Western world, the primarily domestically oriented service sector has been largely unaffected by the turmoil surrounding foreign trade. We expect that manufacturing can slowly recover in the autumn of 2019. When that happens, the unusual divide between the currently weak state of manufacturing and the more robust state of services will gradually close again.

Loans to households and enterprises outside the financial sector

Annual rate of change in % Period: 01 Jan 2016 until 31 May 2019

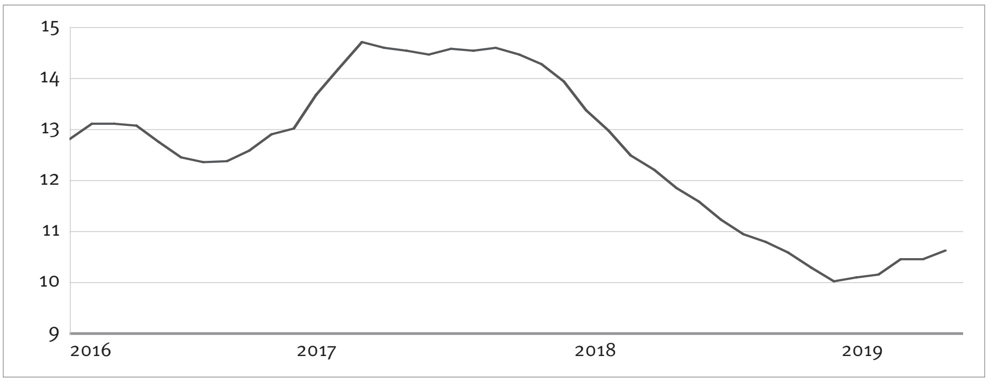


Fig. 1 Source: PBoC.

Trump keeps the world in suspense

In order for the economy in the Western world to pick up steam again overall, two conditions need to be met:

First, the trade tensions must ease. It cannot be said with certainty whether the United States and China will be able to reach a partial agreement in the coming months after the latest escalation. Considering the economic slowdown, however, neither side can have an interest in a further escalation. In the dispute between the United States and the European Union, which is even more important for Europe and global trade, the additional time until November that Trump granted for negotiations with the EU suggests that he would like to avoid a trade war with the EU. That makes sense for a President who wants to be re-elected next year. Considering that the United States exports three times as much to the EU than to China, the EU could in the worst case retaliate so hard against US automobile tariffs that it would ruin Trump's election chances. For that reason, we expect that the negotiations between the two sides will be long, tough, and strident, but that it will not come to a genuine trade war.

Second, China must overcome its pronounced economic weakness. Beijing has already taken steps to this end. The monetary and credit policy steps taken in late 2018 will gradually take effect in the form of somewhat brisker lending (see graph). In addition, China announced in early March that it will lower taxes (by around 2% of economic output), further loosen lending standards, and increase infrastructure spending again. If the new dispute with the United States hits the Chinese economy hard, China could be expected to quickly launch another stimulus programme. Because such programmes only take effect after a delay, however, the Chinese economy will probably only regain momentum in the autumn.

Political risks in Europe

Despite making modest gains, the right-wing populists did not achieve the landslide victory in the European parliament elections that many observers had feared. In France, Marine

Le Pen actually fared worse than five years ago. The risk that the populists could permanently disrupt European politics remains low. It is true that a strident argument over national budget rules could break out between Italy and Brussels. However, because Rome cannot afford higher risk premiums, Italy will eventually have to yield, in all probability, just as it did last autumn.

Central banks pivot

Wage pressure is rising only slowly in the United States and Europe. Thus, core inflation rates are either very low, at around 1% in the Eurozone, or well below the targeted rate of 2%, at around 1.6%, in the United States. Central banks can therefore adjust their policies to reflect the outlook for the economy. The world's two most important central banks have already reacted to the unexpectedly low inflation rates and the risks inherent in Trump's trade policy. The US Federal Reserve will end the gradual run-off of its balance sheet already in the autumn of this year. Furthermore, its latest statements suggest that it could soon cut interest rates. Therefore, we now expect that the Fed will lower interest rates in July and October 2019 by 0.25 percentage points at a time.

The ECB is offering generous new liquidity injections to banks. The ECB has also opened the door to a potential rate cut and renewed asset purchases later this year if growth and core inflation remain subdued over the summer. The pivot of central banks limits the downside risks for the economy.

Cautiously optimistic into the second half of the year

Till Christian Budelmann
Equity Strategist

- **Equities are currently not expensive, they are actually quite cheap compared to bonds**
- **Market participants are not over-positioned, lack of euphoria is a positive factor**
- **US equities continue to offer the greatest return potential; some caution is recommended with respect to emerging market equities**

After a pleasant start to the year for global equity markets, the positive trend initially continued in the second quarter. Contrary to expectations, the US economy expanded at a surprisingly fast rate in the first quarter. After global profit projections for 2019 had been broadly revised downward at the beginning of the year, expectations have stabilised over the last three months (exception: emerging markets). The upward march of equity prices was finally interrupted by the very risk scenario to which we have always ascribed the greatest importance for global equity markets: a renewed escalation of the trade dispute between the United States and China. Considering valuations and the positioning of market participants, we remain cautiously optimistic about equities, despite the political risks.

Equities are currently not expensive

Compared to the historical average, global equities are moderately valued now; compared to bonds, they actually seem quite cheap (measured by current valuations using a forward P/E approach).
The P/E ratio is the result of a simple calculation: the current equity price divided by a company's latest annual earnings per share. This indicator shows how many times current earnings per year an investor pays for adding a portion of equity to his portfolio. The forward P/E ratio is an extension of this approach: expected future profits are applied instead of reported corporate profits.
For our analysis, we study the S&P 500 and the MSCI All Country World Index (MSCI ACWI) currently comprised of 2,852 equities.

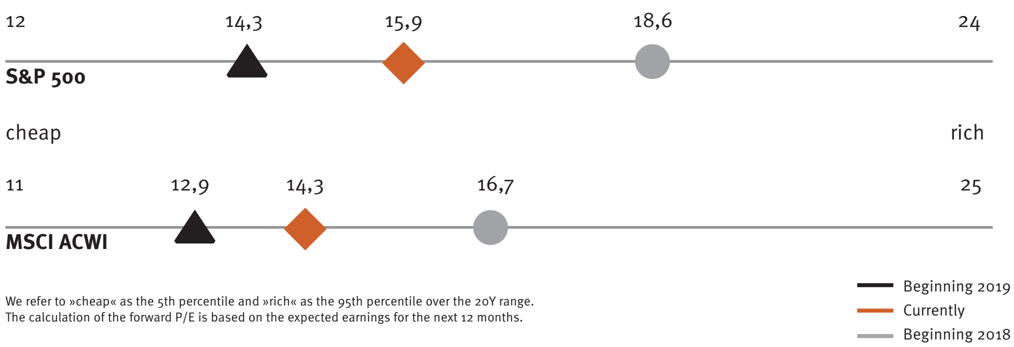
Looking back at the range of the last 20 years for the MSCI ACWI, we regard a 12-month forward P/E ratio of 11 as cheap and 25 as expensive. Extreme values such as the P/E ratio shortly before the bursting of the dotcom bubble or at the height of the financial crisis are deliberately excluded. Currently, we have calculated a result of almost 15; at the start of this year, it was actually still around 13. The market was somewhat higher valued at the start of 2018, when we calculated a value of almost 17; therefore, we can conclude that global equities are currently moderately valued compared to the historical average.

In this analysis, consideration should also be given to the changed weights within the MSCI ACWI. Especially considering the changed structure of the heavily weighted US share over the last decade, the massive shifts in the index composition are remarkable. The five biggest companies today are all high-margin stocks, namely Alphabet, Amazon, Apple, Facebook, and Microsoft. Because these companies have grown so much and continue to grow, a higher P/E ratio is also attributed to these companies as a group. For example, Amazon currently has a forward P/E ratio of almost 50. This leads to a structural distortion of the valuation of US equities overall. The fact that these five companies have since become an even more important element of the overall index suggests a structural distortion in the direction of high P/E ratios. And even then, valuations are below the historical average, on aggregate.

Valuations are likely to trend higher

Considering the attractiveness of investment alternatives, we consider it more likely than not that equity valuations will increase in the coming quarters. The more unattractive bonds appear, for example, the more likely it is that equity prices will rise. Bond yields are currently below their historical average. Normally, this would imply that equity P/E ratios should be above their historical averages, but they are not. The low-interest policy of central banks, with interest rates around zero (with the exception of the US central bank, or Fed), is especially relevant in this context. But even the Fed is now expected to cut interest rates over the next 12 months. It is therefore un-

Global valuations based on the S&P 500 forward P/E ratio and the MSCI ACWI forward P/E ratio



We refer to »cheap« as the 5th percentile and »rich« as the 95th percentile over the 20Y range.
The calculation of the forward P/E is based on the expected earnings for the next 12 months.

Fig. 2

Source: FactSet, MSCI, Data as of 31 May 2019 likely that bonds will become more lucrative, and that should fundamentally support equities. The relative valuation of equities compared to bonds in the United States has recently neared its 24 December 2018-peak, when equity markets reached their last lowest point. This means that US equities are cheaper than bonds right now.

However, the P/E ratio analysis is based on current prices and analyst's estimates (which have already been lowered since the beginning of the year). The extent to which the trade conflict will further weigh on profit outlooks and therefore influence global equity valuations cannot yet be fully estimated.

The background of moderate valuations should also be seen in the context of the stress felt by market participants as a result of the trade conflict. In early May, for example, markets were shocked by US President Trump's tweets stating that drastically higher tariffs against China are being considered. Markets experienced an exogenic shock as market participants had previously been firmly convinced that the conflict would soon be resolved.

We ascribe less importance to the Shiller P/E ratio, also known as the CAPE (Cyclically Adjusted Price-Earnings Ratio). The appeal of the Shiller P/E ratio lies in the fact that cyclical factors are excluded from the valuation analysis. However, it has a disadvantage compared to our forward P/E ratio approach in that it only considers the profits of the last ten years. Measured by the Shiller P/E ratio, the equity market seems to be massively overpriced, and has been for some time, namely over the last ten years. However, we will soon enter a phase in which the Shiller P/E ratio could possibly look much different because the financial crisis year of 2009 will no longer be included in the calculation. When the years 2019 and 2020 are soon included in the analysis, the Shiller P/E ratio should fall, with the result that those investors who followed the Shiller P/E ratio and therefore missed out on the entire rally will suddenly receive an alleged buy signal, according to Shiller.

USA and Eurozone are similarly valued on sector-neutral basis

Corporate profits in the United States have developed well in the last ten years, especially compared to Europe and especially compared to the Eurozone. There are indeed pronounced sectoral differences between the two equity markets: thanks to their profit momentum and strong innovation capacity, the high-growth, high-margin US companies are high-P/E companies with compelling stories, whereas there are no such companies in the Eurozone. That is why the Eurozone P/E ratio only appears to be much lower than in the United States. However, sector compositions in the United States and the Eurozone are completely different and for this reason the valuation of Eurozone equities compared to US equities should always be calculated on a sector-neutral basis. Taking this into account, it can be found that both markets are roughly fairly valued in comparison with each other. This also applies to the comparison of developed countries with emerging market countries.

So what happens next? Will US corporate profits continue to outpace profits in the rest of the world? We believe that this will continue to be the case. First, we continue to expect higher revenues in the United States. Second, profit margins in the United States are still at a higher level, even though signs of a certain catch-up process can be observed here, for example in the Eurozone. Third, US companies are still much more inclined to engage in extensive equity buybacks, which support earnings per share (EPS) and therefore reduce P/E ratios. The development of corporate profits in emerging market countries appears downright worrisome. In these countries, profit expectations have developed much worse than in the developed countries since the beginning of 2018, not least of all due to the trade war.

Current status of global sector valuations

Looking at global sector valuations, four sectors are particularly striking. Cyclical energy and financials are the most undervalued. These companies have increased their profits substantially, but the market has not yet rewarded them for that. The heavily weighted financial sector currently has a global P/E ratio of a little over 10, while that of energy equities is a little over 12. The IT sector still appears to be overvalued. In this sector, prices have recently outpaced profits. On aggregate, therefore, the IT sector's global P/E ratio is well above the average values. The communi-

AII Sentiment

Note: The American Association of Individual Investors (AAII) surveys its members every week about how the market will perform in the coming six months.

Fig. 3

Source: AAII, Data as of 26 June 2019

cations sector is also higher than its historical average, but this is largely due to the fact that certain (former) IT companies have recently been attributed to this sector.

Positive outlook for US equities

We anticipate steady US growth in the future; we do not see a recession in the current or next calendar year. The Fed's interest rate cuts (»insurance cuts«) should support economic growth in the United States. Naturally, a »value trap« (meaning that US equities only seem inexpensive, while the situation is actually much worse than the fundamental data suggest) cannot be ruled out. However, we continue to take a positive view on US equities (also due to their relative profitability) and believe that the political noise will begin to subside at a certain point. The US market is also holding up well, because valuations are low and market participants are not over-positioned in equities, unlike the case at the beginning of 2018. Investors are not euphoric, rather the opposite. Based on the different profit expectations described above, we take a neutral view on European equities and a somewhat cautious view on emerging market equities.

Bond markets oscillate between celebration and caution

René Bolhar
Bond Strategist

- **Central bank policies are increasingly expansive; two interest rate cuts by the Fed between now and the end of this year are now the baseline scenario**
- **The ECB too is clearly trending in the direction of expansion; market participants are now eyeing the possibility of further interest rate cuts or a resumption of bond purchases**
- **The fixed-income market is still performing very well; widening risk spreads are more than offset by the generally lower level of interest rates**
- **Market participants are positioning themselves for a further weakening of the global economy; rising demand for fixed-income securities in general and duration in particular**
- **Caution is advisable, but there are still no signs of panic in the markets**

The second quarter largely saw a continuation of the trends in effect at the end of the first quarter. Markets are increasingly preoccupied with geopolitical conflicts, the frequency of weaker economic data has increased, and investor sentiment has become more cautious. Nevertheless, valuations within the segment of fixed-income investments are not sending a clear message.

Although the renewed intensification of the trade conflict between the United States and China caused credit risk spreads to widen at the start of May, specific events such as the sharpened rhetoric between the United States and Iran and the continuing political problems in Italy prompted some investors to sell, leading to lower bond prices. However, the great majority of issuers benefitted from the generally declining level of interest rates throughout the quarter, which more than offset the negative effects.

Even in the high-yield segment, the drop in valuations that occurred in May proved to be only temporary. Emerging-market bonds,

Credit spreads on investment grade and high-yield bonds in EUR and USD

Period 1 July 2009 until 30 June 2019

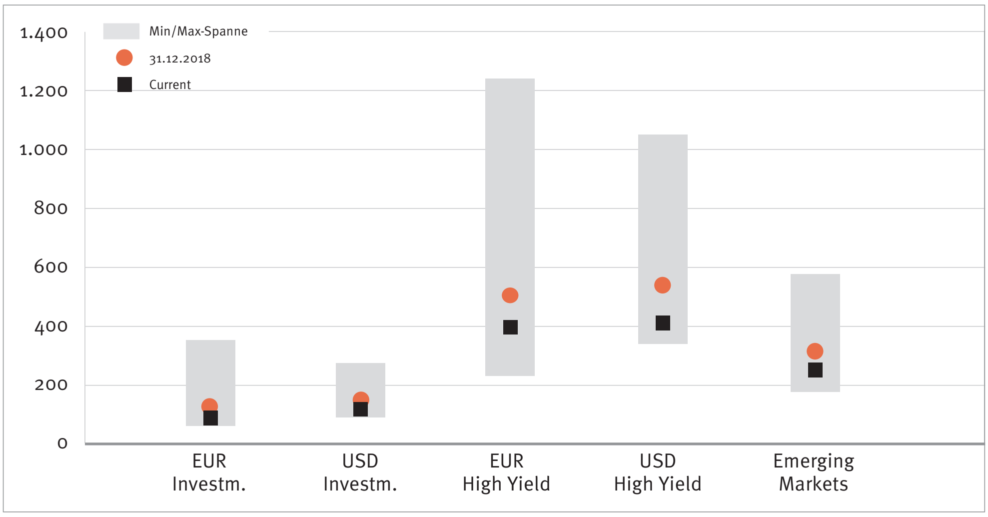


Fig. 4 Source: Bloomberg, Illustration Bergos Berenberg AG

particularly those denominated in US Dollars, ignored the negative headlines entirely. There has been and still is no hint of panic in the markets.

Taking a closer look at the bond markets, we notice that supposedly safe investments have particularly benefitted from uncertainty. Investors have apparently learned to deal with the persistent concerns, as evidenced by the very low volatility of bond markets – even though a certain feeling of familiarity is becoming noticeable.

However, preparations are also being made for the »day after«. Duration is in demand again and new issues are being easily absorbed by the market in most cases, even though the inversion of the US yield curve is supposedly a Damocles Sword hovering above the markets. US Treasury yields have continued to trend lower, reaching an interim low of close to 2.0% for ten-year bonds. German bond yields have actually blown through their previous all-time low, reaching -0.33% in the middle of June.

Whereas US Treasuries have undergone a flattening of the yield curve for several months already, this trend has recently begun to affect German government bonds as well. In the case of German bonds, however, the yield curve can be said to have a regular shape, with lower yields for short maturities compared to longer maturities. By contrast, US Treasuries have lower yields in the range from 3 months to around 15 years than at the edges of the curve.

In this environment, a significant reinterpretation of future central bank policy could be observed. Recent official comments and statements by the Fed openly suggest an adjustment of monetary policy or even interest rate cuts. Moreover, the implied probabilities derived from the money market point to recently more expansive policy in the form of interest rate cuts. At the lowest end of the range, they

Market implied Fed Funds Rate January 2020

In points

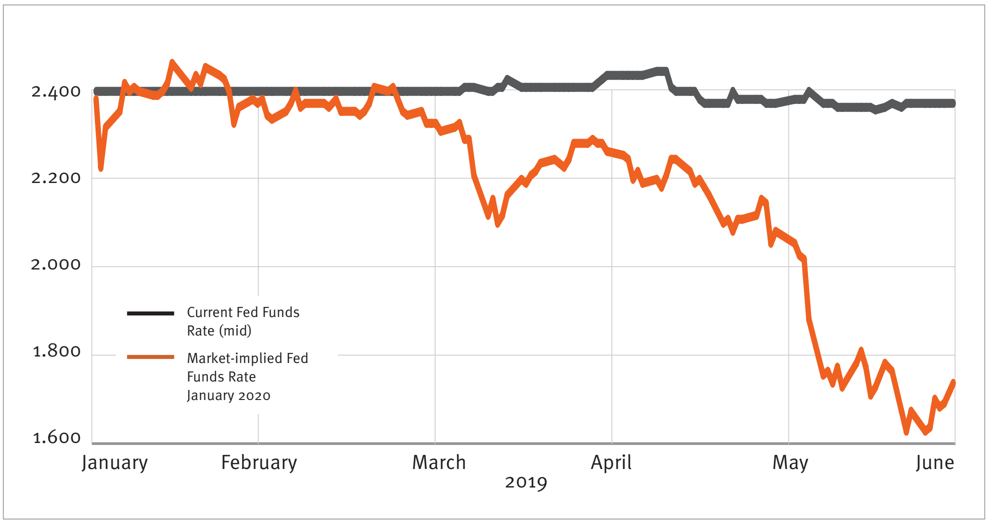


Fig. 5

Source: Bloomberg, Illustration Bergos Berenberg AG

imply that base interest rates will be cut by 75 bps between now and the end of the year. Admittedly, market-implied probabilities are highly volatile and changes resulting from new insights happen often and quickly. However, the changed rhetoric of the US central bank deserves notice. In view of the current uncertainty, we see one to two rate cuts between now and the end of the year. As we understand it, however, this will not happen in an attempt to avert a coming recession (»recession cut«), but rather to supply fresh impetus to the current growth phase (»insurance cut«).

Textbook wisdom suggests that a reduction of interest rates should weaken the US Dollar and so provide an indirect boost to the manufacturing sector. As an additional effect, such a reduction should lower interest rates at the short end of the yield curve, making the overall curve steeper or at least slowing the trend of increasing inversion.

The European Central Bank (ECB), which finds itself in a much less comfortable situation now due to the negative interest rates, took the same line at its regular June meeting. In view of the weakening economic situation, it will postpone the first interest rate hike, which had been expected in the first half of 2020, to at least the end of 2020, after having already postponed it in the first quarter from 2019 to 2020.

The ECB also announced the details of the third refinancing facility for European banks (targeted longer-term refinancing operations, TLTROs). This is another measure aimed at stimulating lending within the Eurozone. In the course of the month, ECB President Draghi repeated his view that additional stimulus in the form of new interest rate cuts and a resumption of bond purchases would be appropriate if no signs of a quick improvement of the economic situation are detected. For this reason, we believe that the maximum

Yield Curve

In %

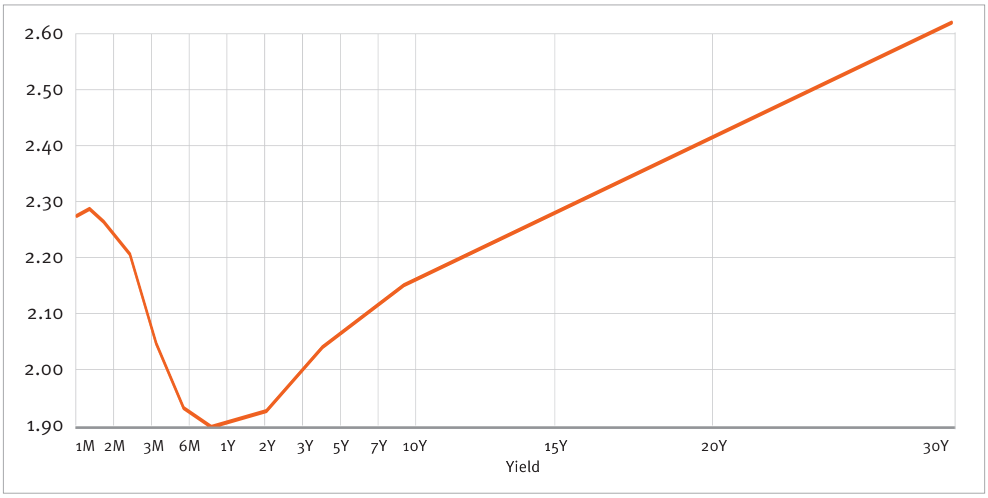


Fig. 6 Source: Bloomberg, Illustration Bergos Berenberg AG

in relation to Eurozone and US interest rates has not yet been reached and assume that interest rates will fall further by the end of the year.

The fundamental situation of companies on both sides of the Atlantic is still positive. They are currently in a comfortable situation, thanks to the cheap money of the last years and the corresponding adjustments of average terms to maturity. The risk of being caught off guard by a sudden rise in interest rates as soon as debt securities need to be refinanced seems to have been dispelled for now. However, there is still a risk of widening credit spreads if we enter a recessionary environment. We therefore prefer higher-quality issuers in the middle to upper rating segment, with solid financial ratios and a broadly diversified, crisis-resistant market positioning.

We are currently very selective and opportunistic in relation to high-yield bonds and bonds with low investment grade ratings. We are convinced that pure market beta, meaning a passive participation in the broad market, would entail overly high risks in the current environment. On the other hand, thorough and extensive analysis of individual issuers undoubtedly delivers value-added for diversified portfolios.

Although credit risk spreads for high-yield bonds have widened somewhat in the last few weeks, we consider them to be inadequate for the Euro and US Dollar, in view of the growing risks of a weakening global economy.

The general level of interest rates on bonds in both currency zones can now be described as »stretched« again. Whereas yields of 3.50% could still be earned on medium-dated US corporate bonds in the first quarter, the situation at the end of the second quarter, with yields at 2.75%, is considerably less attractive. Nevertheless, we still see value in US and European bonds. Particularly in the event of a further slide in the direction of stagnation or

Fed Dot Plots

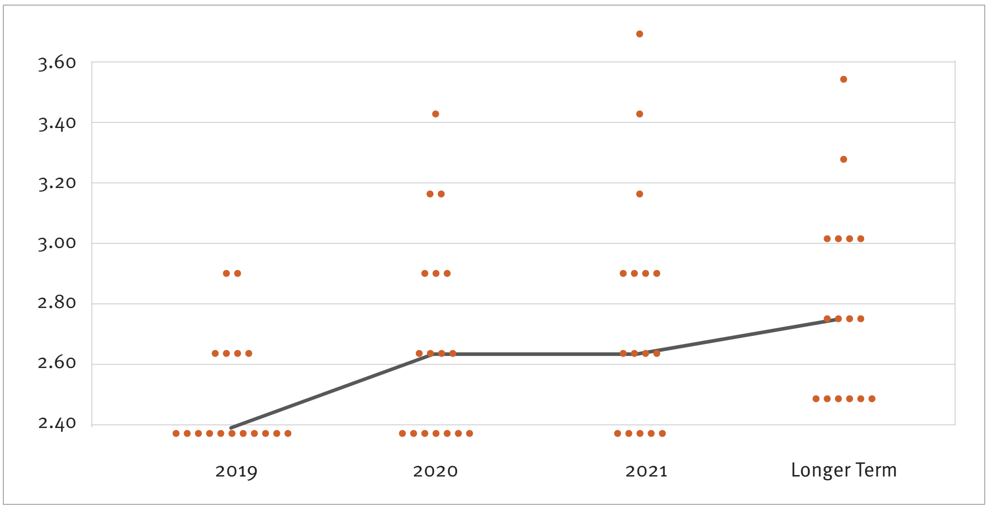


Fig. 7

Source: Bloomberg, Illustration Bergos Berenberg AG

even recession, the demand for first-class corporate bonds and government bonds of solid issuers will increase.

Despite the political disturbances and diminishing economic momentum, we are sticking with our preference for emerging-market bonds denominated in hard currencies (US Dollar). The fundamental situation is consistently solid, so that no bad news can be expected from this direction for now. Furthermore, emerging-market countries are benefiting from the lessening pressure of central bank measures and the expected weakening of the greenback. The high income component of emerging-market bonds delivers a steady carry. Barring a dramatic escalation of the trade conflict or a massive loss of economic momentum, we see this segment as one of the last remaining attractive diversification elements in the fixed-income market.

We also like US mortgage-backed securities as a source of low-volatility and steady income streams. Despite the modest slowing of growth within the United States, a collapse of the US housing market is not to be expected at this time. Instead, US mortgages deliver relatively steady and plannable income streams with low volatility.

Commodity markets reflect the state of the global economy

Soumaila Tékété
Alternative Investments Strategist

- **The modest economic slowdown and further escalation of the trade dispute have had a more noticeable impact on commodity markets than on equity and bond markets**
- **However, laxer monetary policy and few leading economic indicators are fuelling hopes that prices will recover in the second half of the year**

After the price gains of the first three months, commodity markets consolidated in the second quarter. Most of the accumulated price increases were given up, partly as a result of the weaker economic momentum, but mainly due to the worsened market sentiment resulting from the re-escalation of the trade conflict between the United States and China. However, better prints of some leading economic indicators and the pivot of nearly all relevant central banks to a more expansive and stimulative monetary policy point to a possible improvement in the second half of the year.

One Year Commodity Performance

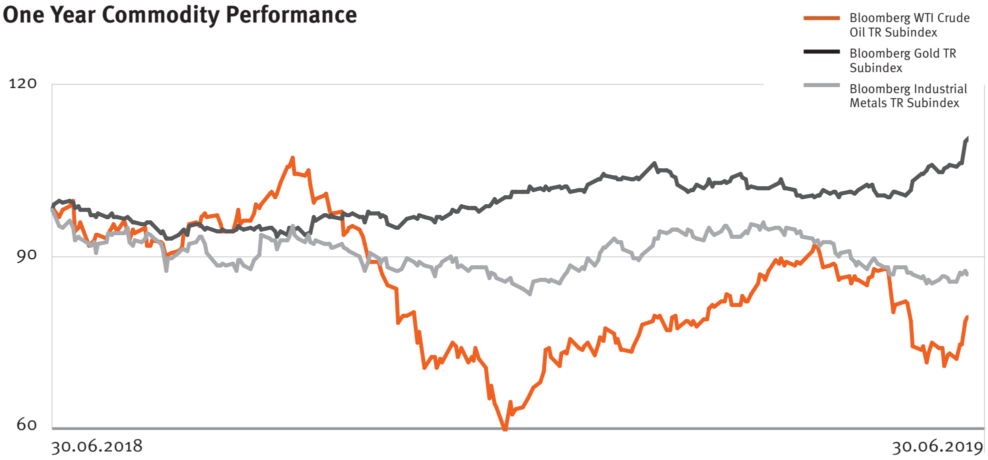


Fig. 8

Source: Bloomberg, Bergos Berenberg

5YR Crude Oil Inventory Range, US Department of Energy

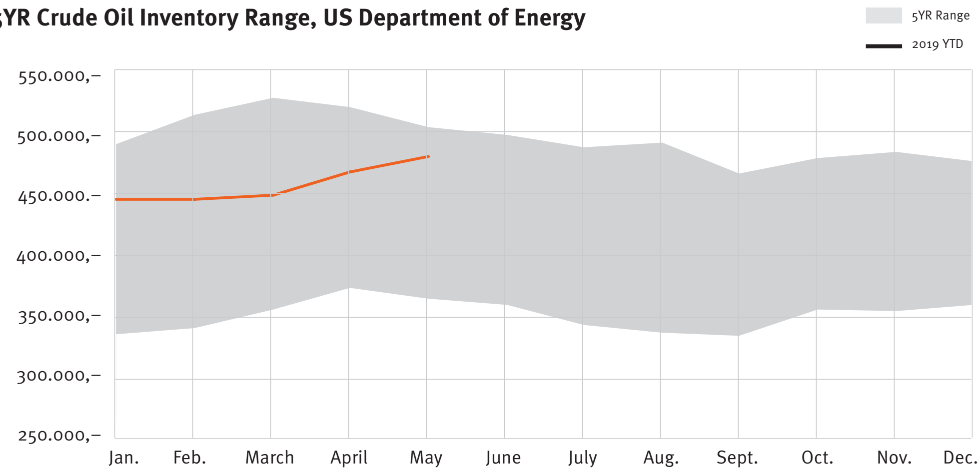


Fig. 9

Source: Bloomberg, Bergos Berenberg

Crude oil in thrall to politics

The high level of US shale oil production continues to be a negative factor for global oil prices. The United States is still producing record amounts of oil and the number of active drilling rigs adapts only slowly and after a long delay to the lower level of prices. Accordingly, US crude oil inventories have risen again in the last few weeks, contrary to the normal seasonal pattern.

Furthermore, the original time period for the agreed OPEC production cuts of 1.2 million barrels per day is running out. These cuts made an important contribution to stabilising prices in the first quarter. Besides the future development of the global economy, oil prices are highly dependent on what other measures the member states will adopt at their next OPEC meeting in early July.

Moreover, a further intensification of the political confrontation between the United States and Iran cannot be ruled out, especially considering the latest accusations surrounding the alleged sabotage of two oil tankers in the Gulf of Oman. These geopolitical risks remain in effect and could cause substantial increases in oil prices in the event of an escalation.

Steady tailwinds for gold

We still consider the current market environment to be very constructive for the further progression of the price of gold. The changed monetary policy is providing the greatest support as all major central banks are pursuing more expansive monetary policies, again. Market consensus expects the Fed to begin cutting interest rates before the end of this year. This will keep the opportunity costs for gold low and whet more interest on the part of investors. The renewed demand for gold ETFs has recently lifted the price of gold to fresh highs for the year. We expect that the recently resumed positive trend of the gold price will continue.

China OECD Leading Indicator, normalized

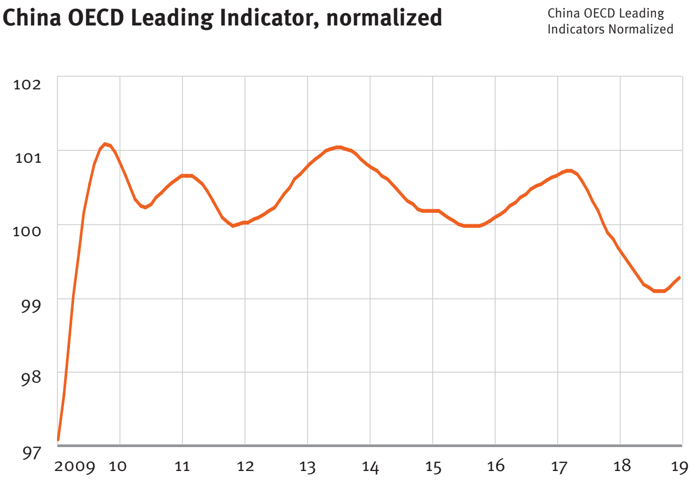


Fig. 10 Source: Bloomberg, Bergos Berenberg

CFTC – Current Net Speculativ Positioning and Historical Range

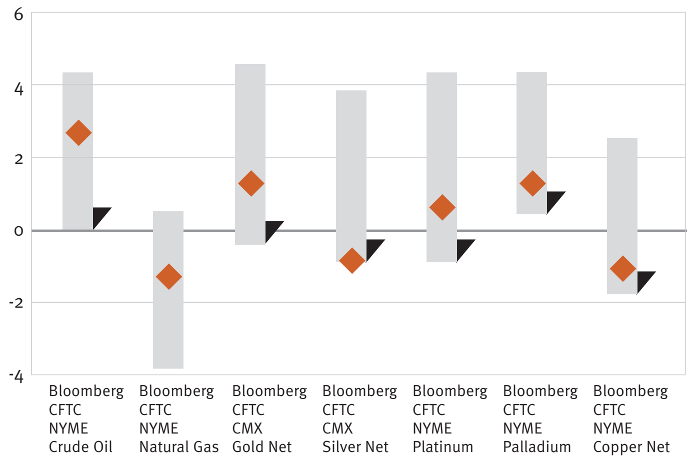


Fig.11 Sourcee: Bloomberg

Industrial metals trapped between the trade dispute and economic impulses

Industrial metals gave up most of their first-quarter gains in the second quarter, due in part to the general trade tensions, but also to the current phase of economic weakness in China, which is still the main driver of marginal demand in the global market for industrial metals. With its laxer monetary and lending policies, announced tax cuts and infrastructure spending, China has enacted targeted measures to stimulate economic growth in the last few months. However, the further escalation of the trade conflict and the ongoing confrontation course of the United States have caused the economic acceleration to proceed more slowly and with a longer delay. However, leading economic indicators and critical parameters such as lending activity, for example, represent first signs of a revival.

Trump's continuing course of confrontation and the possible further escalation of the trade dispute pose considerable risks to commodity demand. In such a scenario, however, China could always take further counter-measures in the form of economic and infrastructure programmes to prop up growth. We are therefore cautiously optimistic regarding the development of industrial metal prices in the second half of the year.

Swiss Equities' all-time highs on shaky grounds

Sven-Erik Schipanski
Active Advisory Equities

- **Swiss equity market: safe haven for European investors**
- **The future outlook has dimmed and the SNB seems powerless to act**
- **Nevertheless, Swiss companies are highly attractive thanks to their operational excellence, low debt levels, and strong innovation capacity**

The SMI is trading close to its all-time high

Trade war. Plummeting purchasing manager indices across the world. The Franc regaining strength. The SMI is currently defying many fundamental arguments for a consolidation. It seems as though the Swiss equity market is living up to its role as a safe haven, at least in the context of European equity indices.

The above contradiction features a lot in current media reports about the economy and capital markets. In many cases, however, the contradictions only represent a snapshot of the moment and make good sense when viewed from a distance.

The strong Franc has been a burden for Swiss companies since 2015, although the significant upward trend began already in early 2010 and was only stopped one year later by central bank intervention. Clearly, Swiss companies have undergone unprecedented productivity improvements since the end of the financial crisis in order to remain competitive. The stabilisation of the Franc helped many companies sustain their competitiveness and gain market shares.

However, the strong Franc is primarily attributable to the weak Euro, which has improved only temporarily in the last eight years. The yield difference on the bond side is certainly not attractive, considering that 10-year Swiss government bonds yield about 20 basis points less than the German Bunds as the most stable Eurozone country; in both cases, however, yields are negative.

EUR/ CHF Exchange Rate & 10-yr yields for CH & Bunds

In CHF and %

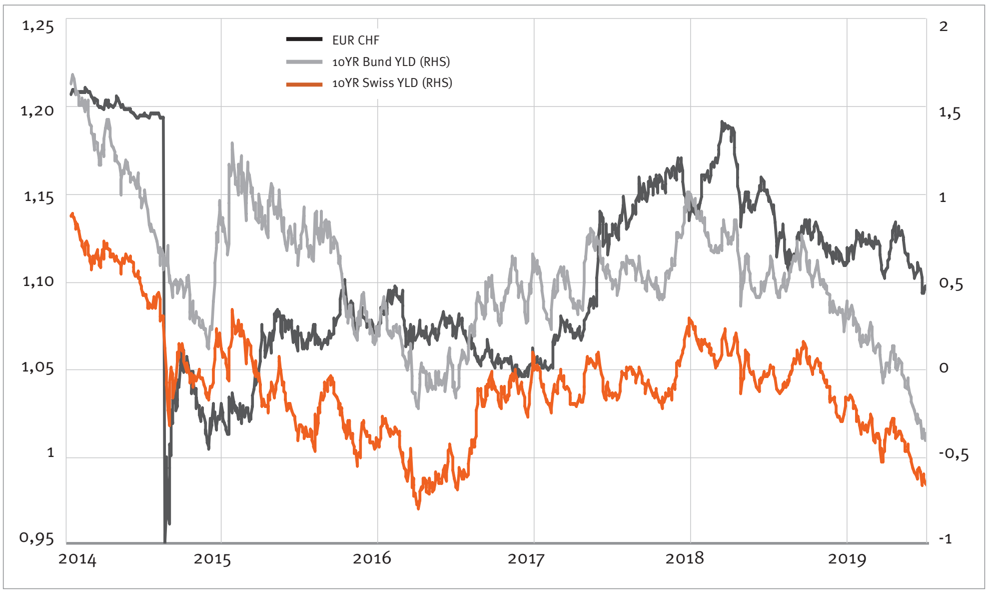


Fig. 12

Source: Bloomberg

The Swiss National Bank (SNB) is handcuffed by the ECB

The European Central Bank has contained, but not yet solved the crisis in the periphery. The quick widening of risk spreads in Greece and Italy last year clearly illustrated that, short term, these countries cannot afford higher capital costs, whether driven by rates or spreads. Therefore, fast interest rate increases remain a taboo and the SNB is, thus, powerless to prevent a further appreciation of the Franc. At the same time, however, cutting interest rates will hardly be of any help and may even put more pressure on financial institutions.

As such it should come as no surprise that the hard currency-induced money flows in the direction of the Swiss Franc have mainly gone to the equity market. Aside the real estate market, there is currently no alternative to equities as an asset class, except the latter is considerably more liquid. Many institutional investors focused on Europe still take a critical view of the Euro, but do not have an alternative in the Pound given the current Brexit disaster, and therefore continue to overweight Franc-denominated equities as a hard currency alternative.

Another factor favouring Switzerland are the global heavyweights representing core positions in many investment funds such as Nestlé, Roche, Novartis, Swiss Re, ABB, and European banks that are well-capitalised to pay handsome dividends.

Valuation levels are not necessarily expensive

Despite being close to all-time highs at the time of writing, both the SMI and the broader Swiss Leader Index SLI are trading at P/E ratios of slightly over 20. But looking two

Swiss Leader Index with Indication of Relative Strength

In points

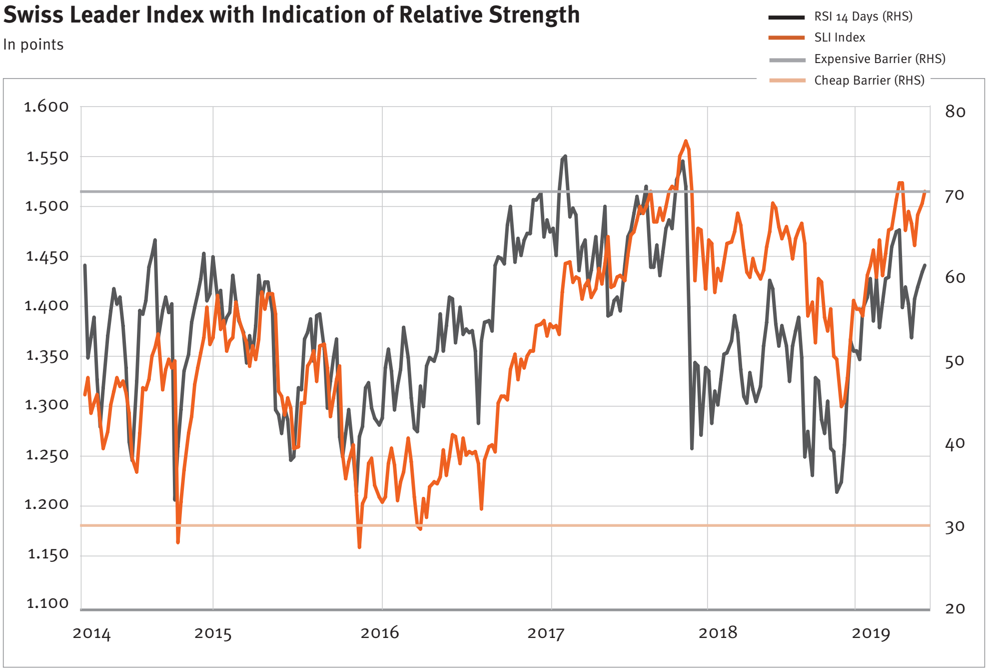


Fig. 13

Source: Bloomberg

years into the future, valuations are only 15 times net profit. This represents a discount of at least 20-25% from the historical average.

On the other hand, the Relative Strength Index (RSI) just retracted from overbought territory, but at a level below 60 still offers short-term consolidation potential.

Strong fundamentals for many Swiss companies

The equity story of many Swiss large caps is based on global market presence and strong innovation capacity, while some mid-caps positioned in attractive market niches are benefiting from new megatrends and occupy global technology leadership positions in their smaller markets. They earn attractive profit margins by offering differentiated products and services. What these two market segments have in common are high research and development costs in relation to revenue and low levels of debt, on average. This latter advantage is paired with disciplined capital allocation, making it possible to generate returns above the level of capital costs and positive cash flows.

Nevertheless, Swiss companies are not insulated from overall macroeconomic trends. The purchasing managers index as a leading indicator has been falling since the third quarter of 2018, signalling a contraction of economic activity.

The first reaction to the uncertainty created by the trade war between the United States and China has been business investment restraint. This has been pronounced among Swiss mechanical engineering firms based. Furthermore, the importance of the Chinese economy for consumer goods and particularly the importance of a healthy middle class

Swiss PMI
In points

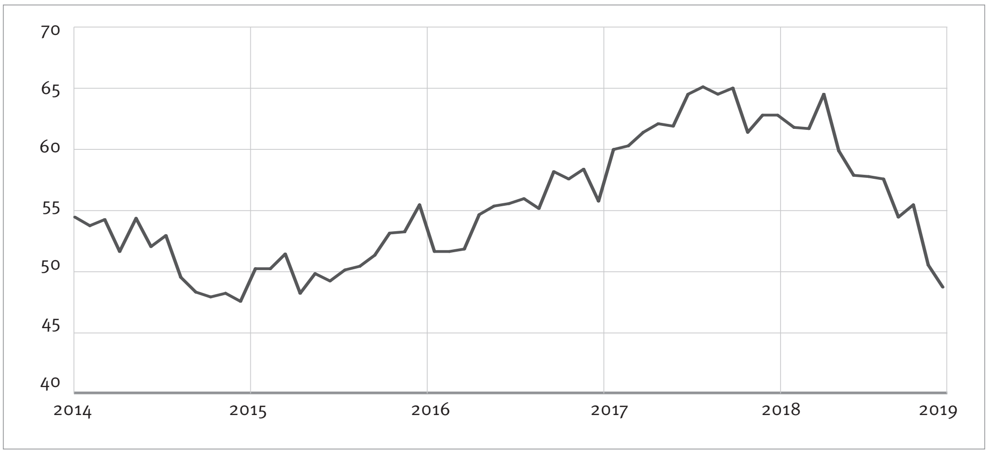


Fig. 14 Source: Bloomberg

with strong appetite for luxury goods are not to be underestimated, and therefore persistent weakness in China could depress demand for watches.

Stocks in focus

In the current environment we prefer two kinds of companies that serve different needs. First, we prefer companies with healthy cash flows allowing for stock buybacks or high dividend yields. In this category revenue growth is rather secondary, in our view; instead, we focus on cost control and profit margin stability. Second, we see opportunities in companies that generate excellent growth while still generating cash (e.g. Temenos/ Interroll). Companies with exposure to the semiconductor sector should be considered interesting investment ideas in the second half of the year. Companies that generate some of their revenue as automotive suppliers look inexpensive. In this case, however, timing is critical because the turnaround is not yet in sight.

Considering that the capital market environment has not improved since October of last year - with the exception of the interest rate reversal in the United States – and also considering our expectation of a trade conflict between the United States and Europe in addition to the trade war between the US and China, the equity market could certainly encounter turbulence again. In an environment of slowing growth momentum, stocks like Nestlé, Novartis, Swiss Re, and even Swisscom may offer stability.

2020 US election bears risks for capital markets

Till Christian Budelmann
Equity Strategist

The US economic engine continues to run. As mentioned in the Economics section, we continue to expect solid economic growth. Even though the onerous trade conflict with China has not yet been resolved, we see no signs of a coming recession. Naturally, we do see risks, especially political risks. A crucial risk that is being underestimated by market participants, in our opinion, is the next Presidential election. Although it will not be held until 3 November 2020, the run-up to US elections is long and can move global markets considerably already in advance. Especially if the United States, who are known for freedom and competition, makes a structural turn in the direction of socialism, global markets will not be spared the consequences of such a shift.

The current President Donald Trump will run for the Republicans, in all probability. He notified the US Federal Election Commission of his 2020 candidacy right at the start of his first term. He wants to campaign against his Democrat opponent in 2020 on the slogan »Keep America Great«. It is not yet clear who the eventual Democratic nominee will be. The Presidential candidate is determined by nationwide primaries, which will begin in Iowa and New Hampshire in February 2020. More than 20 candidates are currently competing for the nomination. And the first public debates were already held in Miami in late June.

Six promising candidates

Our in-house analysis instrument for estimating election probabilities is based on four pillars: opinion polls, statistical models, expert opinions, and the prediction market. In the current phase, only surveys and the prediction market, which estimates probabilities on the basis of betting odds, are available for use. Our analytical approach shows that only six of the declared candidates to date have a realistic chance of winning from today's stand-

2020 Democratic Presidential Nomination Polling Data

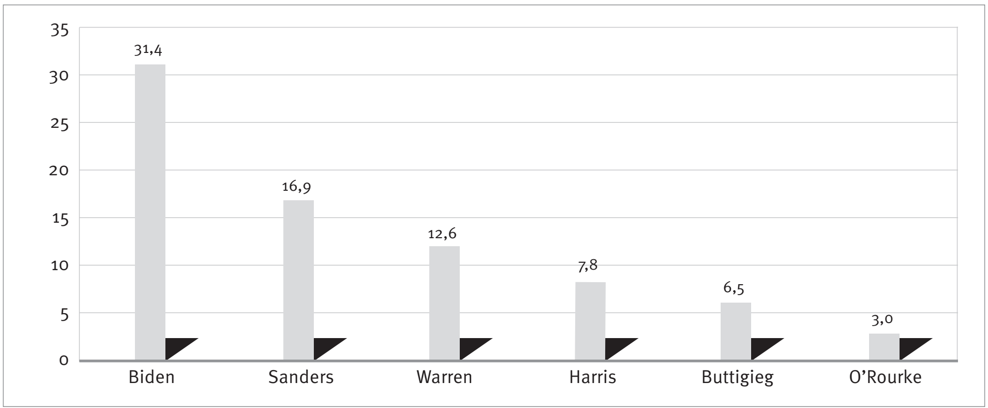


Fig. 15 Source: Politico, Economist, Emerson, Monmouth, The Hill, USA Today, FOX News, Quinnipiac

point. However, these six candidates also include the extreme wings of the party and hold very different views in terms of economic policy.

We divide these six candidates into three groups based on their friendliness to economic growth and capital markets. The middle group comprises the California Senator Kamala Harris, Robert Francis (Beto) O'Rourke, who ran against the ultra-conservative Ted Cruz for a Senate seat in the midterm elections in Texas and nearly won, and the only 37-year-old Pete Buttigieg, mayor of a small city in Indiana. In terms of their economic policies, insofar as they have made clear statements on this subject, these three belong neither to the extreme left wing nor the moderate wing of the party. And their current chances are rather in the middle range (although O'Rourke has somewhat fallen behind in the meantime and Harris numbers have soared recently). Candidates with more explicit positions are ahead in the surveys.

Socialist Bernie Sanders would be a nightmare for the stock market

One of them is the avowed socialist Bernie Sanders. The 77-year-old barely lost to Hillary Clinton in the last primaries. He is a strong advocate of the Green New Deal, stands for less individual responsibility, and has declared war on big corporations. Furthermore, Sanders thinks that equity buybacks should be banned or at least restricted. Sanders would certainly try to reverse Trump's deregulation initiative and reform of corporate taxes. Just as Trump's business-friendly policies have boosted stock markets, a President Bernie Sanders would be a nightmare for Wall Street. In that case, it would no longer matter that political markets usually do not last long. Even temporary successes of Sanders in the debates and primaries could be a drag on markets.

Elizabeth Warren is another candidate who is to be regarded as extremely progressive. Her victory would likewise be a nightmare scenario. The Senator from Massachusetts is currently in third place in the polls, somewhat behind Sanders in second place.

Joe Biden would be less business-friendly than Trump, but also less stressful

Joe Biden is currently Sanders' strongest competitor for the Democratic Presidential nomination. The 76-year-old belongs to the opposite Democrat camp and advocates a centrist course. He was the Senator from Delaware for many years, followed by eight years as Vice President under Barack Obama. Biden is the positive Democratic candidate for the stock market. He could prove to be a typical »Bill Clinton Democrat« and capital market friendly. Although he will certainly need to make further concessions in the primary campaign, we do not think that he will explicitly support socialist ideas. He would also not enact a Green New Deal and would probably also not overturn Trump's tax reform. He is currently well ahead in the opinion polls among Democrats. Also in the prediction market, he currently holds the pole position ahead of the rest of the field.

The markets would probably also welcome Trump's re-election. Except for his trade policy, Trump's actions have been market-friendly so far, but he is certainly also a President who stresses market participants with his tweets and political vacillations. Many are thirsting for normality. Therefore, Biden with his centrist Democrat programme would probably not be that much worse for markets. Although there would be fewer pro-business initiatives than under Trump, the stress would be gone.

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Last updated: June 2019.

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