Quarterly CIO View | Letter to Investors
Client audience: Retail

DWS

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Still optimistic but with modest expectations

As Europe and China are not really getting into their stride, it is once again up to the U.S. and above all its consumers to keep the rally going. In our core scenario, we believe they can do that.

"What 10-year U.S. Treasuries will yield in a year's time is a difficult question – in part because where we are now is highly uncertain. Has the U.S. economy remained strong despite high interest rates, or are the leading indicators pointing to a slowdown because of the high interest rates? Are bond yields falling recently because of easing inflation, or growth fears? Can the U.S. Fed cut interest rates, or does it have to? It's not easy at the moment to pin down the state of the U.S. economy – and both positive and negative future scenarios are possible."

Björn Jesch
Global Chief Investment Officer

Investors are nervous. The market slumped at the beginning of August and at the beginning of September. The volatility of the S&P 500 (VIX Index) has not fallen below 15, its average over the past twelve months, since mid-July. In bonds volatility[1] has not really receded since 2022 and has also risen sharply since July. In addition, the end of the negative (i.e. inverted) yield curve in the U.S.[2] in August saw yields fall at both the short and long ends. That defensive utilities are the strongest sector in the U.S. stock market, despite the Artificial Intelligence (AI) hype, is further evidence of this nervousness. So is the fact that it now takes about 35 barrels of oil, roughly twice as many as 2 years ago to buy an ounce of gold: oil tends to rise when growth is picking up while gold responds to rising fear.

In our opinion, the skepticism is justified as richly valued markets are sailing into an economic slowdown. Even if the U.S. economy has so far held up better than expected, enough leading indicators are sending out negative signals to make the warning serious. In addition, neither China nor Europe is getting into their stride. Germany shows the problem clearly. The economy is suffering from the lack of a global upturn in manufacturing. We had hoped for a tailwind from private consumers, as their real incomes are rising, but it hasn't yet appeared. But we have not given up hope and do expect consumer confidence in Germany and Europe to pick up. Nonetheless, for the moment the global economy doesn't have any strong regional engine to drive it forward. And though we still expect the U.S. slowdown to bottom out at a growth rate of a still quite solid 1.4% (year-on-year) in the second quarter of 2025, we also put the probability of a recession over the coming 12 months at a quite high level: 38%. Risks remain.

I have to admit this doesn't sound very uplifting so far. These points highlight the challenges considered during our strategy meeting at the beginning of September, at which we make forecasts for the end of September 2025. Will we really be through with the U.S. slowdown by then? Or will disillusionment set in after the presidential election, when the high budget deficit forces the new government to shift down a few gears fiscally? Or will the U.S. already be picking up speed again, leading to higher interest rates?

The core scenario that emerged from our assessment is that the worst risks will likely be avoided. We see a slight economic slowdown – and a modest subsequent recovery. With inflation falling significantly, the U.S. Federal Reserve (the Fed) and Europe's central banks will be able to cut interest rates: Our expectation is five 25 basis point (bp) cuts by the European Central Bank (ECB) and six by the Fed (including the expected interest rate cuts this September). For government bonds this means we expect yields to fall at the short end but rise slightly at the long end. Given the high yields we are starting with, however, the total yields for all major government bonds

[1] MOVE Index, which measures the volatility of the US government bond market.
[2] In the second week, the yield curve of 2-year and 10-year bonds settled above zero for the first time since July 2022.

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should remain clearly in positive territory. We continue to favor the medium maturities. Corporate bonds continue to look very attractive in our view. During the phase of weak economic growth, we favor the investment grade (IG) segment, especially in Europe. In currencies we do not expect any major moves in the most important pairs over the next twelve months. This could change after the U.S. election, especially if Donald Trump wins. However, we stand by our assessment that the Democrats have a better chance of winning the White House, but that the Senate could fall into Republican hands, which would severely restrict the new government's legislative room for maneuver.

Provided there is, as we expect, no marked slowdown in the U.S. economy or a shock on the interest rate side, equity prices should continue to move sideways with a slight upward trend. Their rock will be the U.S. consumer once again. Solid corporate earnings (we expect 10% growth over the next twelve months) look so far likely to cushion equities from major downside risks; stable labor markets and the prospect of interest rate cuts by the central banks are a further support. Globally we have a slight regional preference for Europe based on the record high valuation gap it has versus the U.S. We see better growth opportunities in the U.S. but value and small caps are particularly interesting in Europe. In Japan, meanwhile, inflation after years of deflation and corporate reforms are bearing fruit. In emerging Asia, with the exception of a few sectors, we are primarily looking outside China. On a sector basis, we have downgraded telecoms service providers, which have become quite expensive, to neutral. AI is still a remarkable source of dynamism when you look at the investment plans of the largest buyers of AI semiconductors, for example, but the market is also beginning to question the speed at which AI can be monetized. However, healthcare, an older sector, is delivering good growth at a reasonable valuation and is likely to be less at the center of the U.S. election campaign this time. We have moved it to Overweight.

Among alternatives our gold forecast of USD 2,810/ounce (oz) reflects continuing central bank buying. Our Brent oil forecast of USD 80 per barrel assumes there will be no major supply side shortages. In real estate, prices are stabilizing and, in some cases, even rising. Logistics and residential property are benefiting from strong structural demand drivers in all regions. We also see upside potential for private loans, an increasingly popular source of financing for companies.

All in all, it looks as if we are in for a prolonged, albeit tepid, economic upswing that will be favorable for most financial assets. But there are considerable risks to our hopeful central scenario and we continue to focus on broad diversification of our investments. This approach may help provide secure income streams for investors even in a poor capital market environment – for example via stocks that pay good dividends and relatively high-yielding corporate bonds – and it also may allow investors to participate in the growth of the economy and of the corporate profits that we expect in 2025.

Glossary

Artificial intelligence is the theory and development of computer systems able to perform tasks normally requiring human intelligence.

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

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

Diversification refers to the dispersal of investments across asset types, geographies and so on with the aim of reducing risk or boosting risk-adjusted returns.

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

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.

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

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Small cap firms generally have a market capitalization of less than $2 billion.

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

Value stocks are stocks from companies that are trading at prices close to their book value and that are therefore cheaper than the market average on that metric.

The VIX is the popular name for the Chicago Board Options Exchange's Volatility Index. It is a popular measure of the stock market's expectation of volatility based on S&P 500 index options.

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.

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.

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