DWS

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Another amazingly good quarter. What next?

The markets easily withstood many adversities in the summer. In the coming twelve months equities and real estate remain our favorites, though their potential returns are only moderate.

"Low real interest rates and high corporate profits have propped up equity markets. There may seem few grounds to doubt that the upswing will continue. But the difficulty of forecasting reliably during a pandemic is a reason to be cautious."

Stefan Kreuzkamp
Chief Investment Officer and
Head of Investment Division

A surprisingly good quarter is behind us. Despite the delta variant, the U.S.-China conflict, inflation spikes, supply-chain disruptions, waning recovery momentum and a harsh wave of business regulation in China, equities climbed to new highs and corporate bonds also did well. The reason? Two other surprises: the strength of corporate earnings and declining government-bond yields.

The question now, after this summer that has been so kind to investors, is what do the markets have left? The ambivalent view seems almost familiar: the upswing is intact, but valuations appear at the point of exhaustion: surely they can't go any higher? We feared back in the spring that such high valuations would not be able to withstand any disappointment. But the markets have once again shown themselves to be extraordinarily resilient. Investors, we think, are finding reassurance in two beliefs: 1. lost sales will be made up at a later date; 2. real interest rates will remain negative in the medium term. We share these views but we also know that this worst pandemic in a century is pushing forecasting to its limits. There is huge uncertainty about the consumer's willingness to buy and the solidity of the economy after the end of the direct government aid programs, and whether rising inflation is compatible with the continuation of low interest rates. These are just some of the reasons why we have not set higher valuation multiples for equities and foresee only a slight narrowing of the risk premium for corporate bonds.

We expect the economic recovery to continue. Our growth forecasts for 2021 and 2022 have shifted somewhat in terms of timing and region, but, overall, there is little change up to the end of 2022 (global economy: 5.8% in 2021 and 4.5% in 2022). In 2023, we expect growth rates to normalize at around pre-Covid levels. If the digitization of the economy driven by Covid translates into higher potential growth, there could be some upside to our forecast. Central banks are likely to allow the upswing to continue, even if inflation targets are exceeded for a longer period, as a high employment rate has become the primary objective. Having said that, we believe that inflation in the U.S. and in the Eurozone will decline by half a percentage point in 2022.

We therefore expect the U.S. Federal Reserve (Fed) to gradually scale back its bond purchases in the course of 2022 so that its total assets would continue to grow next year and probably begin to stabilize only from 2023. Interest-rate hikes may

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be implemented independently of this. To date, the market expects two interest-rate hikes by the end of 2022, but, here too, the Fed is likely to be guided by the unemployment figures.

The European Central Bank's (ECB's) purchase program is set to expire in March 2022, but we still expect a transition period before purchases are significantly scaled back. There are no interest-rate hikes in sight for the next two years. We therefore expect yields to rise only marginally over the forecast period. As a result, government bonds in industrialized countries are likely to show a negative total return for the most part, while corporate bonds with investment-grade ratings are likely to just make it into positive territory. Only high-yield bonds and Asian securities look more promising in our view. When it comes to Chinese bonds, however, we were skeptical even before the regulatory push because their valuations are high in our view.

In equities, the bottom line is that our strategy has not changed much in the last quarter. Many indices reached new record highs, but earnings also rose more than expected. We still expect double-digit earnings growth on average over the next twelve months. Europe and Japan are ahead of the U.S. due to their more cyclical nature, but the large U.S. technology and media platforms remain in a league of their own and we continue to back them. We also continue to like Asia but the ongoing regulatory push in China is likely to keep prices volatile for a few more months.

However, we believe that many of the Chinese regulatory initiatives have the potential to improve the quality of economic growth in the medium term – and to assist with the environment. Sustainability has been on everyone's lips again this summer, not least because of the many examples of extreme weather. This attention is welcome, given that the race is against time. Even though 130 countries have already set climate targets, the initiatives to date would still lead to a temperature increase of 2.4 degrees Celsius until 2100, well above the Paris Agreement targets of 1.5 degrees. Private-sector initiatives therefore remain very important, and asset managers also need to respond. We are continuing to do everything possible to refine our sustainability tools.

The combination of a low-interest-rate environment and concerns about higher inflation rates continues to make alternative investments attractive in our view. In addition to infrastructure projects, we continue to like real estate, which does not yet appear overpriced given the low level of real interest rates. Industrial/logistics as well as residential real estate continue to appeal to us, but we are increasingly paying attention to a more balanced positioning as these sectors benefit directly from the economic reopening and have been performing very well.

Look at our forecasts to see our 12-month outlook in numbers.

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GLOSSARY

A corporate bond is a bond issued by a corporation in order finance their business.

Cyclical is something that moves with the cycle.

The European Central Bank (ECB) is the central bank for the Eurozone.

The Eurozone is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

Headline inflation is the raw inflation figure based on the consumer price index (CPI) and not adjusted for seasonality or for the often volatile elements of food and energy prices.

High-yield bonds are issued by below-investment-grade-rated issuers and usually offer a relatively high yield.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Investment grade (IG) refers to a credit rating from a rating agency that indicates that a bond has a relatively low risk of default.

The Paris Agreement was reached after the 2016 United Nations Climate Change Conference in Paris. It sets goals on greenhouse-gas emissions mitigation, adaption and finance.

The real interest rate is the nominal interest rate adjusted for inflation as measured by the GDP deflator.

The risk premium is the expected return on an investment minus the return that would be earned on a risk-free investment.

The U.S. Federal Reserve, often referred to as "the Fed," is the central bank of the United States.

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