DWS

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Step by step, uncertain direction

We do not expect a bad investment year. But the all-important development of interest rates and inflation could continue to cause surprises.

"We expect a moderate year, both economically and on the financial markets. Even without the occurrence of one of the major risks. But there is also "risk potential" to the upside. I am still surprised about the adaptability of companies in the difficult year 2022."

Björn Jesch
Global Chief Investment Officer

It is quite possible that we will be happy in twelve months' time if our current market forecasts come true. Although they are quite cautious anyway. In the case of equities, the low single-digit return potential is fed almost exclusively by the expected dividend payments. And in the case of bonds, although we expect higher returns than in some previous years, possible further increases in key interest rates or risk premiums put pressure on the return potential. These forecasts are based on our core scenario. But the basis for the forecasts is less reliable than valuations in many parts of capital markets would suggest. The first two months of the year have impressively shown how shaky the macro-economic foundation currently is. In January, investors believed to see only positive things. For example, a stronger-than-expected economy in the U.S. with declining inflation concerns. Already in February, the tide turned, partly because some of the published economic figures were revised downwards. Which should serve as a reminder of how badly some data series have been messed up by the Covid episode. They could send wrong signals for a few more quarters. In any case, the ugly word stagflation quickly made the rounds, even if we think little of it at present. To give just one example of how quickly market opinions have changed: Since the beginning of February, inflation expectations[1] in the U.S. have risen by more than a full percentage point to now 3.4%.

In our opinion, there is further potential for surprises when it comes to inflation and (central bank) interest rates: 1) Inflation rates at today's level were last seen in the 1980s[2]. 2) Despite a more restrictive monetary policy, labor markets remain strong. And financing conditions remain supportive. And there is no real stress in the financial markets. Despite higher interest rates and inflation, consumers, especially in the U.S., remain surprisingly willing to spend[3]. 3) Monetary policy works with a time lag of several quarters, which could push central banks to overreact. Added to these problems is a reaction of the capital markets that is difficult to predict: how long would the market celebrate a looser monetary policy before worrying about the danger of a protracted fight against inflation? It gets even more complicated the other way round: how long would the market's fright over a tighter monetary policy if it also increased the conviction that inflation would be largely under control by 2024? And wouldn't this looseness then again counteract central bank efforts (see point 2b above)?

I am giving much space to these considerations in order to illustrate that not only central banks but also investors have to shimmy from one macroeconomic data point to the next in this environment - "data dependent", as central bankers call it. The forecast framework that was ultimately adopted is as follows:

[1] Based on 2-year break-even rates of inflation protected Treasuries
[2] On the basis of U.S. figures. Back in 1980, public debt was only 40% of GDP, today its three times as high.
[3] Although first cracks are becoming visible now.

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- Growth/recession: In general, economies have performed better than feared, but are still weak in absolute terms. For the U.S., we continue to expect a mild recession in the course of the year, the Eurozone should narrowly escape it. The subsequent recovery is likely to be moderate (1.1% for 2024 for both regions). In China, on the other hand, we expect more than 5% GDP growth for 2023 and 2024.

- Inflation and central banks: We think central banks will do almost everything to get inflation back under control. We see inflation rates below 3% for the Eurozone and the U.S. by the end of 2024, even if the decline in core inflation is currently slower than hoped. However, we also see the first signs of slowing activity in some areas (credit demand by companies and house builders, temporary employment, M1 money growth) caused by the previous interest rate hikes. We expect the Fed funds rate to peak at 5.5%, and the ECB deposit rate at 4%, in the second quarter. From the Bank of Japan, we expect a gradual end to **yield curve control**, followed by two small, symbolic rate hikes.

- Fixed income: We think government bond yields have not yet peaked and see in 12-month 10-year Treasuries at 4.3% and 10-year Bunds at 2.9%. Only for 2-year Treasuries do we see declining yields (target: 4.4%), which is why we like this segment. Corporate and emerging market bonds may see a widening of the risk premium, but the high current yields offer some risk buffer, especially based on good corporate balance sheets. We expect a slight appreciation of the euro and yen against the dollar.

- Equities: With high interest rates, stagnant earnings, but still high profit margins in developed markets, we see little upside for global equities. Our 12-month targets are 4,100 for the S&P 500; 16,300 for the Dax and 480 for the Stoxx 600. We believe European small caps, Asia and the communications sector will outperform.

- Alternatives: We expect Brent oil to trade at 100 USD per barrel and gold at 1940 USD/oz in 12 months.

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GLOSSARY

The Bank of Japan (BoJ) is the central bank of Japan.

A barrel (bbl) is the commonly used unit to measure crude oil. One barrel is about 159 liters.

Core inflation excludes items which can be susceptible to volatile price movements, e.g. food and energy.

The Dax is a blue-chip stock-market index consisting of the 40 major German companies trading on the Frankfurt Stock Exchange.

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.

The federal funds rate is the interest rate, set by the Fed, at which banks lend money to each other, usually on an overnight basis.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

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

M1 is a money-supply measure that includes both physical money and bank deposits that can be quickly converted to money.

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

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

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

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Stagflation is the combination of the words "stagnation" and "inflation," referring to a period where inflation is high while the economy is stagnating.

The Stoxx Europe 600 is an index representing the performance of 600 listed companies across 18 European countries.

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