

Our monthly market analysis and positioning



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IN A NUTSHELL

- In a sharp reversal of many of the patterns we saw amidst June’s disappointments, markets in July have delivered a roaring start into the second half of 2022.
- Both U.S. equities and U.S. Treasuries delivered strong monthly returns, setting an upbeat tune for global financial markets.
- For coming weeks, though, keep in mind that liquidity is seasonally low, and there are plenty of uncertainties on macroeconomics, monetary policies and geopolitics.

1 / Market overview

After a grim first half of 2022 in terms of financial-market performance, July has delivered a roaring start into the rest of the year. As often happens at such market turning points, this had little to do with any concrete signs of good news on the various fronts that have kept investors on edge. In Southern and Eastern Ukraine, Vladimir Putin’s brutal war of attrition continued to drag on. After the annual maintenance of a key pipeline Nordstream 1, the Kremlin’s increasingly despotic ruler left Europeans guessing on gas supplies during this winter’s heating season, by partially switching them on and off again.¹ As a result of this and other supply disruptions, notably in food, short-term inflation estimates continued to be revised upwards.

In reaction, central banks have been keen to buttress their inflation-fighting credentials. The U.S. Federal Reserve (Fed) delivered its second 75-basis-point interest-rate hike in as many months. Most central banks in both emerging and developed markets are now in tightening mode in our opinion. With its first interest-rate increase in 11 years, the European Central Bank (ECB) took its deposit rate to zero. It also unveiled a new anti-fragmentation instrument enabling it to put a lid, if need be, on “unwarranted, disorderly market dynamics.” It did not specify exactly what it would take, for example in terms of spreads of Italian government bonds over Germany’s Bunds, for the new tool to be deployed.²

A little awkwardly, all this coincided with signs of slowing economic momentum. The U.S. saw its second consecutive quarter of negative growth in gross domestic product (GDP), fulfilling one of the common criteria used to demarcate technical recessions.³ Meanwhile, Italy’s government of national unity collapsed, triggering snap elections on September 25, 2022.

¹ Network Data - Nord Stream AG (nord-stream.info)

² [Mamma Mia, here we go again?]

³ Is the US in recession? Measuring the slowdown in the world’s largest economy | Financial Times (ft.com)

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1.1 Robust markets amidst all the uncertainties

None of these potentially unnerving developments could spoil the mood in global equity markets for very long. During the month of July, the S&P 500 gained more than 9%, with Europe's Stoxx 600 up almost 8%, the MSCI AC World Index up 7%, and Germany's Dax just under 6%.⁴

As significantly, the price gains in equity markets coincided with U.S. Treasuries also performing very well. Yields on 10-year Treasuries ended the month down 37 basis points, resulting in monthly returns of 1.7%, the best performance since March 2020, according to Deutsche Bank Research. Coming hard on the heels of the disastrous performance of mixed equity and bond portfolios during the first half of 2022 – highlighted in our July investment traffic lights⁵ – it was quite a sharp reversal.

In terms of potential justifications cited by market participants, the most common one has been that interest rates may eventually be cut again, at some point in 2023. The trouble with this logic, though, is that it presupposes inflation will somehow be defeated, without causing too much collateral damage to Western economies in the process.

1.2 A mixed, and not particularly encouraging, economic outlook

Unfortunately, such hopeful readings of inflation and growth dynamics are very much at odds with many recent economic indicators. Throughout the OECD, consumer confidence hit lows in July not seen even in the darkest days of the Global Financial Crisis of 2007-2009, while high-frequency measures of economic growth pointed towards slowing momentum.⁶

Inflationary pressures, meanwhile, remain stubbornly high, not least as labor markets are still going strong. Of course, wages and employment tend to be lagging behind economic activity. It takes quite a while for labor shortages to manifest in wage growth and the same logic also tends to hold in reverse during downturns.⁷ Moreover, such lags in how long it takes for labor markets to respond to economic turning points augur against pauses, let alone reversals in monetary policy any time soon. The Fed, in particular, has clearly signaled that it wishes to see signs of labor-market moderation, before it considers its job in containing inflation to be done.

1.3 Our interpretation: good old swings of the market pendulum

Perhaps, the explanation of recent patterns in financial markets is somewhat simpler. At least, that is what is suggested if in addition to equity and bond markets we look at the patterns in commodity and foreign-exchange markets. With the important exception of natural-gas prices, price rallies in commodities have largely stalled. Crude prices continued to see choppy trading at around \$100 per barrel for Brent, compared to their March peak of almost \$140. Meanwhile, gold ended the month pretty much where it started, and most agricultural commodities have been going side-ways. By contrast, base-metal prices rebounded last week, after sharp sell-offs from June to the first half of July.

Commodities – notably ones such as crude oil and copper that are key inputs to a wide variety of different sectors – have a special place as signal providers for market and macroeconomic forecasters. That is because prices usually cannot decouple from physical supply-and-demand considerations for very long. Market mistakes in one direction or the other tend to self-correct and the bigger the previous price swing, the less it takes in terms of new information to cause the market pendulum to swing back.

⁴ Bloomberg Finance L.P., as of August 1, 2022

⁵ Investment Traffic Lights – July 2022

⁶ Why it is too early to say the world economy is in recession | The Economist

⁷ Bewley, T. (2002) Why Wages Don't Fall During a Recession, Harvard University Press

The same logic, we think, probably holds more broadly when we look back at July. Take foreign exchange, as another example. Against the euro, the dollar briefly strengthened beyond parity in mid-July, before weakening by about 2.7% by the end of the month. For each one of these movements, it is certainly possible to come up with some elaborate story of what particular parts of the markets are, or are not pricing in at any given point, say in terms of growth or labor-market dynamics and monetary reaction functions. A more plausible interpretation is that markets this year suffered from a bit of information overload, in the aftermath of (i) the pandemic and all the disruptions in its aftermath in both real economic activity and the collection of economic statistics⁸; (ii) Europe's largest land war since 1945; (iii) the scrambling of central banks and other policymakers to decide how to react to these developments.

After such major changes in the environment investors find themselves in, it tends to take time and quite a bit of learning by trial and error for prices of various assets to adjust.⁹ Most of the recent patterns we saw in July should, in our view, be interpreted in this light: the market pendulum swinging back in July, to make up for previous price reactions that started to look excessive. That may seem like a weak foundation to build a lasting rally on, but it will all depend on future developments. For now, we would simply point out that the encouraging trends we saw in equity markets and the prices of other risky assets in July should not be extrapolated for the rest of the year either.

2 / Outlook and changes

For coming weeks, keep in mind that liquidity is seasonally low. That would tend to accentuate price swings in case of surprises, and there are plenty of uncertainties on macroeconomics, monetary policies and geopolitics. Against this backdrop, we are mostly taking tactically cautious stances.

Russian gas supplies remain a wildcard and not just for Europe. Given how interconnected global supply chains still are, the effects of natural-gas rationing for, say, German industry, would be felt globally. Energy blackmail and trying to sow political and economic instability in nearby countries have been a typical foreign-policy tactics of the Russian Federation, arguably since the collapse of the Soviet Union and especially since Putin's ascent to power in 2000.¹⁰ In previously favored countries, notably Germany, Russia's coercive diplomacy has nevertheless come as a shock. Already, this has led to a wide range of initiatives to cut back on gas consumption. Our base case remains the Kremlin will probably continue to weaponize mutual dependency to pursue its geopolitical objectives and win concrete concessions. This, after all, is how the Russian Federation has typically used coercive gas diplomacy in the post-Soviet space, notably against Ukraine.¹¹ The result looks set to be lower-than-usual gas supplies, with taps for various pipelines being continuously turned on and off, but no sufficiently long supply interruption to cause potentially economically devastating rationing measures for European industries.

2.1 Fixed Income

After July's long-awaited relief in credit markets, bargains have become harder to spot. For now, we tactically like euro high yield (HY), mainly because it has been lagging as funds flowed into the U.S.-dollar HY market and out of euro HY. New issuance remained well below typical levels across both markets in July. By contrast, we see little upside in U.S. investment grade, either from a tactical or a strategic perspective. For rates on sovereign bonds, we are mostly neutral in the short term and skeptical in the long term, given looming interest-rate rises. Yields in two-year German Bunds, in particular, may not fully reflect the ECB's intended hiking path. We are also taking a cautious stance on Italy, as the election campaign has only just started and the outcome, on September 25, remains anyone's guess with significant scope for negative – but also positive! – surprises.

⁸ [Sense and nonsense in pandemic times (dws.com)]

⁹ Lo, Andrew (2017) *Adaptive Markets: Financial Evolution at the Speed of Thought*, Princeton University Press

¹⁰ Maness, R., Valeriano B. (2015) *Russia's Coercive Diplomacy: Energy, Cyber, and Maritime Policy as New Sources of Power*, Palgrave Macmillan

¹¹ At last minute, Russia and Ukraine agree to new five-year gas deal. Here's who won. – Meduza

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2.2 Equities

Given still tight financial conditions, recessionary fears, commodity-price volatility and geopolitical frictions, we take a similarly cautious stance on equities, with a tactically neutral positioning across all regions. In terms of sectors, we continue to favor healthcare, due to its defensive characteristics, as well as energy. European small caps in our view also remain attractive at current valuation levels.

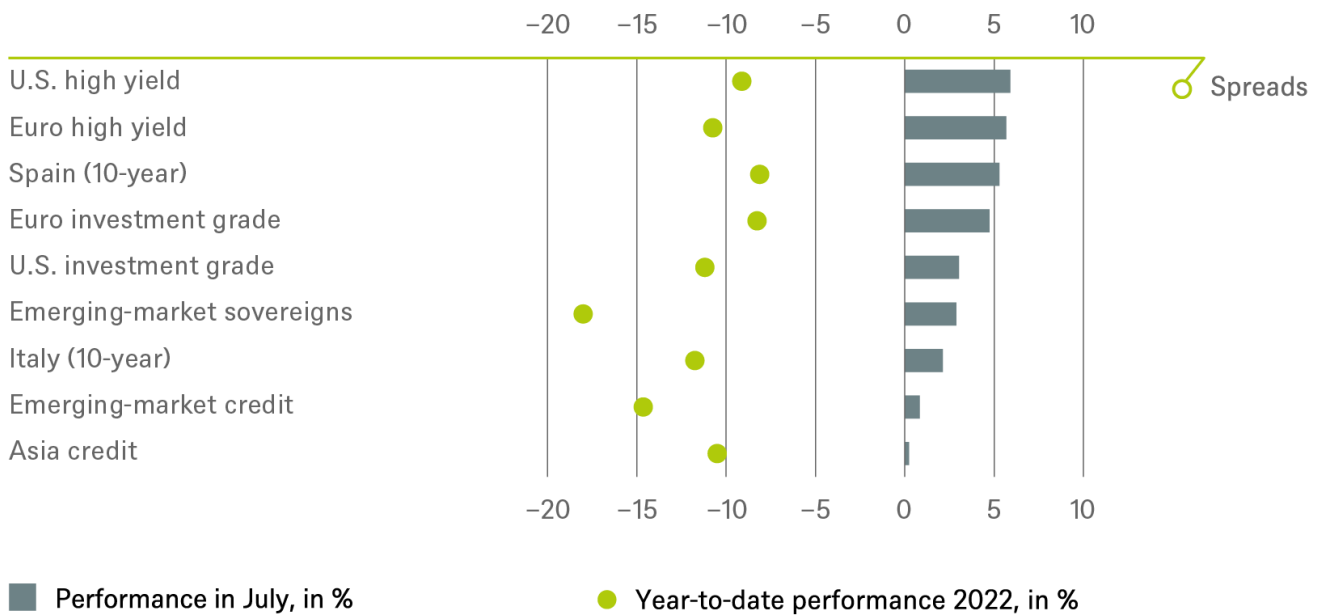
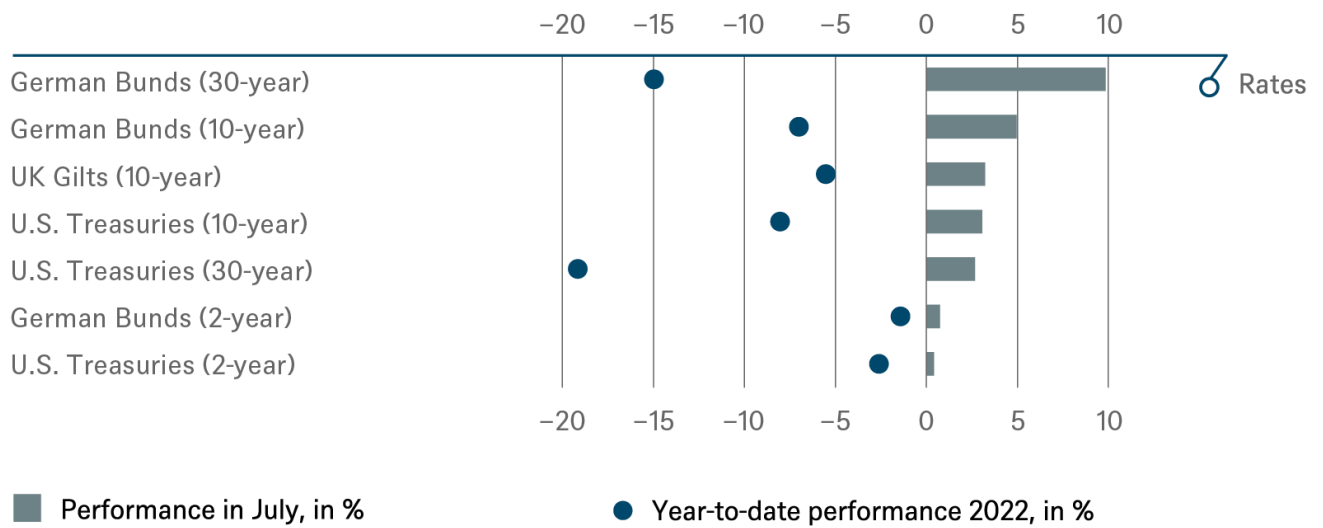
Beyond sector, style and regional considerations, we would strongly emphasize the need for more granular, company-by-company analysis, at this point in time. Across almost all sectors, the ability to protect margins by being able to either contain expenditures or at least pass on higher input costs, is going to be more important than it has ever been in the last 15 years. But because it has been so long since the last episode of inflation at such high levels in most industrialized countries, identifying which companies within a sector can do so better than others is often a matter of judgment and of reading between the lines, when companies present and discuss their results. Each time, the key question should be not just how high earnings were in the last quarter compared to market expectations (for which the overall picture looked mildly encouraging for both the U.S. and Europe, based on the results so far; partly, that's because expectations had already been cut by a lot). Instead, it also needs to be how sustainable earnings will prove, if input-price pressures continue to mount. Pricing power is, so to say, where the wheat will be separated from the chaff in coming weeks and months across almost all sectors.

2.3 Alternatives

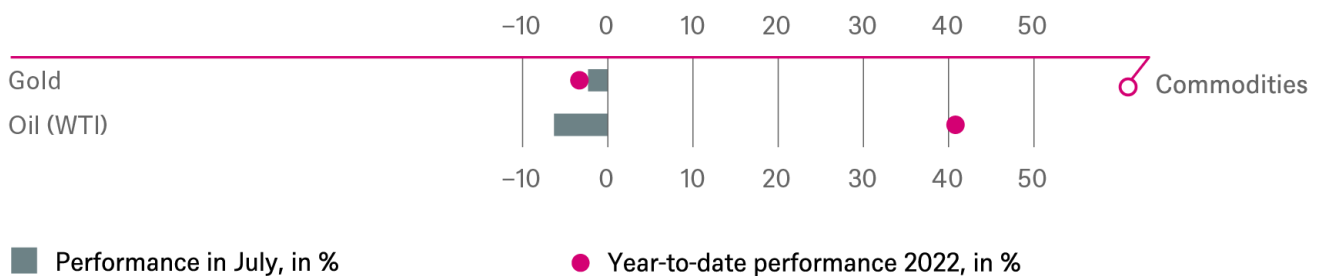
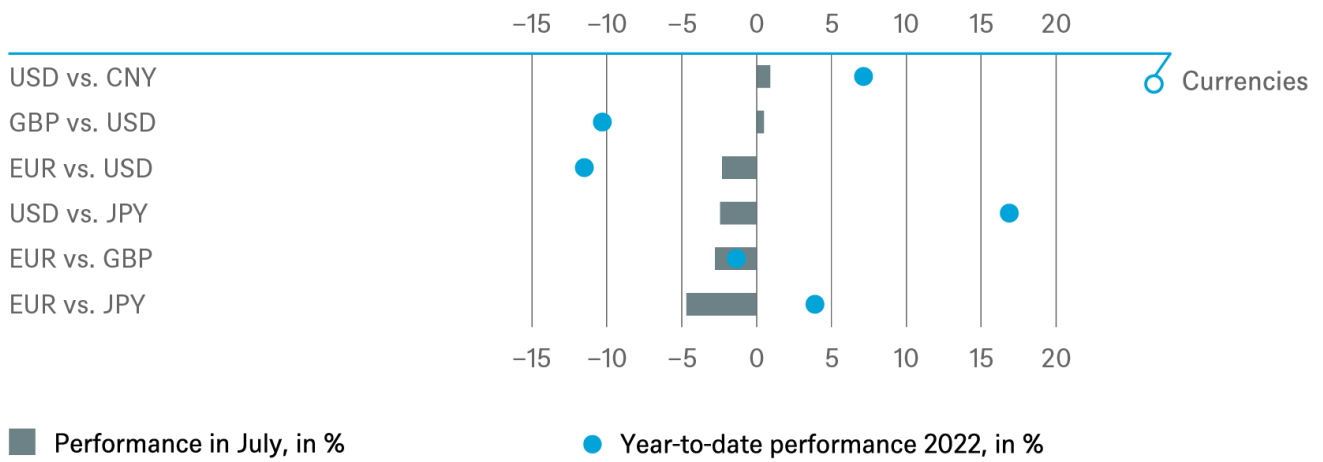
For listed infrastructure and real estate, we remain tactically and strategically optimistic that these will continue to perform well in the current inflationary environment. Global uncertainties call for investment strategies centered on defensive growth: downside protection with the ability to capture inflationary upside, for example through adjustment to rents via escalation clauses or infrastructure fee income. Recession risks and sectoral, as well as regional, dynamics within particular market segments, such as office real estate need to be watched carefully, too, especially in non-listed real estate. As for commodities, we think investors will need to be quite nimble in coming months as outlined above.

3 / Past performance of major financial assets

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



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Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 7/31/22

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4 / Tactical and strategic signals

The following exhibit depicts our short-term and long-term positioning.

4.1 Fixed income

Rates	1 to 3 months	until June 2023
U.S. Treasuries (2-year)	●	●
U.S. Treasuries (10-year)	●	●
U.S. Treasuries (30-year)	●	●
German Bunds (2-year)	●	●
German Bunds (10-year)	●	●
German Bunds (30-year)	●	●
UK Gilts (10-year)	●	●
Japanese government bonds (2-year)	●	●
Japanese government bonds (10-year)	●	●

Securitized / specialities	1 to 3 months	until June 2023
Covered bonds ¹	●	●
U.S. municipal bonds	●	●
U.S. mortgage-backed securities	●	●

4.2 Equities

Regions	1 to 3 months ²	until June 2023
United States ³	●	●
Europe ⁴	●	●
Eurozone ⁵	●	●
Germany ⁶	●	●
Switzerland ⁷	●	●
United Kingdom (UK) ⁸	●	●
Emerging markets ⁹	●	●
Asia ex Japan ¹⁰	●	●
Japan ¹¹	●	●

Style	1 to 3 months
U.S. small caps ²²	●
European small caps ²³	●

Spreads	1 to 3 months	until June 2023
Spain (10-year) ¹	●	●
Italy (10-year) ¹	●	●
U.S. investment grade	●	●
U.S. high yield	●	●
Euro investment grade ¹	●	●
Euro high yield ¹	●	●
Asia credit	●	●
Emerging-market credit	●	●
Emerging-market sovereigns	●	●

Currencies	1 to 3 months	until June 2023
EUR vs. USD	●	●
USD vs. JPY	●	●
EUR vs. JPY	●	●
EUR vs. GBP	●	●
GBP vs. USD	●	●
USD vs. CNY	●	●

Sectors	1 to 3 months ²
Consumer staples ¹²	●
Healthcare ¹³	●
Communication services ¹⁴	●
Utilities ¹⁵	●
Consumer discretionary ¹⁶	●
Energy ¹⁷	●
Financials ¹⁸	●
Industrials ¹⁹	●
Information technology ²⁰	●
Materials ²¹	●

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4.3 Alternatives

Alternatives	1 to 3 months ²	until June 2023
Commodities ²⁴	●	●
Oil (WTI)	●	●
Gold	●	●
Infrastructure (listed)	●	●
Real estate (listed)	●	●
Real estate (non-listed) APAC ²⁵		●
Real estate (non-listed) Europe ²⁵		●
Real estate (non-listed) United States ²⁵		●

¹Spread over German Bunds. ²Relative to the MSCI AC World Index (only for the tactical signals), ³S&P 500, ⁴Stoxx Europe 600, ⁵Euro Stoxx 50, ⁶Dax, ⁷Swiss Market Index, ⁸FTSE 100, ⁹MSCI Emerging Markets Index, ¹⁰MSCI AC Asia ex Japan Index, ¹¹MSCI Japan Index, ¹²MSCI AC World Consumer Staples Index, ¹³MSCI AC World Health Care Index, ¹⁴MSCI AC World Communication Services Index, ¹⁵MSCI AC World Utilities Index, ¹⁶MSCI AC World Consumer Discretionary Index, ¹⁷MSCI AC World Energy Index, ¹⁸MSCI AC World Financials Index, ¹⁹MSCI AC World Industrials Index, ²⁰MSCI AC World Information Technology Index, ²¹MSCI AC World Materials Index, ²²Russell 2000 Index relative to the S&P 500, ²³Stoxx Europe Small 200 relative to the Stoxx Europe 600, ²⁴Relative to the Bloomberg Commodity Index, ²⁵Long-term investments.

Tactical view (1 to 3 months)

The focus of our tactical view for fixed income is on trends in bond prices.

- Positive view
- Neutral view
- Negative view

Strategic view until June 2023

- The focus of our strategic view for sovereign bonds is on bond prices.
- For corporates, securitized/specialties and emerging-market bonds in U.S. dollars, the signals depict the option-adjusted spread over U.S. Treasuries. For bonds denominated in euros, the illustration depicts the spread in comparison with German Bunds. Both spread and sovereign-bond-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.
- The 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

Glossary

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

The **Bloomberg Commodity Index (BCOM)** traces 23 commodities and reflects commodity futures price movements.

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

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

The **deposit rate** is the rate banks receive when they make overnight deposits with the ECB.

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

The **Euro Stoxx 50** is an index that tracks the performance of blue-chip stocks in the Eurozone.

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

The **FTSE 100** is an index that tracks the performance of the 100 major companies trading on the London Stock Exchange.

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.

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.

Liquidity refers to the degree to which an asset or security can be bought or sold in the market without affecting the asset's price and to the ability to convert an asset to cash quickly.

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 Communication Services Index** captures large- and mid-cap securities across 23 developed- and 26 emerging-markets classified in the Communications Services sector.

The **MSCI AC World Consumer Discretionary Index** captures large- and mid-cap securities across 23 developed- and 26 emerging-markets classified in the Consumer Discretionary sector.

The **MSCI AC World Consumer Staples Index** captures large- and mid-cap securities across 23 developed- and 26 emerging-markets classified in the Consumer Staples sector.

The **MSCI AC World Energy Index** captures large- and mid-cap securities across 23 developed-markets classified in the Energy sector.

The **MSCI AC World Financials Index** captures large- and mid-cap securities across 23 developed- and 26 emerging-markets classified in the Financials sector.

The **MSCI AC World Health Care Index** captures large- and mid-cap securities across 23 developed- and 26 emerging-markets classified in the Health Care sector.

The **MSCI AC World Industrials Index** captures large- and mid-cap securities across 23 developed- and 26 emerging-markets classified in the Industrials sector.

The **MSCI AC World Information Technology Index** captures large- and mid-cap securities across 23 developed- and 26 emerging-markets classified in the Information Technology sector.

The **MSCI AC World Materials Index** captures large- and mid-cap securities across 23 developed- and 26 emerging-markets classified in the Materials sector.

The **MSCI AC World Utilities Index** captures large- and mid-cap securities across 23 developed- and 26 emerging-markets classified in the Utilities sector.

The **MSCI AC Asia ex Japan Index** captures large- and mid-cap representation across 2 of 3 developed-market countries (excluding Japan) and 8 emerging-market countries in Asia.

The **MSCI Emerging Markets Index** captures large- and mid-cap representation across 23 emerging-market countries.

The **MSCI Japan Index** is designed to measure the performance of the large- and mid-cap segments of the Japanese market.

The **MSCI World Index** tracks the performance of mid- and large-cap stocks in 23 developed countries around the world.

The **Organization for Economic Co-operation and Development (OECD)** started in 1948 as the Organization for European Economic Co-operation (OEEC) and changed its name in 1960, now representing 34 countries with democratic governments and market economies.

Purchasing power parity (PPP) is a technique used to determine the relative value of currencies, whereas the purchasing power in both currencies is the same.

In economics, a **real** value is adjusted for inflation.

The **Russell 2000 Index** is an index that captures the 2,000 smallest stocks of the Russell-3000 index, which again comprises 3,000 small- and mid-cap U.S. listed stocks.

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

Sovereign bonds are bonds issued by governments.

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

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

The **Stoxx Europe Small 200** is an index representing the performance of 200 small capitalization companies across 17 European countries.

The **Swiss Market Index (SMI)** is Switzerland's most important equity index, consisting of the 20 largest and most liquid large- and mid-cap stocks.

A **technical recession** occurs when GDP growth is negative for two consecutive periods.

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.

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