

## OUR TACTICAL AND STRATEGIC VIEW

In March, the U.S. yield curve inverted and 10-year Bund yields turned negative. Little reason to rejoice. Nevertheless, equities remained stable, anticipating a potential recovery in the second half of the year.

### MARKET OVERVIEW

Anyone who just takes a glimpse at the development of the stock markets in March might think, given the almost unchanged final figures that a rather uneventful month has come to a close. Especially after the two previous strong months. But actually, the opposite is the case. A month in which the MSCI AC World Index crawled up by just 0.5% was rich in drama and possibly important turning points. There was also drama in the turning points that did not occur: the Brexit adventure has not yet ended (CIO Flash Goodbye Brexit?<sup>1</sup>), nor have the trade disputes between the United States and China or the United States and Europe over car tariffs. Meanwhile Brazil, Venezuela or Turkey, to name just three, face many political challenges. At the economic level, weak new orders and many sentiment indices failed to improve, especially in the auto sector. Similarly, the downward trend in consensus earnings estimates in virtually all equity markets persisted.

However, what did change in March was no less exciting. It was probably the bond market which offered the two most striking examples. In the United States, many areas of the yield curve inverted, such as the difference between the yield on 10-year government bonds and the yield on three-month T-bills<sup>2</sup>, which the U.S. Federal Reserve (Fed) likes to refer to. In Germany, on the other hand, the return of the minus sign on the yield on 10-year German government bonds frightened not only savers, but also many financial institutions. The San Francisco Fed pointed out in a much noticed study last year that in the past 60 years an inverse yield curve had predicted ten of the nine recessions (i.e. only once, in the mid-1960s, did it send out a false signal). However, it should be noted that the U.S. yield curve is not consistently negative, which it was before the five most recent recessions. In addition, there are good reasons to believe that its significance has diminished, no matter how reluctant one may be to say "this time it is different." Those who believe in the prognostic power of even a partially inverted yield curve can perhaps be reassured by the fact that

the recession follows inversion on average with a delay of 18 months (the record was 39 months) and equity markets gained another 10% on average. However, this observation, like all on this subject, is only based on a very meager amount of data: around 60 years of economic history in a single country. However, the drastic interest-rate declines were not without reason, and we do not want to play them down. In addition to the already mentioned weak macro figures, the central banks contributed to the more sceptical market outlook. Both the European Central Bank (ECB) (CIO Flash ECB Meeting<sup>3</sup>) and the Fed (CIO Flash Fed Meeting<sup>4</sup>) revised their growth forecasts for 2019 – with the ECB cut for the Eurozone sizeable, from 1.6 to 1.1% – and took further interest-rate hikes for this year off the table either explicitly (the ECB) or implicitly (the Fed). The Fed's move, in particular, was surprising, as just a few months ago Fed Chairman Jerome Powell believed interest rates were far below their target value.

Though stock markets normally cheer the absence of interest-rate hikes, the joy this time was restrained. There was no stock market rally. But markets did not go downhill either. The combination of stable markets in an environment of negative growth and profit downgrades and a leading stock exchange that is only a few percent below its historic high would not seem to reflect excessive pessimism among investors, one might think. What is the source of this stoic shareholder calm? The magic word of the hour is "looking through," i.e. looking through a valley of weakening economic data that will soon be crossed. And therefore paying prices for shares now that they will only be able to justify in the second half of the year with improved figures. Although you always have to look six to twelve months ahead on the stock market, the peculiarity now is that there has to be a turnaround in incoming orders, and thus in the mood in the economy, during this period. The hope for this turnaround is omnipresent. Most company leaders and market strategists point to an improvement "in half a year." But the risk is that

<sup>1</sup> <https://dws.com/AudienceSelectionPage/Accept/?culture=en&returnUrl=%2Finsights%2Fcio-view%2Femea-en%2Fgood-bye-brex>

<sup>2</sup> It is a short-term debt obligation backed by the U.S. Treasury Department with a maturity of one year or less.

<sup>3</sup> <https://dws.com/AudienceSelectionPage/Accept/?culture=en&returnUrl=%2Finsights%2Fcio-view%2Femea-en%2F201903-ecb-meeting>

<sup>4</sup> <https://dws.com/AudienceSelectionPage/Accept/?culture=en&returnUrl=%2Finsights%2Fcio-view%2Femea-en%2F201903-fed-meeting>

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such hopes may prove to be wishful thinking. Even in narrowly defined sectors, such as the semiconductor industry, opinions diverge on the medium-term outlook. While some speak of rosy prospects at the same time as making a profit warning, other company leaders judge the bullish forecasts premature. All the more so, if they are in what are currently the unattractive sectors, such as automotive. But investors are "looking through" the valley of tears. This valley seems rather flat compared to previous valleys, when deep red figures were recorded in the chip sector at the low of the cycle. Now consensus is only anticipating two years of reduced profits compared to a record high in 2018.

Of course, such a drop in profits hurts, all the more so if it is not only cyclical but also structural, such as in the German auto sector. Together with the chemicals sector, it has been a key driver of the weak Dax. "We are dealing with a profit

recession in German industry," says Tim Albrecht, Head of German Equities at DWS. Outside Germany, too, it was the manufacturing sector that pulled sentiment indicators down, while the services sector held up well. "In the coming months it will be important for industry to recover in time before the bad mood spreads to the more late-cycle services sector," says Martin Moryson, DWS Chief Economist for Europe. In addition to this hope, the markets are also keeping an eye on China in the coming months, where the hard figures still look rather weak, but the government's intensified stimulus efforts are having an impact on sentiment indicators. Beijing announced on Sunday, March 31, that the Purchasing Managers' Index (PMI) has again crossed the crucial 50 mark. Otherwise, in light of the number of opposing trends, investors and central banks alike will have to wait and see.

## OUTLOOK AND CHANGES

Interpreting the divergent current market and economic picture is occupying the asset class specialists' time. For all asset classes, the base scenario remains that the major economies are in a temporary weak phase which could come to an end in the second half of the year.

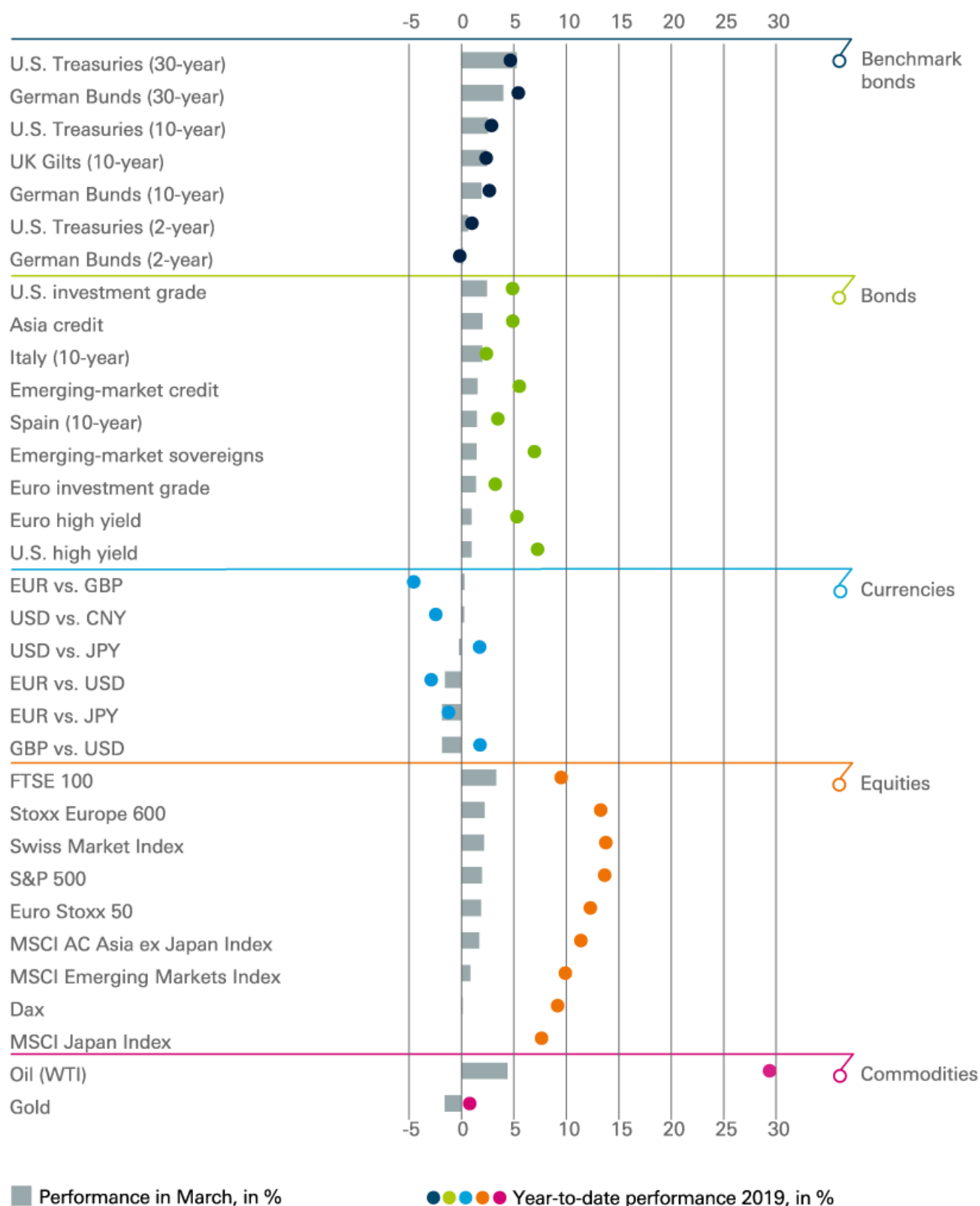
We did not make any tactical changes in equities in March. Clear sector trends were difficult to spot, but instead, as Thomas Schüssler, Co-Head of Equities at DWS, puts it, "expensive stocks are becoming increasingly expensive and cheap stocks increasingly cheap, regardless of their sector." It is not surprising that after the rally in the first two months investors are looking for companies that can keep their growth or margin largely constant even in a weaker macro environment. But some cyclical companies are also in demand again. In the United States, sectors as diverse as utilities and semiconductors are trading near record valuation multiples, while financial stocks have been severely punished by the low interest-rate environment. However, we are keeping them on overweight as we are convinced by their balance-sheet strength and ability to pay out. However, we believe a little caution is required with regard to U.S. equities in coming weeks. As it is the reporting season companies will not be allowed to buy back their own shares in the first quarter. As they regularly represent the largest buyer group for U.S. equities, their absence in recent years has often made hypersensitive markets. From a regional perspective, we continue to favor emerging markets, which continue to benefit from a more dovish Fed. We are sceptical about Brazil, as investors may have given the new president a little too much advance credit, especially given the problems that are now emerging.

As for bonds – our positive view of U.S. government bonds from the previous month has paid off. We remain positive for 10- and 30-years. Otherwise, we see no clear direction for most other government bonds, but initially expect sideways movement, which is why we remain neutral. However, we remain negative on Italy's government bonds, as the danger of political accidents has not been averted. In corporate bonds, we remain positive in almost all sectors and regions. Although we see little potential for tightening risk premiums, the segment appears to be supported by the more moderate pace of central bank activity and still good fundamentals, with default rates still quite low. However, we have tactically reduced emerging-market credit to neutral as we believe that growth concerns, coupled with political setbacks in some countries, have reduced investors' risk appetite for the time being. We have also made another change in currencies, where we now expect a weaker Euro against the U.S. dollar. In an environment in which the central banks are outbidding each other with cautious forecasts and the postponement of interest-rate hikes, we believe a relative high-interest regime such as that of the United States should benefit against the Euro.

In summary, it might be said that we enter April in a kind of tense calm. While we see few imbalances on the valuation side, the Brexit issue definitely has the potential to take a decisive turn in April. There could also be some movement in the U.S.-China dispute, and the reporting season should provide a better picture of companies' future prospects. Surprises in both directions are possible – as is always possible with April weather.

## PAST PERFORMANCE OF MAJOR FINANCIAL ASSETS

Total return of major financial assets year-to-date and past month



Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 3/31/19

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## FIXED INCOME

Rates	1 to 3 months	until March 2020
U.S. Treasuries (2-year)	●	↗
U.S. Treasuries (10-year)	●	↗
U.S. Treasuries (30-year)	●	↗
UK Gilts (10-year)	●	↗
Italy (10-year) <sup>1</sup>	●	↗
Spain (10-year) <sup>1</sup>	●	↘
German Bunds (2-year)	●	↗
German Bunds (10-year)	●	↗
German Bunds (30-year)	●	↗
Japan (2-year)	●	→
Japan (10-year)	●	↗
<b>Securitized / specialties</b>		
Covered bonds <sup>1</sup>	●	↘
U.S. municipal bonds	●	↗
U.S. mortgage-backed securities	●	↗

## EQUITIES

Regions*	1 to 3 months	until March 2020
United States	●	→
Europe	●	→
Eurozone	●	→
Germany	●	→
Switzerland	●	→
United Kingdom (UK)	●	→
Emerging markets	●	↗
Asia ex Japan	●	↗
Japan	●	↗

Corporates	1 to 3 months	until March 2020
U.S. investment grade	●	→
U.S. high yield	●	↗
Euro investment grade <sup>1</sup>	●	→
Euro high yield <sup>1</sup>	●	↗
Asia credit	●	→
Emerging-market credit	●	→
<b>Currencies</b>		
EUR vs. USD	●	→
USD vs. JPY	●	→
EUR vs. JPY	●	→
EUR vs. GBP	●	↗
GBP vs. USD	●	→
USD vs. CNY	●	↗
<b>Emerging markets</b>		
Emerging-market sovereigns	●	→

Sectors*	1 to 3 months
Consumer staples	●
Healthcare	●
Telecommunications	●
Utilities	●
Consumer discretionary	●
Energy	●
Financials	●
Industrials	●
Information technology	●
Materials	●
Real Estate	●
<b>Styles*</b>	
U.S. small caps**	●
European small caps***	●

\* relative to the MSCI AC World Index

\*\* relative to the S&amp;P 500

\*\*\* relative to the Stoxx Europe 600

<sup>1</sup> Spread over German Bunds in basis points

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## ALTERNATIVES

Alternatives	1 to 3 months	until March 2020
Infrastructure (listed)	●	↗
Commodities	●	→
Real estate (listed)	●	↗
Real estate (non-listed) APAC	●	↗
Real estate (non-listed) Europe	●	→
Real estate (non-listed) United States	●	↗
Hedge funds	●	↗

## COMMENTS REGARDING OUR TACTICAL AND STRATEGIC VIEW

### Tactical view

- The focus of our tactical view for fixed income is on trends in bond prices, not yields.

### Strategic view

- The focus of our strategic view for sovereign bonds is on yields, not trends in bond prices.
- For corporates and securitized/specialties bonds, the arrows depict the respective option-adjusted spread.
- For bonds not denominated in euros, the illustration depicts the spread in comparison with U.S. Treasuries. For bonds denominated in euros, the illustration depicts the spread in comparison with German Bunds.
- For emerging-market sovereign bonds, the illustration depicts the spread in comparison with U.S. Treasuries.
- Both spread and yield trends influence the bond value. For investors seeking to profit only from spread trends, a hedge against changing interest rates may be a consideration.

## KEY

### The tactical view (one to three months)

- ● Positive view
- ● Neutral view
- ● Negative view

### The strategic view up to March 2020

#### Equity indices, exchange rates and alternative investments:

The arrows signal whether we expect to see an upward trend ↗, a sideways trend → or a downward trend ↘.

The **arrows' colors** illustrate the return opportunities for long-only investors.

- ↗ Positive return potential for long-only investors
- → Limited return opportunity as well as downside risk
- ↘ Negative return potential for long-only investors

### Fixed Income

For sovereign bonds, ↗ denotes rising yields, → unchanged yields and ↘ falling yields. For corporates, securitized/specialties and emerging-market bonds, the arrows depict the option-adjusted spread over U.S. Treasuries: ↗ depicts a rising spread, → a sideways trend and ↘ a falling spread.

The **arrows' colors** illustrate the return opportunities for long-only investors.

- ↗ Positive return potential for long-only investors
- → Limited return opportunity as well as downside risk
- ↘ Negative return potential for long-only investors

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## APPENDIX: PERFORMANCE OVER THE PAST 5 YEARS (12-MONTH PERIODS)

	03/14 - 03/15	03/15 - 03/16	03/16 - 03/17	03/17 - 03/18	03/18 - 03/19
UST 30yr	20.8%	3.0%	-4.8%	3.2%	6.2%
UST 10yr	8.6%	3.8%	-2.6%	-0.4%	5.8%
UST 2yr	1.0%	1.0%	0.2%	0.0%	2.7%
UK 10yr	11.0%	3.9%	4.5%	-0.8%	5.1%
GER 10yr	12.0%	2.1%	-0.1%	-0.4%	5.5%
GER 2yr	0.7%	0.1%	-0.2%	-0.8%	-0.4%
GER 30yr	33.2%	-0.9%	-2.3%	0.2%	10.9%
Japan 2yr	0.2%	0.4%	-0.2%	-0.2%	0.0%
Japan 10yr	3.0%	4.3%	-0.8%	0.5%	1.6%
EM Sovereign	5.6%	4.2%	8.9%	4.3%	4.2%
EM Credit	4.1%	2.9%	9.7%	3.3%	5.2%
US HY	2.0%	-3.7%	16.4%	3.8%	5.9%
US IG Corp	6.7%	0.9%	3.0%	2.6%	4.9%
EUR HY	6.1%	-0.6%	9.5%	3.8%	2.1%
Asia Credit	7.9%	4.1%	4.8%	1.7%	5.5%
EUR IG Corp	7.2%	0.4%	2.5%	1.7%	2.3%
Spain 10yr	18.6%	1.3%	1.3%	6.2%	3.0%
MSCI Asia xJ	8.1%	-14.0%	14.7%	23.1%	-7.4%
MSCI EM	-2.0%	-14.1%	14.5%	22.2%	-9.6%
S&P 500	10.4%	-0.4%	14.7%	11.8%	7.3%
MSCI Japan	28.4%	-14.5%	11.4%	12.1%	-6.0%
SMI	8.0%	-14.5%	10.9%	0.9%	8.4%
DAX	25.2%	-16.7%	23.6%	-1.8%	-4.7%
FTSE 100	2.6%	-8.8%	18.6%	-3.6%	3.2%
Stoxx600	18.8%	-15.0%	12.9%	-2.7%	2.2%
Eurostoxx 50	16.9%	-18.7%	16.5%	-4.0%	-0.3%

Past performance is not indicative of future returns.

Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 4/1/19

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## GLOSSARY

### Balance sheet

A **balance sheet** summarizes a company's assets, liabilities and shareholder equity.

### Brexit

**Brexit** is a combination of the words "Britain" and "Exit" and describes the exit of the United Kingdom of the European Union.

### Bunds

**Bunds** is a commonly used term for bonds issued by the German federal government with a maturity of 10 years.

### Corporate bond

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

### Dax

The **Dax** is a blue-chip stock-market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange.

### Dove

**Doves** are in favor of an expansive monetary policy.

### Emerging markets (EM)

**Emerging markets (EM)** are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

### Euro (EUR)

The **euro (EUR)** is the common currency of states participating in the Economic and Monetary Union and is the second most held reserve currency in the world after the dollar.

### European Central Bank (ECB)

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

### Government (sovereign) debt/bonds

**Government (sovereign) debts/bonds** are debt/bonds issued and owed by a central government

### MSCI AC World Index

The **MSCI AC World Index** captures large- and mid-cap companies across 23 developed- and 24 emerging-market countries.

### Multiple

A **multiple** is a ratio that is used to measure aspects of a company's well-being by setting various of the company's metrics against each other and thereby building indicative ratios.

### National Central Banks (NCBs)

**National Central Banks (NCBs)** are the central banks of the euro area, and the non-euro area central banks that decide to settle their currencies in TARGET2-Securities.

### Purchasing Managers Index (PMI)

The **Purchasing Managers Index (PMI)** is an indicator of the economic health of the manufacturing sector in a specific country or region.

### Recession

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

### Risk premium

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

### Treasuries

**Treasuries** are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

### U.S. dollar (USD)

The **U.S. dollar (USD)** is the official currency of the United States and its overseas territories.

### U.S. Federal Reserve (Fed)

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

### Valuation

**Valuation** attempts to quantify the attractiveness of an asset, for example through looking at a firm's stock price in relation to its earnings.

### Yield

**Yield** is the income return on an investment referring to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

### Yield curve

A **yield curve** shows the annualized yields of fixed-income securities across different contract periods as a curve. When it is inverted, bonds with longer maturities have lower yields than those with shorter maturities.

### Yield-curve inversion

A **yield-curve inversion** is when the yields on bonds with shorter duration are higher than the yields on bonds that have a longer duration.



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