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DWS Long View – Q3 2020 update

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Within this report, we present the DWS long-term capital market assumptions[1] as of the end of September 2020 for major asset classes.

The COVID-19 crisis sent the global economy into its deepest post-war recession. Because of the uncertainties that existed about the depth and duration of the crisis, DWS developed, back in March, three scenarios to assess its impact on long-run return forecasts. Given the increased clarity on the economic and fundamental outlook for financial markets—dividend cuts and credit default losses have reflected in market pricing—we, now, feel comfortable forecasting and presenting just 1 scenario for our 10-year return outlook.

The initial economic shock from the pandemic was quite severe but the recovery has also been swift. At the global level the economic output is expected to shrink by 4.4% this year and grow by 5.2% next year. In the US the loss of output is roughly comparable to that of the Global Financial Crisis ("GFC"). In Europe the impact is more severe but the output loss is likely to be smaller than during the financial and the subsequent Euro crisis. This in large part is because of the timely actions from central banks and national governments.

This rescue has come at a high cost, however, with its impact likely to be felt for years to come. **Our models now suggest a return of 5% from the MSCI All Country World Index ("ACWI") annually for the next decade, about half of what investors have received over the past decade[2]. A diversified portfolio of assets is now likely to return 4.2%, down 70 bps from the level at the end of the second-quarter and 150 bps from the level in March this year.** Still, attractive opportunities exist within equities and alternative asset classes. Developed Market REITs and Global Infrastructure are expected to return 6.5% annually over the coming decade providing the necessary diversification and a favorable income stream to investors.

FIGURE 1. DWS TEN YEARS ANNUAL FORECASTED RETURNS

	As of 30 Sep. 2020	∆ since June 2020
S&P 500	5.3%	-0.2%
MSCI Europe	4.5%	0.0%
MSCI UK	5.9%	-0.9%
MSCI Germany	4.1%	+0.1%
MSCI Japan	3.5%	0.0%
MSCI World	4.9%	-0.1%
MSCI EM	5.6%	-0.3%
MSCI ACWI	5.0%	-0.1%
US Treasuries	0.6%	-0.1%
Euro Agg Treasuries	-0.3%	-0.2%
US Corporates	1.5%	-0.1%
Euro Agg Corporates	0.2%	-0.3%
US High Yield	3.6%	-0.9%
Pan-Euro High Yield	2.8%	-0.6%
EM Sovereigns	4.5%	-1.1%
Developed REITs	6.5%	0.0%
US REITs	6.9%	-0.9%
Global Infrastructure	6.5%	+0.3%
Americas Infrastructure	7.0%	+0.2%

Source: DWS Investments UK Limited. Forecasts from of 30 September 2020 to 30 September 2030. Due to various risks, uncertainties and assumptions made in our analysis, actual events or results or the actual performance of the markets covered may differ materially from those described.

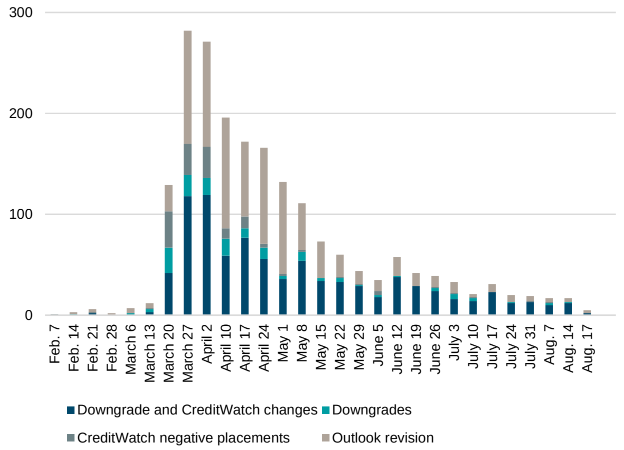
[1] Long-term forecasts are based on 10-year models and should not be compared with 12-month forecasts published in the DWS CIO View
[2] MSCI ACWI generated an annualized 9.62% total return from 9/30/2010 to 9/30/2020

Asset fundamentals have recovered

Asset fundamentals continue to evolve but have adjusted down from the highly stressed levels they were at earlier this year. The expectations of credit default rates and negative rating actions from credit rating agencies illustrates this. In March and April, both climbed to levels not seen since the GFC but have moderated since then as visibility about monetary and fiscal stimulus and the ability of companies to adjust in stressed environments became clear.

In the past 2 quarters, the outlook for companies has been not nearly as bad as previously feared. This has been reflected in the steady decline in the number of ratings downgrades issued by the agencies as shown in Figure 2.

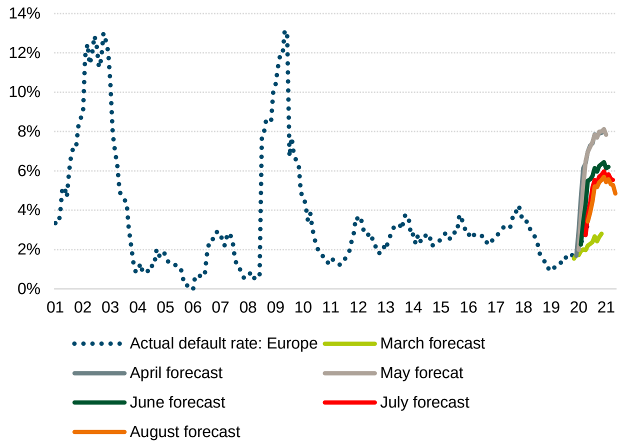
FIGURE 2. NUMBER OF NEGATIVE RATINGS ACTIONS DUE TO COVID-19



Source: DWS Investments UK Limited, Moody's S&P. Data as of 25 September 2020.

This more optimistic outlook for corporate credit ratings is also reflected in the gradual moderation of expected default rates as shown in Figure 3.

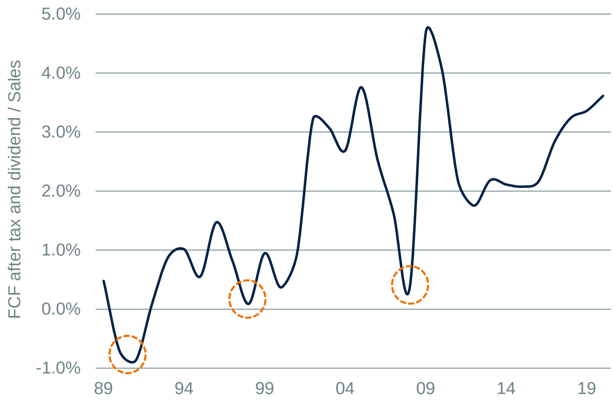
FIGURE 3. SPECULATIVE DEFAULT RATES AND MOODY'S BASELINE FORECAST FOR EUROPE



Source: DWS Investments UK Limited, Moody's S&P. Data as of 25 September 2020.

DWS Research Institute argued this in *History Lesson II: Estimating the dilution from a COVID-19 recession for equity investors* published in April this year. The paper used the analogy of 'bricks' and 'sponges' arguing that although equities are perceived as 'bricks', falling badly (even breaking) during the times of crises, the bulk of the large-cap equities actually are 'sponges' with great ability to adapt and recover from crises. This is evident from their free-cash-flow to sales ratio that over the past three decades improved from the trough of one recession to the next. This shows that the large-cap companies have become more resilient with greater flexibility in managing their costs and cash flows than in the previous crises. The Research Institute estimated that most companies would manage by cutting their dividends and even though leverage may increase, large-scale share issuances that some had feared would not be necessary.

FIGURE 4. FCF-TO-SALES



Source: DWS, CROCI. The chart shows after tax-free cash flow to sales of companies for which CROCI has comparable data going back to 1989. Data as available on 9 April 2020. For illustrative purposes only.

Dividend yields have converged to levels estimated under our '2009-repeat' scenario

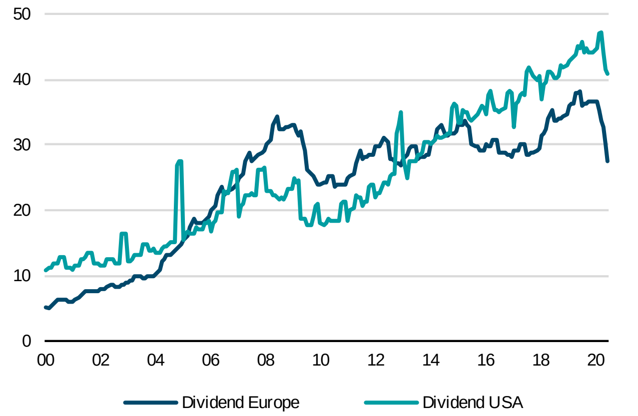
FIGURE 5. TRAILING 12-MONTH DIVIDEND YIELD VERSUS DIVIDEND YIELD UNDER 2009-REPEAT SCENARIO

	30 June		30 September
	Trailing 12M	2009-Repeat	Trailing 12M
S&P 500 Index	2.0%	1.9%	1.8%
MSCI Europe	3.0%	2.7%	2.6%
MSCI Swiss	2.8%	2.7%	2.8%
MSCI Japan	2.5%	2.3%	2.2%
MSCI Germany	2.9%	2.7%	2.6%
MSCI World	2.3%	2.1%	2.0%
MSCI Emerging Markets	2.6%	2.4%	2.2%
MSCI ACWI	2.3%	2.2%	2.1%

Source: DWS Investments UK Limited, MSCI Inc, S&P Dow Jones Indices, Factset. Data as of 30 September 2020. Due to various risks, uncertainties and assumptions made in our analysis, actual events or results or the actual performance of the markets covered may differ materially from those described.

The experience over the past two quarters confirms our view. Dividends have been cut, substantially in some cases, for example, Energy. The spot measure of dividend yield has largely converged to the levels we had previously estimated in our ‘2009-repeat’ scenario. Figure 5 shows our expectations of dividend yield in the ‘2009-repeat’ scenario and the experience over the past quarter.

FIGURE 6. SUBSTANTIAL DIVIDEND CUTS IN EUROPE AND THE US (FIGURES IN USD BILLIONS)



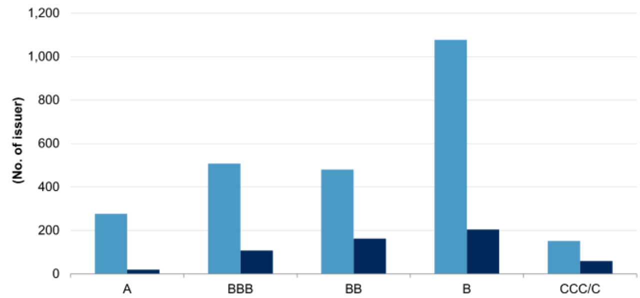
Source: DWS Investments GmbH, Bloomberg Finance L.P. The chart shows rolling twelve months dividends of the S&P 500 and STOXX 600 indices in USD billion. Data as of 25 September 2020.

Liquidity concerns for corporations have eased

This more positive outlook for corporate fundamentals can be attributed to quick and decisive actions by companies and a very supportive technical market environment. This has alleviated liquidity concerns quickly allowing companies to tap into various liquidity channels over recent months. These channels fall into 3 main categories:

- Short-term bank facilities, especially used by non-investment grade companies
- Fiscal and monetary support via programs directed at small and medium-sized enterprises (“SMEs”)
- Bond markets where investment grade companies were able to source significant liquidity via new issuance

FIGURE 7. NUMBER OF NON-INVESTMENT GRADE ISSUERS: TOTAL AND NUMBER THAT HAVE DRAWN ON REVOLVERS

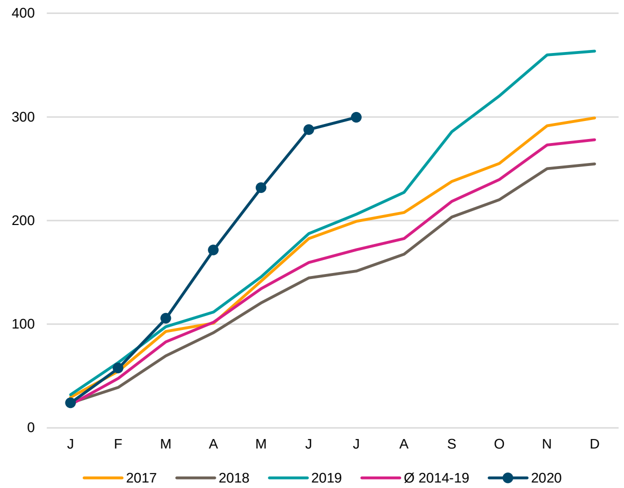


Source: DWS Investments UK Limited, Moody’s S&P. Data as of 25 September 2020.

Figure 7 illustrates the number of non-investment grade corporate bond issuers who have drawn on short-term revolvers. While this activity has been spread across rating cohorts, it’s clear that, proportionate to the total number of issuers, CCC/C-rated firms have the highest proportion of issuers having drawn on these short-term borrowing facilities.

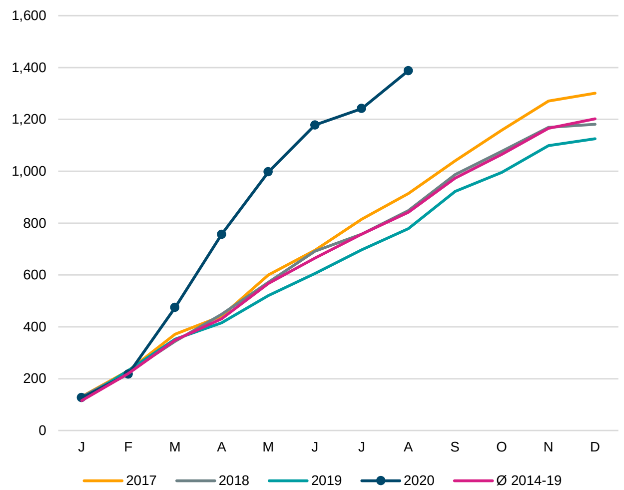
As a result of this supportive activity, corporate bond buyers have flooded back into the market, providing an additional strong liquidity valve for corporations across both US and European markets. Strong uptake for new corporate issuance has resulted in record-high issuance volumes thus far this year, as shown in Figure 8 and Figure 9.

FIGURE 8. PRIMARY BOND ISSUANCE VOLUMES OF INVESTMENT GRADE NON-FINANCIALS: EUR (IN EUR BN)



Source: DWS Investments UK Limited, Moody’s S&P. Data as of 25 September 2020.

FIGURE 9. PRIMARY BOND ISSUANCE VOLUMES OF INVESTMENT GRADE NON-FINANCIALS: USD (IN USD BN)



Source: DWS Investments UK Limited, Moody’s S&P. Data as of 25 September 2020.

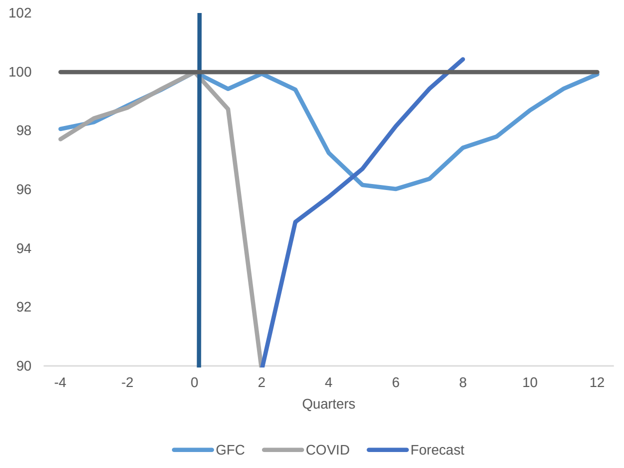
Hard recession, fast recovery

The COVID-19 crisis has been with us for nearly three-quarters now. Even though economic conditions have improved, uncertainty remains elevated but is clustered around one single base path.

The pandemic has sent the world economy into its severest recession since the end of World War II. By IMF estimates, the global economy will shrink by 4.4% this year. However, by the same token, the recovery is likely to be swift. DWS estimates the world economy will grow by 5.2% in 2021. In the U.S., the COVID-19 crisis would lead to a loss in GDP roughly comparable to the GFC. The initial drop in GDP was much greater but there is one fundamental difference: the rebound happened almost instantaneously. Therefore, we assume that the long term economic fallout will be smaller this time. We expect the major part of the recovery is already behind us with future growth likely to be much slower.

The economic damage in Europe will be slightly larger than that in the U.S. Still, it will likely be much smaller than during the financial and subsequent Euro crisis. The much faster recovery is mainly due to the much more decisive fiscal response to the crisis. In an unprecedented manner, states stepped in and pushed large rescue packages through its parliaments. According to the IMF, in the U.S. the debt to GDP level is expected to increase from 109% to 132%; in the Euro area it will increase from 84% to 101%. All this is made possible by central banks cutting interest rates to virtually zero and starting various bond buying programs. We expect central banks to keep policy rates very low for an extended period to alleviate the debt burden for states ("financial repression"). Hence, we expect very low or even negative real interest shall prevail over the next few years.

FIGURE 10. US REAL GDP: COMPARISON OF GLOBAL FINANCIAL CRISIS AND COVID-19 CRISIS



Source: DWS Investments UK Limited. Data as of 20 September 2020.

How COVID-19 has impacted long term return potential

To estimate the impact of such a crisis on asset classes, the DWS Research Institute has published several research papers since March (see bibliography). In April we published a report *DWS Long View: Q2 2020 update*, which, at the time, modeled three different scenarios, with our base case focusing on a *2009-repeat* scenario.

As economic uncertainty has faded to an extent and fundamental market conditions have materialized (e.g. dividend cuts), we have merged our scenarios into one set of 10-year return forecasts for the main asset classes as shown in the following pages.

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Equity Forecasts

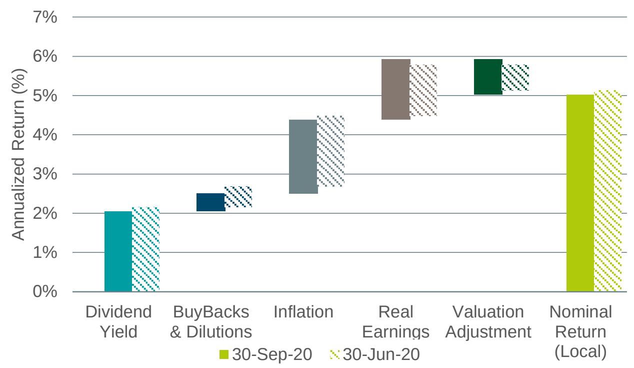
For our equity return forecasts, Figure 12 illustrates the changes to our return pillars for 1-year MSCI All Country World forecast. The return has declined marginally to 5.0% from the 5.1% level at the end of the second quarter. This decline is from a slightly larger valuation adjustment reducing the 10-year expected annual return by another 27 bps (0.9% vs 0.6% in June) partly offset by a more constructive outlook for earnings growth and inflation. These two have increased the return by 32 bps from the June 30 level. The dividend yield also fell by 10 bps.

FIGURE 11. PILLAR DECOMPOSITION FOR EQUITIES

Income		Growth		Valuation
Dividend yield	Buybacks & dilutions	Inflation	Earnings growth	Valuation adjustment

Source: DWS Investments UK Limited. Data as of 30 September 2020.

FIGURE 12. MSCI ALL COUNTRY WORLD: CONTRIBUTION TO 10 YEAR FORECASTED HYPOTHETICAL ANNUALIZED RETURNS

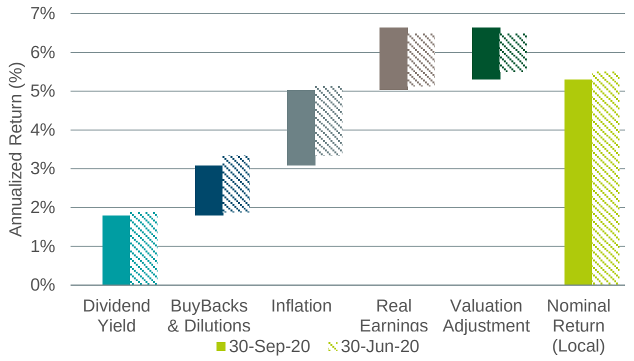


Source: DWS Investments UK Limited. Data as of 30 June 2020. Hypothetical performance is not an indicator of future actual results. Hypothetical performance results have many inherent limitations. No representation is made that actual profits or losses will be similar to those shown.

European returns are lower mainly because of additional dividend cuts

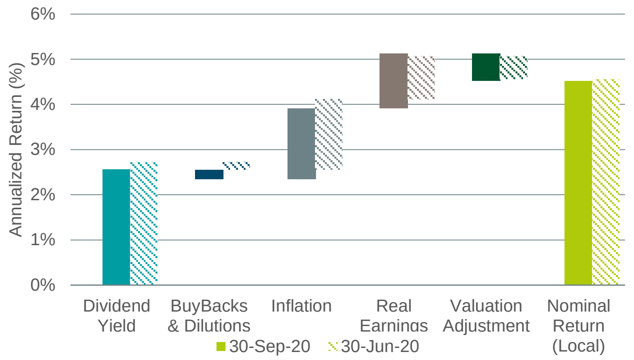
At the regional level, the valuation adjustment and income pillars have affected the returns differently. While valuation adjustment had a bigger role in the US (Figure 13), reducing the forecasted return from the S&P 500 by 35bps (versus MSCI Europe 10bps as shown in Figure 14), the lower returns in Europe are mainly due to additional dividend cuts. This has reduced the MSCI Europe return by 16 bps. Both the US and Europe benefitted from a more constructive outlook for real earnings growth increasing returns by 25 bps and 26 bps respectively.

FIGURE 13. S&P 500: CONTRIBUTION TO 10 YEAR FORECASTED HYPOTHETICAL ANNUALIZED RETURNS



Source: DWS Investments UK Limited. Data as of 30 June 2020. Hypothetical performance is not an indicator of future actual results. Hypothetical performance results have many inherent limitations. No representation is made that actual profits or losses will be similar to those shown.

FIGURE 14. MSCI EUROPE: CONTRIBUTION TO 10 YEAR FORECASTED HYPOTHETICAL ANNUALIZED RETURNS



Source: DWS Investments UK Limited. Data as of 30 June 2020. Hypothetical performance is not an indicator of future actual results. Hypothetical performance results have many inherent limitations. No representation is made that actual profits or losses will be similar to those shown.

Liquid Real Assets Forecasts

While REITs and Infrastructure both leverage very similar pillars to equities (see Figure 15), returns are derived largely from income via dividend distributions as shown in Figure 16 and Figure 17.

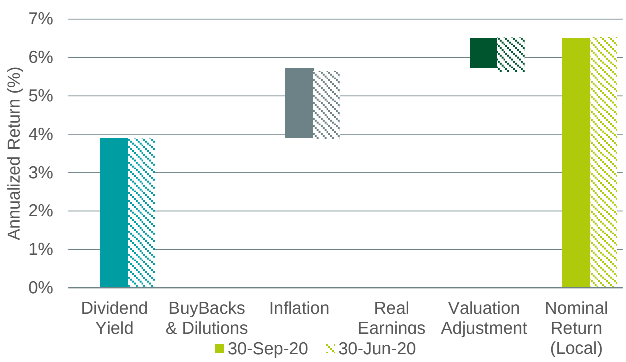
Across liquid real assets, our return forecasts indicate a somewhat more constructive outlook. While valuations remain stretched in traditional equities, REIT dividend yields remain modestly above longer term averages. This provides both advantageous levels on income contribution but also indicates a potential tailwind in terms of compression in valuations. Similarly, infrastructure returns embed a favorable income stream.

FIGURE 15. PILLAR DECOMPOSITION FOR REITS AND INFRASTRUCTURE

Asset Class	Income	Growth		Valuation
Listed real estate equity	Dividend yield	Inflation	Earnings growth	Valuation adjustment
Listed infrastructure	Dividend yield	Inflation	Earnings growth	Valuation adjustment

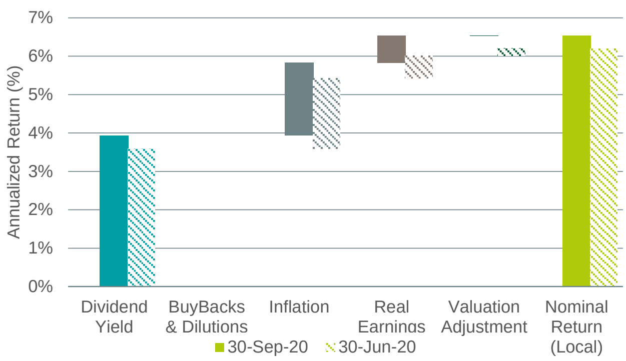
Source: DWS Investments UK Limited. Data as of 30 June 2020.

FIGURE 16. GLOBAL REITS: CONTRIBUTION TO 10 YEAR FORECASTED HYPOTHETICAL ANNUALIZED RETURNS



Source: DWS Investments UK Limited. Data as of 30 June 2020. Hypothetical performance is not an indicator of future actual results. Hypothetical performance results have many inherent limitations. No representation is made that actual profits or losses will be similar to those shown.

FIGURE 17. GLOBAL INFRASTRUCTURE: CONTRIBUTION TO 10 YEAR FORECASTED HYPOTHETICAL ANNUALIZED RETURNS



Source: DWS Investments UK Limited. Data as of 30 June 2020. Hypothetical performance is not an indicator of future actual results. Hypothetical performance results have many inherent limitations. No representation is made that actual profits or losses will be similar to those shown.

Fixed Income Forecasts

The fundamental return outlook across fixed income looks challenged for the next 10 years. The combination of low starting yields, increasing government deficits, and persistent fundamental risk across corporates detract from the pillars of return contribution we utilize in Figure 18.

FIGURE 18. PILLAR DECOMPOSITION FOR FIXED INCOME

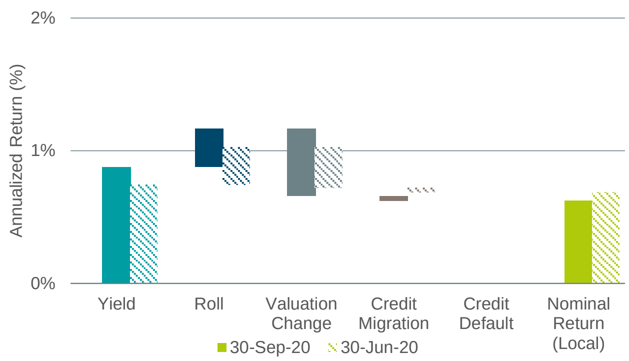
Income	Growth	Valuation		
Yield	Roll return	Valuation adj.	Credit migration	Credit default

Source: DWS Investments UK Limited. Data as of 30 June 2020.

Low expected returns in government securities

Yields on government bonds and other safe-haven fixed income assets remain subdued as guidance from global central banks indicates a more dovish behavior in the short and perhaps medium term. The yield on the Barclays Global Agg Treasury Index was largely unchanged in Q3, ending September at 0.48%. Coincidentally, the yield on the Barclays US Agg Treasury Index also ended the quarter with a yield of 0.48%. Spreads for other traditionally low-risk fixed income such as agency MBS and high quality investment grade corporates continued their significant rally from technical wide levels at the end of Q1. This leaves a continued challenging outlook for core fixed income investors who must deal with the reality of potentially low nominal and real returns for the next decade.

FIGURE 19. US TREASURY BOND INDEX: CONTRIBUTION TO 10 YEAR FORECASTED HYPOTHETICAL ANNUALIZED RETURNS



Source: DWS Investments UK Limited. Data as of 30 June 2020. Hypothetical performance is not an indicator of future actual results. Hypothetical performance results have many inherent limitations. No representation is made that actual profits or losses will be similar to those shown.

Strong technical credit backdrop

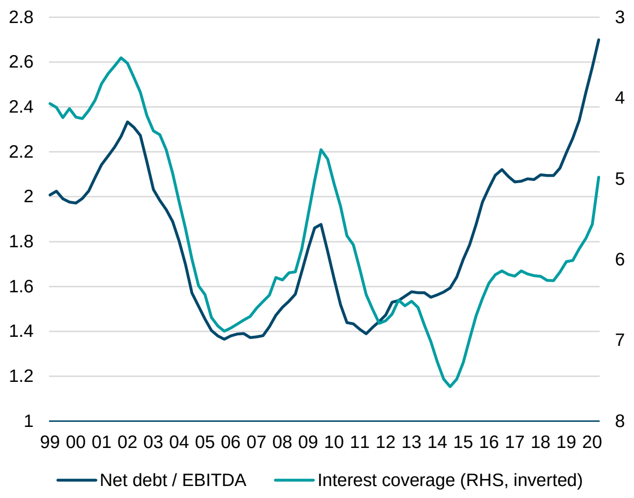
Following significant economic stress in Q1, market expectations for corporate defaults painted a rather morbid fundamental outlook for credit default loss potential. Extreme weakness in energy prices and strong technical selling pressures exacerbates the drawdown in spread markets ranging from money market securities to high yield corporate bonds.

As markets have calmed over the past two quarters, corporate borrowers have been able to tap into the primary issuance market to source significant amounts of liquidity from strong domestic and international demand. As a result, the primary issuance of non-financial investment grade corporates in the US in the first 8 months alone exceeded the total issuance volume in any of the prior three years (see Figure 9). In Europe, primary issuance volumes through July are also significantly outpaced any of the prior three years (see Figure 8). As a result of this more sanguine outlook, starting yields on High Yield bonds and other speculative credit asset classes have fallen since the end of June. For the Barclays US High Yield Index, starting yield levels fell from 6.28% to 5.77%, primarily as a result of further compression in credit spreads.

Mixed bag for credit fundamentals

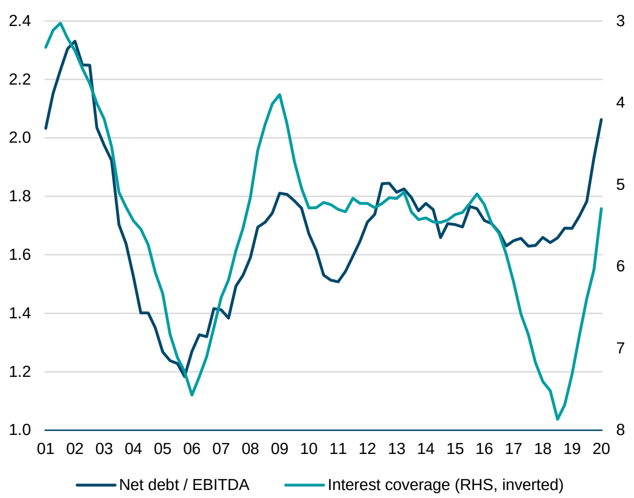
Despite rapid response from corporates and a supportive technical environment, corporate balance sheets still reflect significantly higher levels of leverage. Figure 20 and Figure 21 show the deterioration in interest coverage across US and European investment grade-rated companies, respectively.

FIGURE 20. US INVESTMENT GRADE LEVERAGE 4-QUARTER MOVING AVERAGE



Source: DWS Investments UK Limited. Data as of 24 September 2020.

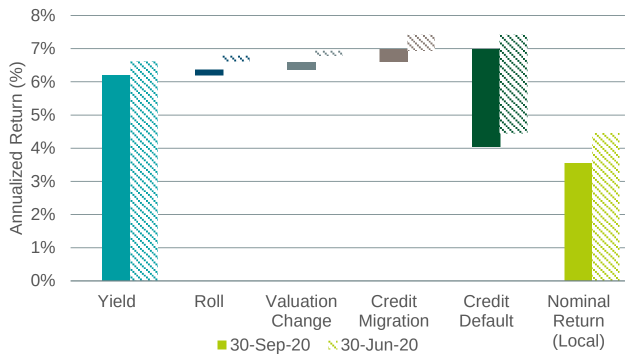
FIGURE 21. EUROPEAN INVESTMENT GRADE LEVERAGE 4-QUARTER MOVING AVERAGE



Source: DWS Investments UK Limited. Data as of 24 September 2020.

In summary, a supportive technical environment, the aid of fiscal stimulus, and unprecedented corporate bond buying from the Federal Reserve were all contributing factors for a strong rally in corporate credit spreads. This supportive technical environment has helped companies navigate this challenging business environment through short term lending facilities, through government stimulus programs aimed at smaller enterprises, and ultimately through a strong market demand for new corporate bond issuance. Despite these strong technical factors, credit default loss forecasts remain at nearly -3%, signifying continued fundamental risk against the strong technical backdrop. Figure 22 illustrates the components of the expected return for the Barclays US High Yield Index.

FIGURE 22. US HIGH YIELD BOND INDEX: CONTRIBUTION TO 10 YEAR FORECASTED HYPOTHETICAL ANNUALIZED RETURNS

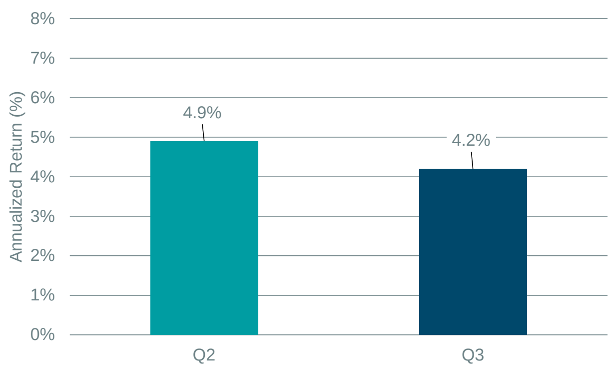


Source: DWS Investments UK Limited. Data as of 30 June 2020. Hypothetical performance is not an indicator of future actual results. Hypothetical performance results have many inherent limitations. No representation is made that actual profits or losses will be similar to those shown.

Conclusion

As market prices have remained resilient amid a clearer economic picture and a strong technical market environment, our 10-year forecasts for returns across asset classes remain low in both nominal and real terms. Figure 23 shows how richer equity valuations, tighter credit spreads, and comparable starting levels of developed market sovereign yields impact a moderate strategic asset allocation. The result leaves a challenging return outlook for investors as risk premia have compressed to correspond with historically dovish central policy. And while economic fundamentals have recovery rather quickly, the potential for persistent economic drag and credit risk resulting from the COVID-19 crisis further dampen return potential.

FIGURE 23. 10-YEAR FORECASTED HYPOTHETICAL ANNUALIZED RETURNS OF MODERATE STRATEGIC ASSET ALLOCATION



Source: DWS Investments UK Limited. Data as of 30 June 2020. Hypothetical performance is not an indicator of future actual results. Hypothetical performance results have many inherent limitations. No representation is made that actual profits or losses will be similar to those shown.

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Appendix

Representative indices

TABLE 1: EACH ASSET CLASS IN THIS PUBLICATION IS FORECASTED AS PER ITS CORRESPONDING REPRESENTATIVE INDEX*

Broad Asset Class	Asset Class	Representative Index
Equities	S&P 500	S&P 500
Equities	Euro Stoxx 50	Euro Stoxx 50
Equities	MSCI Europe	MSCI Europe
Equities	MSCI UK	MSCI United Kingdom
Equities	MSCI Germany	MSCI Germany
Equities	MSCI Switzerland	MSCI Switzerland
Equities	MSCI Japan	MSCI Japan
Equities	MSCI World	MSCI World
Equities	MSCI EM	MSCI Emerging Markets
Equities	MSCI ACWI	MSCI All Country World Index
Fixed Income	US Treasuries	Bbg Barclays US Treasury
Fixed Income	Euro Agg Treasuries	Bbg Barclays Euro Treasury
Fixed Income	Sterling Gilts	Bbg Barclays Sterling Gilts
Fixed Income	US Corporate	Bbg Barclays US Corporate
Fixed Income	Euro Agg Corporates	Bbg Barclays Euro Aggregate Corporate
Fixed Income	US High Yield	Bbg Barclays US High Yield
Fixed Income	EM Sovereigns	Bbg Barclays Emerging Markets USD Sovereign

Source: Bloomberg Finance L.P., DWS Investments UK Limited. As 30 September 2020.

APPENDIX 1. PERFORMANCE OVER THE PAST FIVE YEARS (12-MONTH PERIODS)

	9/15-9/16	9/16-9/17	9/17-9/18	9/18-9/19	9/19-9/20
S&P 500	15.4%	18.6%	17.9%	4.2%	15.1%
MSCI Europe	2.4%	16.9%	2.0%	6.4%	-7.2%
MSCI UK	18.4%	11.0%	5.8%	2.7%	-19.7%
MSCI Germany	9.1%	20.6%	-3.0%	-0.3%	2.9%
MSCI Japan	-4.9%	27.3%	11.6%	-9.0%	4.6%
MSCI World	12.1%	18.9%	11.9%	2.5%	11.0%
MSCI EM	17.4%	22.9%	-0.5%	-1.7%	10.8%
MSCI ACWI	12.6%	19.3%	10.4%	2.0%	11.0%
US Treasuries	4.1%	-1.7%	-1.6%	10.5%	8.0%
Euro Agg Treasuries	6.9%	-3.4%	0.1%	11.6%	0.6%
Sterling Gilts	13.2%	-3.7%	0.6%	14.2%	3.7%
US Corporates	8.6%	2.2%	-1.2%	13.0%	7.9%
Euro Agg Corporates	7.4%	0.5%	0.0%	6.1%	0.3%
US High Yield	12.7%	8.9%	3.0%	6.4%	3.3%
EM Sovereigns	8.5%	8.2%	0.6%	5.4%	-1.0%
Developed REITs	15.8%	3.8%	-2.8%	10.1%	2.4%
US REITs	18.5%	0.0%	4.5%	16.8%	-17.3%
Global Infrastructure	19.6%	-0.1%	3.8%	17.8%	-17.7%
Americas Infrastructure	15.3%	9.2%	-1.6%	16.5%	-9.8%

Source: DWS Investments UK Limited. Forecasts from of 30 September 2015 to 30 September 2020. Past performance is not a reliable indicator of future returns.

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