



Review and outlook

Second Quarter 2023

Important developments in the second quarter 2023

Economy and inflation

- Economic data and business climate in the USA and Eurozone currently do not provide a clear picture (industrial production "weak" / service sector "strong") – sentiment indicators often contradict the data situation
- Inflation increase slows down – but central bank target (2 %) is still missed (CPI USA 4 % in May and HCPI for EU 5.5 % in June)
- Tight labour markets lead to rising wages but also robust consumer demand
- China disappoints as a "growth locomotive" – Stimulus measures and a charm offensive by the Chinese government to pacify and attract foreign investors have not been successful so far – Foreign capital is leaving the country

Monetary and fiscal policy

- ECB with 4 rate hikes (+1.5 percentage points) in the first half of the year – US Fed takes a break after 3 more rate hikes (+0.75 percentage points) – Canada and Australia surprisingly resume rate hikes after pause because inflation rates remain high
- Central banks intervene verbally against increasingly widespread expectation of imminent interest rate cuts – fight against inflation requires further interest rate hikes (especially in the euro area and the UK)
- Regaining confidence is important for central banks – there is fear of ending interest rate hikes too early – increased risk of new monetary policy error (intensification of economic downturn due to "credit crunch")

Politics und geopolitics

- Another rescue of a US regional bank (First Republic Bank) – JP Morgan steps in as buyer at the request of the US government
- Prices for industrial metals, agricultural commodities and energy fall below the level before the outbreak of the Ukraine war
- US debt ceiling suspended after tough negotiations – imminent insolvency of the American state averted just before the deadline – the fundamental problem of the debt level and growth rate of debt is postponed again
- China enacts highly opaque anti-espionage law to facilitate arbitrary interference with foreign direct investment

Financial markets

- Financial markets expected first rate cut before end of 2023 until May – unexpectedly restrictive statements by central banks point to "higher for longer" and trigger market turbulence
- Stock markets expect a "soft landing" of the economy – Euphoria around "artificial intelligence" led to price jumps of some shares in the technology sector
- Bond markets expect economic downturn – inverse yield curves for EUR and USD send clear recession signals
- Gold reached a new high for the year at the beginning of May before interest rate fears triggered another price decline
- BPM – portfolios are aligned with the more cautious expectations of the bond and commodity markets

Stock markets

Sentiment beats data and facts

After the corporate reporting season for the first quarter surprised positively overall, the first low-threshold usable application with artificial intelligence (ChatGPT) caused a kind of gold rush in the awareness of the general public for some technology stocks at the end of May. The increasing attention also led to strong price increases for heavyweights from the technology and consumer sectors and thus pulled the indices upwards. However, it would be deceptive to conclude from the index development that there is a broad-based stock market boom.

The five largest companies in the S&P 500 (Apple, Microsoft, Amazon, Nvidia and Alphabet) have a combined weighting of around 24 %. The strong price increase of these five stocks obscures the less spectacular development of the other 495 stocks - the equally weighted index (S&P 500 Equal weighted) rose by "only" 7 % in the first half of the year. This should be taken into account when comparing market developments (**Chart 1**) and should not lead to the misconception of an overly risk-friendly market environment.

This is because neither current nor expected economic data or estimates of upcoming corporate results make equities look particularly attractive at the interest rate level already reached - the current yields of many bonds are strong competition. Systematically higher risks of equity investments require significantly higher returns compared to bonds. **Chart 2** shows that the "risk premium" for US equities is currently 1.2 % (compared to 10-year government bonds) at a low level (3.2 % on average over the last 10 years) and also significantly below the risk premium for comparable European equities (5.3 %).

The stock markets are in an almost euphoric mood, which requires the best possible development of the entire environment at the valuation level reached. The risk buffer for disappointments is correspondingly small. Nevertheless, we believe it is possible that the good mood will have a contagious effect and that momentum will continue to drive the stock markets for the time being. We therefore remain unchanged with a neutral weighting and selectively invested.

Chart 1: Stock markets – Performance 2023

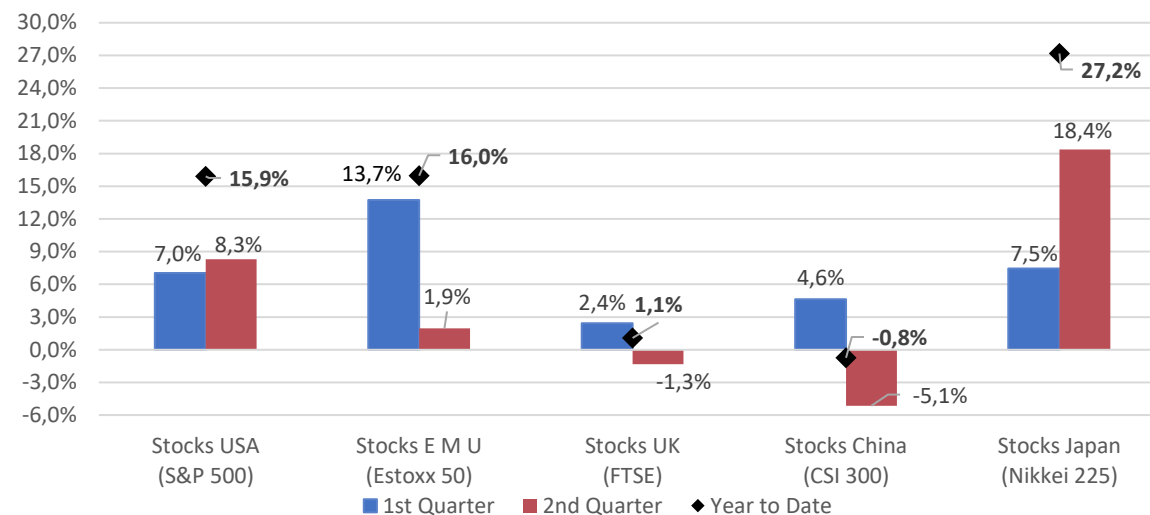
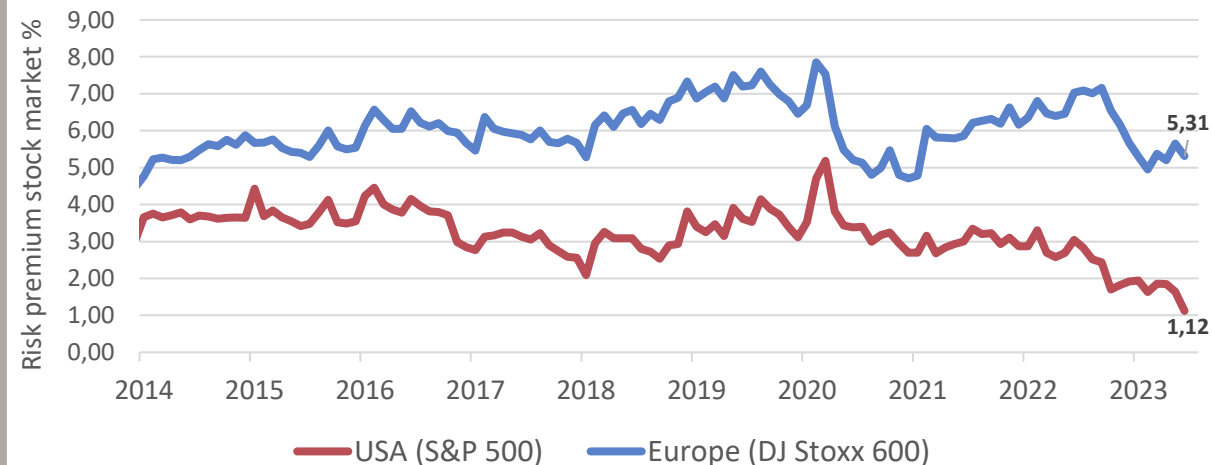


Chart 2: Risk premium for US stock market historically low



Source: Bloomberg, own calculation (expected profit margin of stocks – 10 year sovereign bond yield)

Bond markets and interest rates

When data and facts count

Bonds delivered good to even very good results in the first 6 months of the year (**chart 3**), despite an unbroken trend towards higher key interest rates and tighter central bank liquidity overall.

Barely a year has passed since the first key interest rate hikes by the major central banks. Both the US Federal Reserve and the ECB have raised key interest rates from zero to 5 % and from minus 0.5 % to 3.5 % respectively at record speed during this time, as have many other central banks. These interest rate hikes have so far succeeded in roughly halving the inflation rates from their highs. However, at 4 % (USA) and 5.5 % (EU) they are still clearly too high. At the same time, economic growth rates have also declined significantly and are currently "close to zero". Both the ECB and the FED are currently aligning their monetary policy strictly with economic data, which means that the financial markets are immediately assessing newly published data for effects on the next interest rate decision. This leads to nervous market activity and stronger swings, as in May, when US 10-year yields rose by 0.7 percentage points in a short period of time.

Bonds allow for highly interesting returns in various segments again – also because the strong rise in interest rates has slowed down in the meantime (**chart 4**) and is probably getting closer and closer to its peak in the current cycle. An end to key rate hikes (we are not yet thinking of rate cuts) will help normalise the tense market conditions. The strongly inverted yield curve, in which significantly higher yields are achieved for shorter maturities than for longer ones, should then normalise in the next step via the rise in yields for longer maturities.

We no longer expect large jumps in yields like in 2022 and thus price declines. Today's interest rate levels allow investors to achieve returns that have not been seen for many years. Shorter maturities, selected emerging markets and certain high-yield bonds offer particularly attractive risk-reward profiles. The waiting period until the "interest rate turnaround" and the then upcoming price gains can thus be bridged with high current yields.

Chart 3: Bond markets – Performance 2023

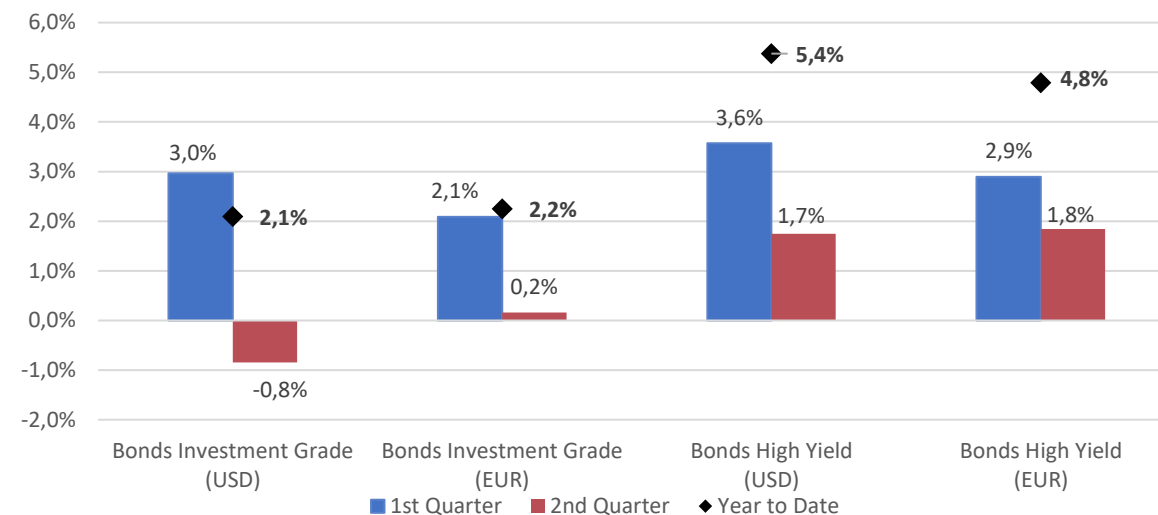


Chart 4: Finally, proper yields again – global investment grade bonds (USD)



Source: Bloomberg

Alternative investments

All alternative investment forms in our overview (chart 5) recorded negative performance in the second quarter and only two, gold and cryptocurrencies, were able to achieve good (gold +5.2 % in USD, +3.6 % in EUR) to very good results overall (cryptocurrencies with over +50 %) in the first half of the year.

Precious metals recorded price declines in the second quarter. The gold price reached its high for the current year of USD 2,062 on 4 May before the prospect of higher interest rates for a longer period of time, which was specifically communicated by the central banks, and the resulting somewhat stronger US dollar triggered a price correction below the USD 1,950 mark. Since then, the gold price has been moving sideways in a range between USD 1,900 and 1,940. We expect a new attempt to break through the previous "price cap" at around USD 2,080 in the second half of 2023. Unchanged high demand from central banks and private investors for gold as a store of value in times of inflation and geopolitical stress is supporting the price.

The result of the hedge fund index only shows an undifferentiated picture. For example, the strategies used in BPM portfolios around option premiums (+8.2% in USD/ +7% in EUR) or also reinsurance premiums (+8.3% in USD/ +7% in EUR) achieved significantly better results than the hedge fund index in the first half of the year.

Prices for energy and industrial raw materials (e.g. copper) declined significantly in the last quarter. Economic concerns about global weakness in the manufacturing sector triggered a decline in demand. This was exacerbated by signals that the Chinese economic recovery hoped for after the end of "Zero Covid" would probably be flat and short-lived.

The price development of gold is often favoured or disturbed by the development of interest rates. On the other hand, the trigger for the currently prevailing expectation of rising interest rates, the persistent inflation trend, is a decisive long-term value driver and reason to buy gold. Just like cryptocurrencies or certain commodities, these alternative investments thus also serve to secure the (real) portfolio value and thus long-term asset protection.

Chart 5: Alternative investments – Performance 2023

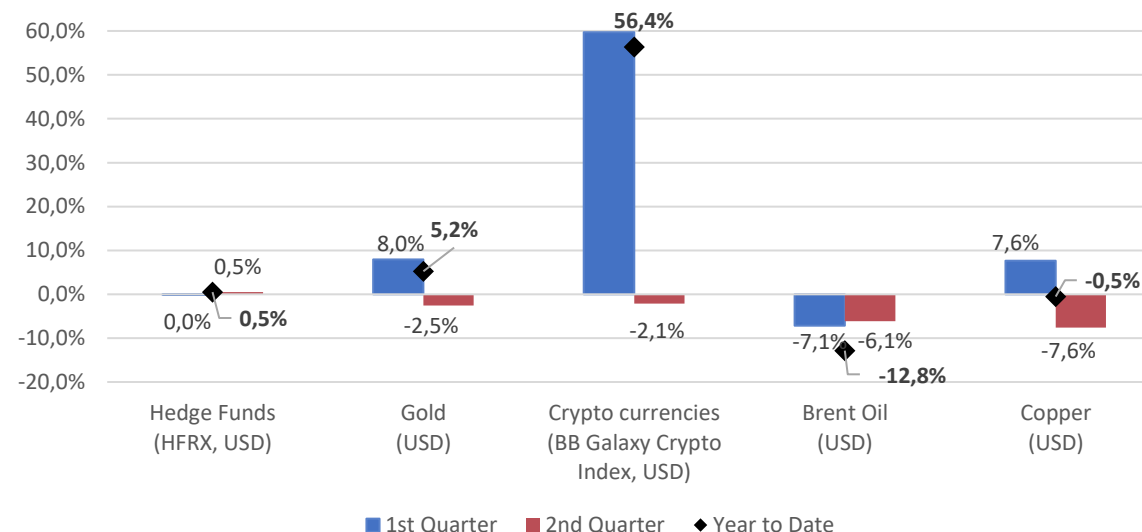


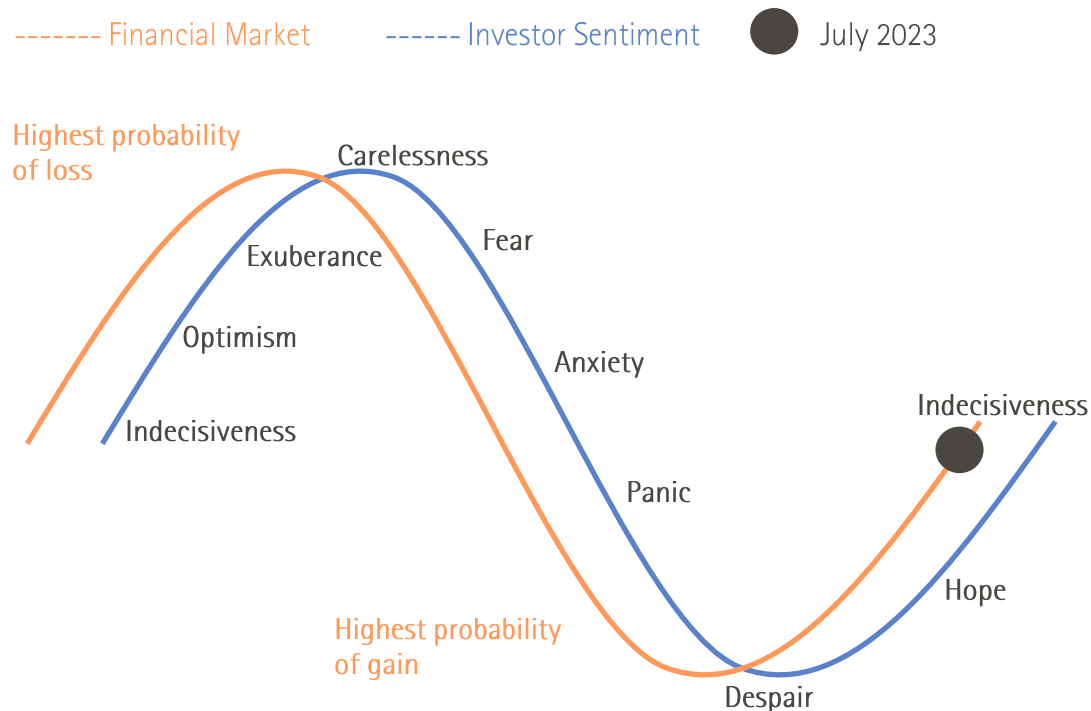
Chart 6: Gold price (in USD) – gathering momentum for the breakthrough



Source: Bloomberg

What will happen next

The „emotional investment cycle“ – Where are we now?



An unusually large number of uncertainty factors continue to weigh on the financial markets. Ongoing conflicts such as the Ukraine-Russia war or the trade war between the USA and China could escalate at any time with serious consequences. In addition, there is a rather confused economic situation, which should actually already be a recession, but does not feel like one, neither in terms of data nor sentiment, and confronts the central banks with hardly solvable tasks.

Expectations and investment ideas in our portfolios

As has often been the case, after some time the financial markets manage to overcome the uncertainty and to regard new circumstances as normality after the period of familiarisation. At least until new shocks occur.

Under this assumption, there are good prospects for a positive second half-year.

Therefore, we continue to follow the hesitantly developing upward trend of many stock markets. We focus the portfolios on high-income quality stocks and take into account the large valuation differences when selecting investment regions.

The bond part of the BPM portfolios is already benefiting from the strong increase in interest rates. The average yield in the typical balanced risk profile of a BPM portfolio was already 7.5 % (in EUR) and over 9 % (in USD) at the end of June. Key interest rates will continue to rise somewhat in the second half of the year and are expected to remain at elevated levels for longer thereafter. Therefore, we prefer bonds with shorter maturities, also because the inverse yield curve does not currently compensate for the higher risks of longer maturities.

A global economic downturn, which no one should rule out at this point, would be a positive scenario for bond and precious metal investors, as the longed-for "interest rate turnaround" by central banks would become much more realistic. Equities, on the other hand, should suffer from collapsing corporate profits and their prices should come under pressure due to the currently high valuation factors.

In addition to their regained function as "yield generators", bonds in portfolios therefore also act as an important stabiliser in times that remain turbulent.

The portfolios designed by BPM always strive for an optimal combination of different sources of return and the limitation of risks through broad diversification. Finding and developing new sources of return, whether in the reawakened bond market or in promising alternative strategies, is what drives us right now. We see it as our task to look for real opportunities and not to be irritated by market whims or to chase short-lived trends that often lack content.

Interesting questions we were asked...

Will Japanese equities become the new superstars?

When the legendary value investor Warren Buffett bought shares in five typical Japanese trading conglomerates almost 3 years ago, this caused many to shake their heads. Today, the head-shakers of yesteryear admire the old master's instinct.

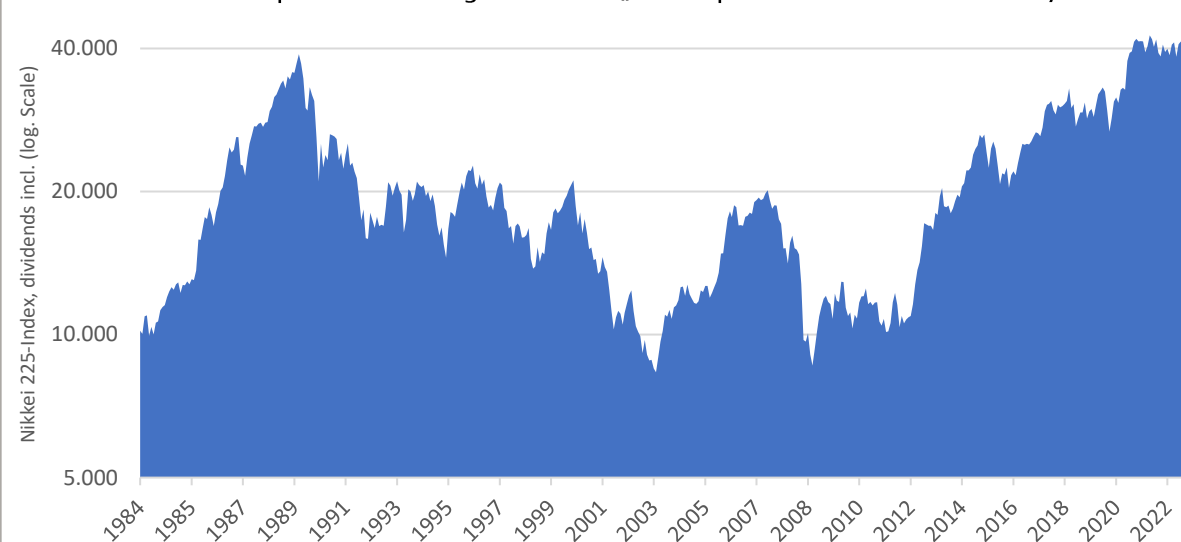
After an unremarkable first quarter, a "run" on Japanese shares began in April. The Nikkei 225 index gained around 20% in 4 weeks, which was somewhat lost in the almost simultaneous excitement about "artificial intelligence". So should we get in now?

Since the bursting of the great speculative bubble at the end of the 1980s, Japanese stocks have often jumped in price, but these did not initiate a lasting trend (**chart 7**). This time it could be different, suggest the following:

- The government is "encouraging" private and institutional investors to put money into Japanese stocks in order to achieve the returns urgently needed for pension provision. The lack of interest income for decades means that the growth of Japan's capital stock is far behind the global average.
- Japanese companies are currently undergoing a major transformation, rebuilding outdated structures and actively courting international investors. High dividends or buybacks of own shares were unusual for a long time. However, dividend yields are now often higher than those of US equities.
- Compared to North America or Europe, Japan's economy is currently in a better position. Inflation rates below 3 % are rather seen as a sign of recovery and a new beginning after the long threat of deflation.
- Japan's central bank continues to pursue an ultra-loose monetary policy. The lowest interest rate level worldwide makes borrowing in yen interesting for speculative investors (also for buying Japanese stocks...).

On the other hand, there are similar structural problems as in Western countries, and their effects are often already much more noticeable in Japan (e.g. strongly ageing population, labour shortage, dependence on energy and raw material imports). Added to this is the world-record high level of public debt, which restricts the country's room for manoeuvre and leaves hardly any alternative to an extremely loose and distorting monetary policy, as higher interest burdens could cause the debt mountain to collapse.

Chart 7: Stocks Japan – including dividends „in the plus" after more than 30 years



Source: Bloomberg, own calculation

For long-term investors, Japan tends to be a deterrent, especially considering the latent weakness of the yen against the euro or the US dollar. Major opportunities are likely to arise only when valuation discounts are "priced out" by serious changes in Japan. The current heavily overbought market situation with extreme values last measured in 2013 advise for caution. They are also caused by strong capital inflows from "fleeing" China investors who need to invest further in Asia.

There is some indication that Japan's seemingly endless period of stagnation is coming to an end. The change in corporate behaviour and the push for domestic stock purchases are a good start. The highly precarious monetary environment of extreme debt and a monetary policy forced to keep interest rates low still make us doubt a sustained upward trend. The current heavily overbought market situation and persistent losses of the yen against the US dollar or the euro (over 12% in 1 year) do not yet make chasing the market a good idea.

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