July 1, 2021 Marketing Material

Things are so good that it's time for a break

A buoyant economic recovery, record stock markets and calm bond markets. Things have been going all too well and the next surprises are unlikely to be positive.

- _ Vaccination progress and economic recovery have been better than expected so far and concerns about inflation are still muted.
- _ But fiscal and monetary support is expected to peak this year, and with it economic growth.
- _ We see little upside potential for very high markets and instead focus on interesting sub-segments.

Global economic growth is slightly up, so are equity price targets, though, we see little upside potential for major indices. There is little change in our fixed-income view, with not much return likely in government bonds, and some opportunities in alternative investments, not least in infrastructure. This summary of our latest strategy session reads as if we are in the quietest of times. Yet the global picture is changing, and investors face significant challenges.

Looming over everything is the question of how sustainable the new wave of inflation is and how central banks will respond. We expect the inflation spike to be temporary, but we believe developments in the coming months will have to be watched closely, as inflation expectations may turn out to be higher than expected. We assume that the central banks are, as they themselves say[1], willing to let inflation run a bit. That argues for only slightly rising interest rates, which in turn is supportive for riskier assets such as equities. Even though we do not think there will be much left to gain at the index level for equities, we think there will be themes that perform better than others. First and foremost, sustainability, even if the current euphoria has already led to some stretched valuations in this area.

Macro

Our overall positive outlook has changed little, and we have even upgraded some growth figures. We now expect the global economy to grow by 5.8% this year, compared with 5.3% previously. The biggest adjustments are for the United States, from 5.0% to 6.7%, and Europe, with the Eurozone forecast raised from 3.5% to 4.2% and the UK forecast from 4.5% to 6.5%. The forecasts for emerging markets have been reduced slightly, but at 6.2% they, and particularly Asia, remain one of the most important sources of global growth.

We have also slightly increased, by 0.2 percentage points, our forecast for global growth in 2022 to 4.6%. Vaccination programs, economic reopening and government bailouts have

1 https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm and other central banks

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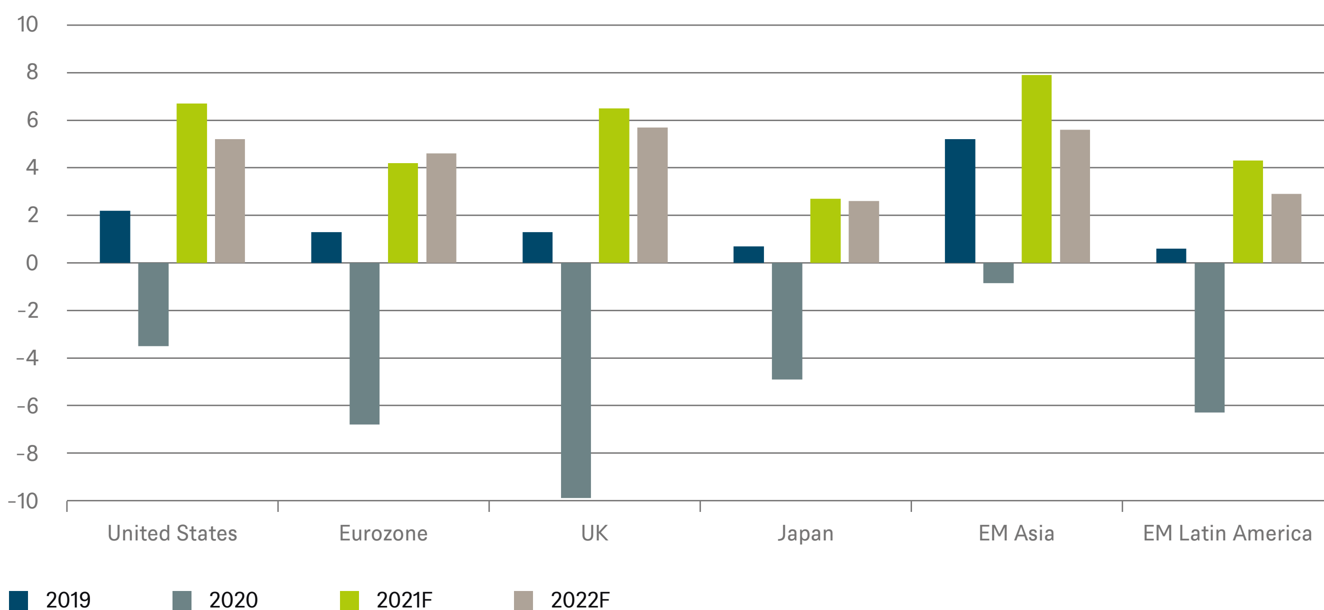
certainly been strongly supportive of growth but the industry's resilience and the strength of global trade, despite all the talk about supply disruptions, have been positive surprises. The more routine handling of lockdowns has also, certainly, helped. But each opening step nonetheless makes clear the extent of pent-up demand in many areas, fed by lavish government support.

GLOBAL GROWTH FORECASTS 2021/2022

We have increased our forecasts, especially for Europe and the United States for 2021.



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Source: DWS Investment GmbH as of 5/27/21

It is not surprising that the huge amounts of fiscal and monetary support and the current economic momentum are drawing attention to the issue of inflation. This is all the more the case given the price development of commodities in the past year – oil and copper, for example, have roughly doubled in price since their 2020 lows – and labor shortages, especially in the service sector. We have also raised our inflation expectations for 2021 and 2022 slightly, to 2.6% and 2.5% for the United States and 2.0% and 1.6% for the Eurozone (the annual average figure in each case), which means we are now above the consensus forecast. However, we stand by our assessment that the inflation peaks will be recorded this year (earlier in the United States, later in Germany) and that the figures will start to come down again in 2022.

The reasons for the spikes in the current year are obvious: one-off effects such as the reversal of tax breaks and introduction of the CO_2 tax[2]; the doubling of some commodity prices; and base effects due to the particularly weak prior-year figures. Added to this are the catch-up effects in consumption while the supply side has not yet returned to its pre-crisis level of activity. All of this should change next year, which is why we expect inflation to fall. But we cannot rule out the possibility that price surges in individual sub-segments could lead to

[2] https://www.cleanenergywire.org/factsheets/germanys-planned-carbon-pricing-system-transport-and-buildings

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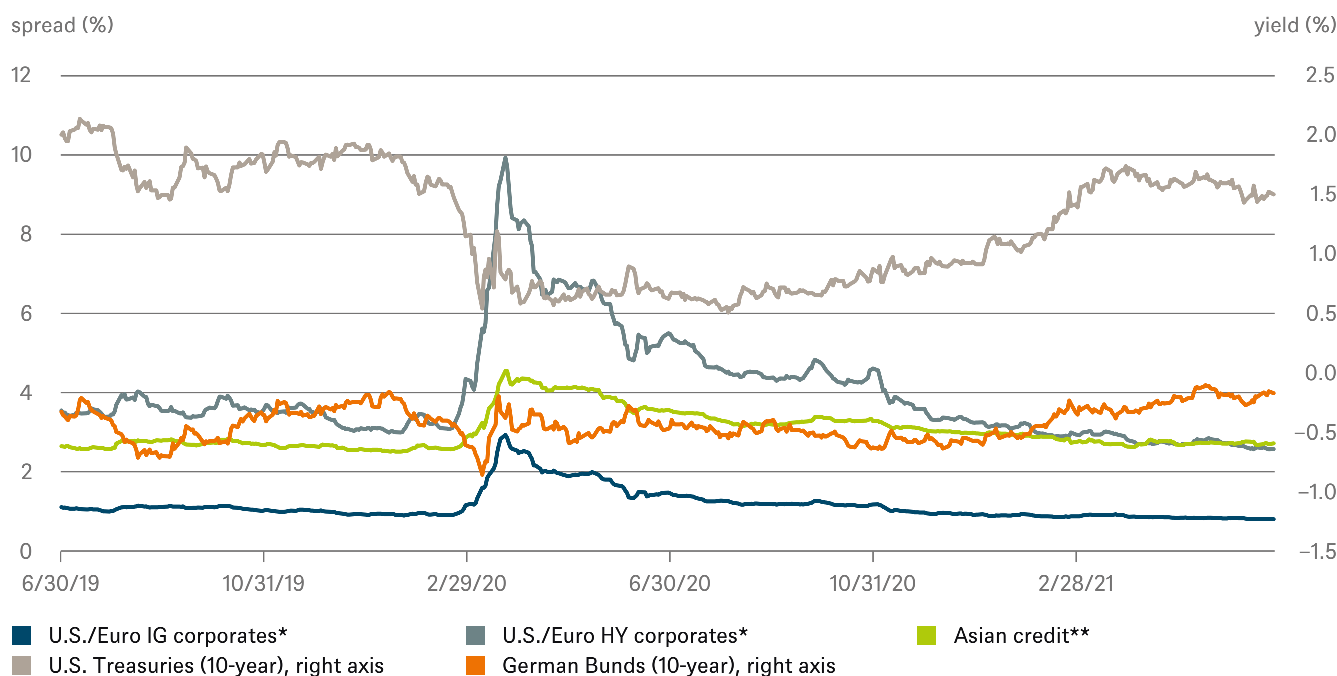
nervousness among consumers and companies, which in turn could result in sustained higher inflation expectations. So far, however, that remains our risk scenario, not our core one. The comments from the U.S. Federal Reserve (Fed) and the European Central Bank (ECB) suggest their view is similar and they are likely to be slow to counteract higher inflation, expecting it to pass.

Fixed income

Our bond-market predictions are based on the assumption that central banks in the industrialized nations are more likely to pull on the monetary reins too late than too early. We expect the Fed to embark on its bond-purchase tapering discussion at the meeting in Jackson Hole in August and to begin to reduce its bond purchases at the beginning of 2022. The ECB is not expected to announce major changes to its monetary policy until publication of the results of its Strategic Review in September this year. However, the ECB's Pandemic Emergency Purchase Program (PEPP) is expected to expire in the second quarter of 2022. We expect a transition period of up to two quarters in which bond purchases will continue almost unchanged. But Fed and ECB bond purchases are likely to be tapered in 2022 and the global level of monetary stimulus is likely to be lower than this year. The Fed and the ECB are unlikely to raise interest rates until 2023 at the earliest but some central banks have already tightened monetary policy this year, most notably China, but also Russia, Brazil and Turkey. Monetary policy is therefore not completely synchronized around the globe after all.

SOVEREIGN AND CORPORATE BONDS JUNE 2019 – JUNE 2021

Sovereign yields are grinding slowly higher while risk premia for U.S. und euro corporate bonds are below their pre-crisis level.



Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 6/28/21

* Average of U.S. and Euro option-adjusted spreads (OAS); U.S. investment grade (IG): Barclays U.S. Aggregate Bond Index; Euro IG: iBoxx Euro Corporate Index; U.S. high yield (HY): Bloomberg USD High-Yield Corporate Bond Index; Euro HY: Bloomberg EUR High-Yield Corporate Bond Index.

** J.P. Morgan Asia Credit Index (JACI Index)

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As there has been little change in the overall market environment in recent months, our forecasts also remain similar. We expect the bond markets to become increasingly nervous as the Fed and ECB elaborate their plans to tighten monetary policy. Thus, little return is expected to be made on government bonds from developed markets, if these returns are positive at all. For 10-year U.S. Treasuries, we expect yields to rise to 2.0%, while 10-year Bund yields could reach the zero line next summer, in our opinion. In real terms we believe both these benchmark U.S. and German bonds will continue to yield negatively. In corporate bonds the high-yield segment in particular should benefit from the continued economic recovery and from reduced insolvencies and defaults forecasts. Asian bonds remain our favorite, as the region's economic upswing is coming on the back of strong corporate balance sheets. We have amended our forecast for the dollar from 1.15 U.S. dollars per euro to 1.20, as the potential for positive surprises has shifted toward Europe.

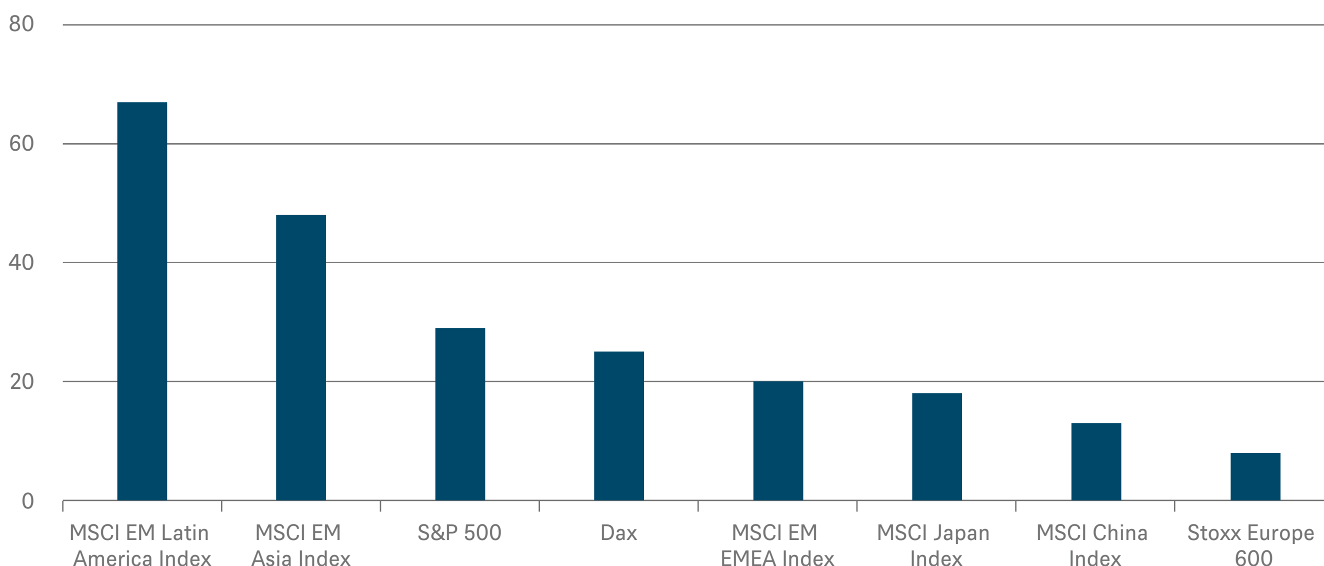
Equities

After the impressive rally in most of the world's major stock indices – the MSCI AC World index recorded a new record high in June – we think the markets will have to jump some difficult hurdles in the summer. The growth outlook is declining in the major economies, with growth likely to peak in the second quarter in the United States and third quarter in Europe; and it has already done so in China in the first quarter. In addition, government support for households will be reduced significantly, and monetary stimulus is also likely to peak this year. Inflation too, is likely to rise to a peak this year and even if it falls again next year, we cannot rule out the possibility that individual sectors will face rising material and labor costs well beyond then. Higher regulatory requirements and corporate taxes are also already on the horizon, which could put pressure on profit margins in the medium term. Initially, however, companies should still benefit from strong sales increases.

REGIONAL 2022 EARNINGS FORECASTS VS 2019 EARNINGS

Corporate earnings have recovered surprisingly fast, yet at different magnitude.

2022 vs 2019 change in %



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Sources: FactSet Research Systems Inc., DWS Investment GmbH as of 6/10/21

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Stock markets can generally cope well with moderate inflation. As companies are usually able to pass on rising manufacturing costs to customers, equities are rightly seen as the better alternative to bonds – especially given the low to negative returns that we expect in bonds. Inflation rates become problematic for equity markets if they drive up nominal interest rates, which in turn can have a negative impact on valuation multiples. Growth stocks and defensive sectors in particular will then come under pressure.

The bottom line is that as long as real bond yields remain negative, investors are likely to favor equities. But we will not further increase our target valuation multiples in this environment. Our forecasts therefore point to little upside potential for the individual equity indices, with returns largely fed by dividends.

At the sector level, technology stocks, European small and mid-cap stocks and individual cyclical sub-sectors (such as cars and mining stocks) remain among our favorites. Given the rise in inflation, quality companies with high pricing power look the most attractive, while the shares of many companies that suffered particularly early in the pandemic and were highly sought after during the reopening rally are quite expensive in our view.

Regionally, Asia's emerging markets remain our favorites, even though they have had a tough start to the year so far. However, the combination of expected high earnings growth (40% this year), a 35% discount to U.S. equities (which is a higher than the average discount over the past 20 years), as well as solid corporate balance sheets and unabated consumer appetite keep us keen on this region – especially as its stock markets are home to a disproportionately large number of technology companies.

Could our assumptions ultimately prove to be too cautious? If so, we believe that a number of factors would have to come together: declining concern about inflation, a market that remains calm even in the face of monetary tightening, persistent consumer and investment spending, high single-digit earnings growth, and willingness on the part of investors to accept valuation multiples well above their historical average in the face of negative real interest rates.

Alternatives

Some of the most lasting changes brought by Covid-19 are likely to affect the real-estate sector. The pandemic has not only created new trends, such as a desire for more spacious accommodation, even in the periphery of major cities as employees work from home, but has also reinforced trends that were apparent before, such as the growth in online retailing and food delivery services. Our preferences in this asset class are therefore logistic properties close to the city centre and residential properties in the surrounding areas of sought-after metropolises. Infrastructure projects are another investment segment that combines stable cash flows with potential compensation for inflation. They should also benefit from the numerous projects being undertaken by governments.

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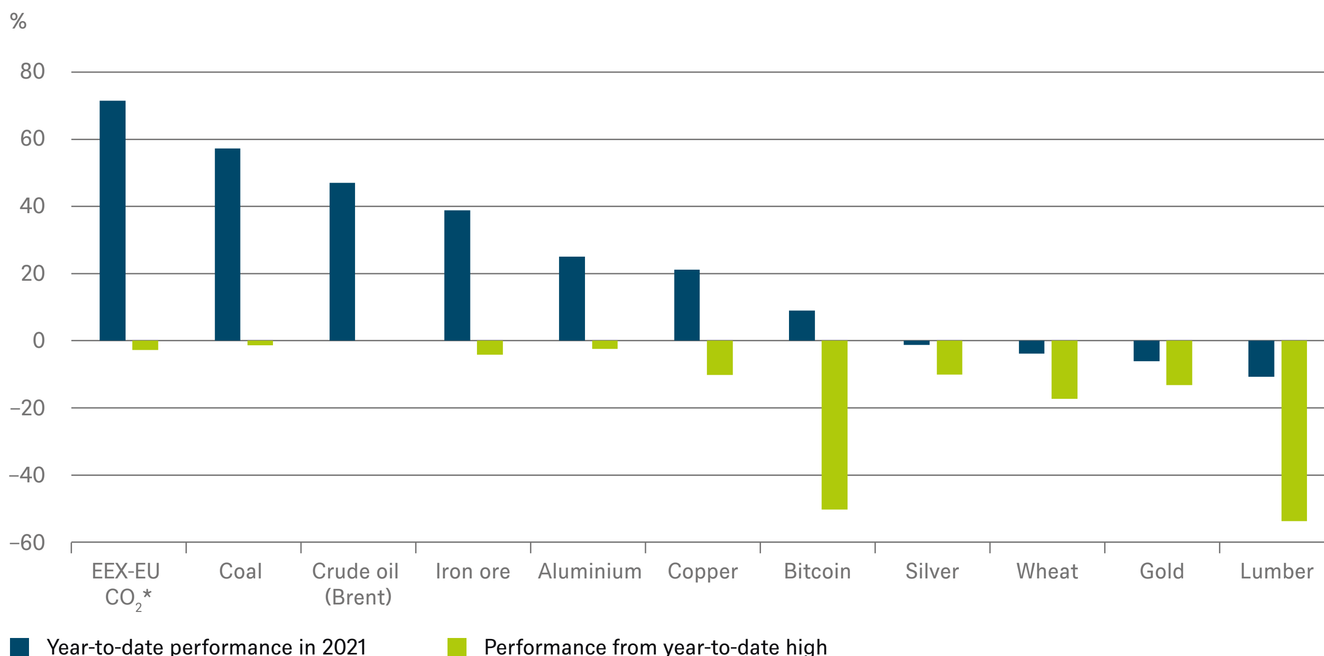
COMMODITY PRICES IN 2021

Commodities have seen experienced high volatility in 2021.



Sources: Refinitiv, DWS Investment GmbH as of 6/28/21
* European Energy Exchange (EEX)

For commodities we are confident overall. A U.S. dollar that has ceased rising and inflation that is rising offer good technical conditions. Demand is picking up overall, although the pace will likely be affected by local Covid setbacks. Prices will also depend on how quickly the supply side can expand production. In some cases, there has been underinvestment for years – and it might take years to build new capacity. In the case of copper this may mean that there will be structural undersupply for many years to come. In the case of oil, however, the OPEC+ countries are still able to react relatively quickly to surges in demand. U.S. shale oil, however, has largely lost its role as the swiftest reacting player in the market. This sector no longer has easy access to fresh money as sustainability comes to the fore. But before oil's swansong we think its price could see a few more spurts to the upside.

In the case of gold, the negative correlation to real 10-year U.S. Treasury bond yields has held up very well in recent years. If this continues, gold's upside potential looks limited as we do not expect real interest rates to plummet again significantly from their current level of around minus one percent. However, if investors' concerns about the sustainability of current monetary and fiscal policy increase, gold could receive a boost independent of real yields. In principle, however, we prefer industrial metals to precious metals at present.

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GLOSSARY

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

The Barclays U.S. Aggregate Bond Index tracks the performance of U.S. investment-grade bonds.

The Bloomberg EUR High-Yield Corporate Bond Index is a market-value-weighted index engineered to measure publicly issued non-investment-grade EUR fixed-rate, taxable and corporate bonds.

The Bloomberg USD High-Yield Corporate Bond Index is a market-value-weighted index engineered to measure publicly issued non-investment grade USD fixed-rate, taxable and corporate bonds. Emerging market debt is excluded

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

A company's cash flow is comprised of its inflows and outflows which arise from financing, operational or investing activities.

A central bank manages a state's currency, money supply and interest rates.

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

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

Cyclical is something that moves with the cycle.

A developed market (DM) is a country fully developed in terms of its economy and capital markets.

A dividend is a distribution of a portion of a company's earnings to its shareholders.

The US Dollar is the common currency of the United States of America and is the most held reserve currency in the world.

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

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.

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.

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.

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

Growth stocks are stocks from companies that are expected to grow significantly above market average for a certain period of time.

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

The iBoxx Euro Corporate Index includes euro-denominated corporate bonds issued by investment-grade-rated entities.

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 J.P. Morgan Asia Credit Index (JACI) provides investors the opportunity to track total return performance of the Asia fixed-rate dollar bond market. The index is a market cap-weighted index comprising sovereign, quasi-sovereign and corporate bonds and it is partitioned by country, sector and credit rating.

GLOSSARY

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).

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

OPEC+ is an informal alliance of OPEC members and other oil-producing countries, led by Russia, aiming to coordinate their production strategies.

The ECB's Pandemic Emergency Purchase Program (PEPP) is a non-standard monetary-policy measure initiated in March 2020 to counter the serious risks to the monetary-policy transmission mechanism and the outlook for the Eurozone posed by the coronavirus outbreak.

In economics, a real value is adjusted for inflation.

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

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).

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

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 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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