

## OUR TACTICAL AND STRATEGIC VIEW

Global equities have had a miserable final quarter, as have many other asset classes. A fore-runner for significantly worse times or exaggerations amid higher uncertainties? We suspect the latter.

### MARKET OVERVIEW

It is not easy to turn 2018, and especially the fourth quarter, into something positive from an investor's point of view. They set a number of records – negative ones. The S&P 500 experienced its worst fourth quarter since the financial crisis and its worst December since the Great Depression. For the first time in several decades, both equities and bonds posted negative annual returns globally over a calendar year. And 90% of the asset classes closed 2018 down on the year (in U.S. dollar terms) – a higher percentage than ever before. Those who, like us, continue to expect that 2019 will be a positive year on the whole, rather than being discouraged by 2018's devastating annual balance sheet, can certainly promise one thing: much more favorable entry prices and thus higher yield potential for the coming twelve months. Our positive forecast also certainly requires a good deal of courage as the number of Cassandras<sup>1</sup> correlates strongly with the size of price losses. And, of course, it won't be possible to say with any certainty what drove this brutal year-end until a few months from now. Was it a temporary setback after previous over-optimism, with market technicals being a factor? A longer-term revaluation of risks in the wake of weaker macro data? Or anticipation of a recession (or at least a profit recession) and thus possibly the beginning of a real bear market?

Similar questions arose at the beginning of 2016 and, in addition to the sharp price losses, other parallels quickly emerge, such as the revisions made to global growth and profit forecasts and the fall in oil prices. Another parallel is the gloomy feeling many investors have had at every stock price swoon in recent years. It is true that growth in China, the change in monetary policy in the developed world from quantitative easing (QE) to quantitative tightening (QT), and, most recently, the China-U.S. trade dispute are all potential sources of a major slump. The U.S. Federal Reserve (Fed), meanwhile, showed on December 19 that monetary policy also still has leverage on the markets. Although the interest-rate rise was expected, and the Fed reduced its

number of expected rate rises in 2019 from three to two, and stressed even these increases would be data dependent, markets reacted very sourly. This despite the fact that employment in the United States is at a record high and real interest rates (allowing for inflation) are only around 1%. This suggests that investors are less concerned about the Fed's influence on the real economy than on capital markets – especially, perhaps, when the Fed is reminding investors that it will continue to shrink its balance sheet by 50 billion U.S. dollars a month by not replacing bonds it bought as part of QE as they mature. And as the goal, and the result, of all the unorthodox ultra-loose monetary policy since the financial crisis was to generate asset-price inflation, it is understandable there is concern that reversing the policy could provoke asset-price deflation. The extent to which the interaction of monetary policy, the economy and financial markets might then generate a negative downward trend is likely to continue to preoccupy investors for some time to come.

We believe investors will also continue to be concerned about the increased influence of politics on the economy and markets. It would not be far-fetched to see the price losses in the fourth quarter of 2018 as an expression of increasing investor skepticism about the unconventional political style of the White House. Towards the end of a year of debt-financed fiscal incentives, a number of issues were brewing disturbingly. Examples include the U.S. President's ongoing tirades against Fed Chairman Jerome Powell. And his willingness to risk a 'government shutdown' that has now lasted several weeks if Congress refuses to finance a wall on the 3,145 kilometer border with Mexico. Or the sudden withdrawal of the U.S. military from Syria and Afghanistan. Or the departures of Secretary of Defense James Mattis and Chief of Staff John Kelly – two of the few remaining members of the administration, who are well-connected politically and in the military.

<sup>1</sup> One that predicts misfortune or disaster

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With the Democrats taking over the majority of the House of Representatives in Congress this week, the pressure on the U.S. President will increase further. There are 17 ongoing legal investigations against him. The degree to which he is able to devote himself to his conflicts with China, Russia, Mexico and Europe in the current year may begin to be questioned, even by his followers. Leaving aside the big economic questions, politics alone will help ensure that the capital markets remain volatile in 2019.

## OUTLOOK AND CHANGES

Due to the extraordinary market moves at the end of the year, we not only made tactical changes in December, but also slightly lowered our full-year price targets. This was done in particular to take account of three developments: 1) the lack of improvement in macroeconomic data at the end of the year, 2) the higher volatility of the markets, which weighed on valuations, and increased investor skepticism, and 3) the de-facto deterioration of the financial environment as a result of these market moves. We initially did not change our economic forecasts but the Fed's likely preference for two instead of three rate hikes does change the interest-rate outlook. We have reduced by 25 basis points (bps) over all maturities our forecasts for U.S. government bonds. We now expect 10-year interest rates of 3% at the end of 2019. 10-year Bunds are expected to yield only 0.6% at year-end down from our previous forecast of 0.8 %. In addition, we have increased the forecast spreads for corporate bonds and bonds from peripheral and emerging countries. Our currency forecasts are unchanged. From a tactical point of view, we have gone back to neutral again on German government bonds, due to the recent price movements, but from a tactical point of view we have raised European corporate bonds from neutral to positive, as we believe that their yields have run up too far and assume a too negative economic outlook. The same applies to U.S. investment-grade corporate bonds, which we are also upgrading to positive. In view of the significantly higher risk premiums at the beginning of the year, we expect demand for this asset class to grow.

From a strategic perspective, our equity forecasts are as follows. Our updated index targets for December 2019 (2,850 for the S&P 500 and 11,800 for the Dax) continue to point to a double-digit rise. However, they assume that the Fed will pause in March, trade tensions will ease and the U.S. economy will continue to grow close to its potential in 2019 and beyond. In addition, consumer and investment indicators, recently uncertain, should stabilize again in the first half of 2019.

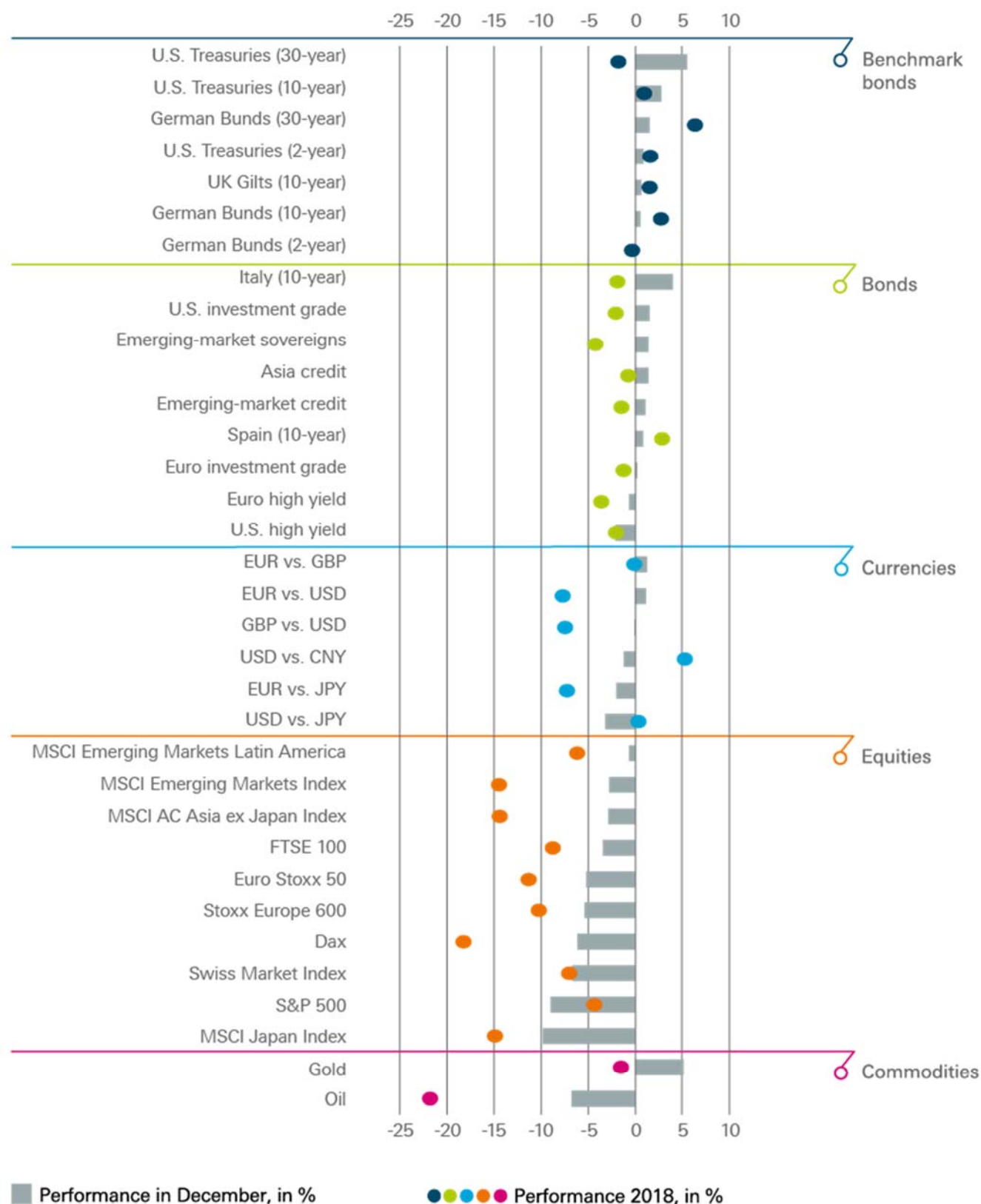
On the other hand, the recent reaction of financial markets across asset classes raises several red flags. Rising risk premiums on corporate bonds, the collapsing oil price, falling yields on 10-year U.S. government bonds and the pitch-black December on the equity markets may all be warnings of further bad news to come. In addition, there is the already mentioned peculiarity of the beginning of the year from an institutional investor's point of view and the danger of negative feedback effects between politics, the economy and markets. Given the strong uncertainties, both the bull and the bear case have a high probability. This should result in continued high volatility.

Of course, equity fund managers benefit from the volatility. Many equities have corrected by 30 to 50% from previous peaks in anticipation of a rougher economic environment. This opens up a number of opportunities for stock picking. However, we continue to avoid companies with high debt levels and rising refinancing costs.

Tactically, we are upgrading the global financial sector to overweight, with a preference for U.S. banks. On a relative price-to-earnings (P/E) basis, the sector is now trading at an almost 30% discount to the overall market – similar to levels during the financial crisis. We believe that current valuations already take into account a slowdown in credit growth and an interruption in the Fed's interest-rate hike path, but without sufficiently acknowledging improving balance sheets. In return, we are downgrading the global-real-estate sector. Within just a few quarters, this sector has turned a discount of 15% on the total market into a premium of 10%. This revaluation is unlikely to continue in the case of our (cautiously optimistic) base scenario.

## 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 12/31/18

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## FIXED INCOME\*

Rates	1 to 3 months	until December 2019
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 December 2019
United States	●	↗
Europe	●	↗
Eurozone	●	↗
Germany	●	↗
Switzerland	●	↗
United Kingdom (UK)	●	↗
Emerging markets	●	↗
Asia ex Japan	●	↗
Japan	●	↗

Corporates	1 to 3 months	until December 2019
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. GBP	●	→
GBP vs. USD	●	→
USD vs. CNY	●	→
<b>Emerging markets</b>		
Emerging-market sovereigns	●	→

\* as of 12/31/18

\*\* relative to the MSCI AC World

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

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## ALTERNATIVES\*

Alternatives	1 to 3 months	until December 2019
Infrastructure (listed)	●	↗
Commodities	●	↗
Real estate (listed)	●	↗
Real estate (non-listed) APAC	●	↗
Real estate (non-listed) Europe	●	↗
Real estate (non-listed) United States	●	→
Hedge funds	●	↗

\* as of 12/3/18

## 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 December 2019

## 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)

	12/13 - 12/14	12/14 - 12/15	12/15 - 12/16	12/16 - 12/17	12/17 - 12/18
UST 30yr	25.0%	-1.0%	1.1%	8.6%	-1.8%
UST 10yr	8.8%	1.7%	0.8%	2.6%	0.9%
UST 2yr	0.6%	0.6%	0.9%	0.4%	1.6%
UK 10yr	12.1%	0.7%	7.8%	1.8%	1.5%
GER 10yr	13.4%	0.8%	4.3%	-0.8%	2.7%
GER 2yr	0.5%	0.3%	0.2%	-0.9%	-0.4%
GER 30yr	26.5%	0.4%	9.5%	-2.6%	6.3%
Japan 2yr	0.4%	0.0%	0.1%	-0.2%	-0.1%
Japan 10yr	4.7%	1.3%	1.6%	0.3%	0.9%
EM Sovereign	7.4%	1.2%	10.2%	10.3%	-4.3%
EM Credit	4.1%	1.0%	11.1%	7.9%	-1.5%
US HY	2.5%	-4.5%	17.1%	7.5%	-2.1%
US IG Corp	7.5%	-0.8%	5.6%	6.2%	-2.1%
EUR HY	5.5%	0.5%	10.1%	6.1%	-3.6%
Asia Credit	8.3%	2.8%	5.8%	5.8%	-0.8%
EUR IG Corp	8.2%	-0.7%	4.7%	2.4%	-1.3%
Spain 10yr	24.4%	1.3%	5.2%	2.1%	2.8%
MSCI Asia xJ	2.2%	-11.3%	2.9%	38.7%	-16.4%
MSCI EM	-4.6%	-17.0%	8.6%	34.3%	-16.6%
MSCI Latam	-14.8%	-32.9%	27.9%	20.8%	-9.3%
S&P 500	11.4%	-0.7%	9.5%	19.4%	-6.2%
MSCI Japan	7.6%	8.1%	-2.6%	17.6%	-16.8%
SMI	9.5%	-1.8%	-6.8%	14.1%	-10.2%
DAX	2.7%	9.6%	6.9%	12.5%	-18.3%
FTSE 100	-2.7%	-4.9%	14.4%	7.6%	-12.5%
Stoxx600	4.4%	6.8%	-1.2%	7.7%	-13.2%
Eurostoxx 50	1.2%	3.8%	0.7%	6.5%	-14.3%

Past performance is not indicative of future returns.

Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 1/3/19

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## GLOSSARY

### Balance sheet

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

### Basis point

One basis point equals 1/100 of a percentage point.

### Bear market

Technically, a bear market refers to a situation where the index's value falls at least 20% from a recent high.

### 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.

### Correlation

Correlation is a measure of how closely two variables move together over time.

### Dax

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

### Deflation

Deflation is a sustained decrease in the general price level of goods and services.

### Democratic Party (Democrats)

The Democratic Party (Democrats) is one of the two political parties in the United States. It is generally to the left of its main rival, the Republican Party.

### Emerging markets (EM)

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

### Fiscal policy

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

### Financial crisis

The financial crisis refers to the period of market turmoil that started in 2007 and worsened sharply in 2008 with the collapse of Lehman Brothers.

### House of Representatives

The United States House of Representatives is a legislative chamber consisting of 435 Representatives, as well as non-voting delegates from Washington, D.C. and U.S. territories. Representatives are elected for two-year terms and each state's representation is based on population as measured in the previous Census.

### Inflation

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)

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

### Monetary policy

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).

### Neutral real interest rate

The neutral real interest rate is the official interest rate, adjusted for inflation, which is estimated to allow an economy to grow at its trend rate.

### Periphery

Periphery countries are less developed than the core countries of a specific region. In the Eurozone, the euro periphery consists of the economically weaker countries such as Greece, Portugal, Italy, Spain and Ireland.

### Price-to-earnings (P/E) ratio or multiple

The price-to-earnings (P/E) ratio compares a company's current share price to its earnings per share.

### Quantitative easing (QE)

Quantitative easing (QE) is an unconventional monetary-policy tool, in which a central bank conducts broad-based asset purchases.

### 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.

### Sovereign bonds

Sovereign bonds are bonds issued by governments.

### Spread

The spread is the difference between the quoted rates of return on two different investments, usually of different credit quality.

### United States Congress

The United States Congress is the legislature of the federal government. It is comprised of the Senate and the House of Representatives, consisting of 435 Representatives and 100 Senators.

### U.S. dollar (USD)

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

### Volatility

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

### White House

The White House is the official residence and principal workplace of the President of the United States.

### 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.

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