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Marketing Material

# A downturn unlike any other?

Why we remain cautiously optimistic on equities – with a strong emphasis on being cautious!

- The case for equities rests on the idea of the downturn being relatively short-lived and not leaving too many lasting scars.
- There are some encouraging signs that the initial waves of Covid-19 may have peaked in many industrialized countries.
- Meanwhile, the severity of the shock varies across countries and sectors, creating potential stock-picking opportunities.



Dr. Thomas Schüssler  
Co-Head of Equities



Andre Köttner  
Co-Head of Equities

Around the globe, the rapidly spreading Coronavirus has created unprecedented political, public-health and economic crises. Not that you would necessarily know, if you had fallen asleep in mid-February and were only now checking up on your stock-market portfolio. At the time of writing, in the last days of April, the S&P 500 is a mere 15% below its February peak, roughly where it was trading in May 2019.

Other stock indices have suffered more, notably in emerging markets. Then again, you might expect as much in the face of a mere political crisis in Brazil; collapsing commodity prices hitting Russia and South Africa; or a strong dollar squeezing heavily indebted emerging-market corporate borrowers from Turkey to India. Instead, all of these countries are also – still – in the early stages of the pandemic. By contrast, China has slowly started to emerge from the damage caused by the initial outbreak in the first quarter. China's CSI 300 Index is down less than 5% in the year to date, having recovered most of its earlier losses.<sup>1</sup>

In Europe, meanwhile, policy makers continue to squabble about a common response to the pandemic. As for Brexit, that – ultimately – happened in January. The UK's future relationship with its main trading partners remains unresolved, however. That said, it is increasingly hard to remember why

exactly Brexit dominated market fears for so long, now that there is a global pandemic to worry about.

There are some hopeful signs that the initial waves of Covid-19 may have peaked on both sides of the Channel, and, according to more tentative signs, in some of the worst hit parts of the United States, too. What is already becoming clear is that slowing the pandemic's initial waves has come at a significant economic cost in all afflicted countries. The required social-distancing measures have pushed the global economy into recession. Global economic activity and corporate profitability clearly peaked in 2019. The length of the economic shut-down will critically determine the magnitude of the negative economic impact.

Fiscal and monetary policy in most rich countries has also shifted into crisis mode, with a range of unprecedented responses in order to mitigate the near-term economic hardship. The long-term implications of the massive rise of public debt levels, financed largely via central-bank balance-sheet expansion, are far from clear. Some observers see parallels with the ancient concept of seigniorage, or the debasement of coinage by a sovereign to fund wars or other royal excesses, with a pick-up in inflation as the likely end result. For now, however, rising unemployment and the resulting

<sup>1</sup> Bloomberg Finance L.P. as of 4/28/20

lack of demand could cause deflationary downside pressure on corporate profit margins instead.

As for the increasingly fashionable idea of holding equities as a hedge against any eventual uptick in inflation, you might want to ask someone old enough to remember the 1970s before betting on it. Or even better, read a classic paper by Franco Modigliani and Richard Cohn. Back in 1979, after a decade of inflation, the pair was admonishing market participants for being far too harsh in how they valued stocks. "Because of inflation-induced errors, investors have systematically undervalued the stock market by 50 per cent."<sup>2</sup> Such thinking may have helped win Modigliani the Nobel Prize in 1985. It left market participants unimpressed and unwilling to pay up, though, until inflation had been brought to heel in the early 1980s.

The case for equities, therefore, rests firmly on the idea that the world after Covid-19 will in some important ways still resemble the one we were familiar with before the crisis: low inflation with interest rates even lower. That could support even higher stock-market valuation multiples for even longer, potentially to the detriment of future returns. The crisis might also accelerate the trends towards digitalization. As our base case, we assume that the technology and social-media sectors keep delivering strong operating performance. Working from home, video conferencing and grocery e-commerce might also create new and lasting niche opportunities.

The most important assumption underlying our optimistic view on equities is that of the downturn being relatively short-lived and not leaving too many lasting scars. Such a scenario would, among other things, require most countries to avoid or at least contain further Covid-19 outbreaks, without having to resort to new country-wide lockdowns. Vaccines and better medical treatments would need to materialize within the next 12-18 months. And when it comes to paying for the crisis, there are already some ominous signs that shareholders, too,

will directly or indirectly foot part of the bill. Plenty of dividends have already been cut, either for economic or political reasons. The longer the crisis, the bigger such pressures will probably be.

Much will also depend on the outcome of November's U.S. elections. As we expected, Democrats have nominated a centrist candidate for the presidency, former Vice President Joe Biden. Unlike more adamantly left-wing candidates of the primary contest, Mr. Biden appears less inclined to meddle with drug prices or to introduce measures to heavily tax capital gains or wealth. Tight Senate contests may also limit what any new administration will be able to do. Given how volatile U.S. politics has been in recent years, however, a reversal of recent U.S. corporate tax cuts can certainly not be ruled out.

On the whole, our optimistic base case is very fragile and lacks a strong conviction. Obviously, there is material downside risk for equities if the crisis turns out more severe. Market multiples are a psychological seismograph of investor confidence. They might well take a prolonged period to recover to previous peak levels. Whatever the longer-term market outcome, short-term volatility is likely to remain very high and markets are likely to test previous lows.

In the meantime, virtually all sectors are negatively impacted by the crisis. Corporate treasurers across all sectors will try to preserve liquidity by cutting discretionary spending, delaying capex and potentially by laying off staff eventually. However, the severity of the shock varies, creating potential stock-picking opportunities. Tourism, airlines and restaurants face existential challenges, while the oil sector has to handle the dual challenge of excess supply and falling demand at the same time. Global banks are in significantly better shape than in 2008, but already have to lift bad debt provisioning. Heavily leveraged companies are likely to underperform. We prefer sticking to a "quality bias," i.e. companies with strong balance sheets and relatively resilient cash flows.

<sup>2</sup> Franco Modigliani and Richard A. Cohn (1979), "Inflation, Rational Valuation and the Market," in: Financial Analysts Journal, Vol. 35, Issue 2, pp. 24-44

### CRISIS? WHAT CRISIS?

Following its recent rebound, the S&P 500 is trading at 18.5 times trailing earnings, above its average valuation of the past 20 years.



\* price-to-earnings ratio

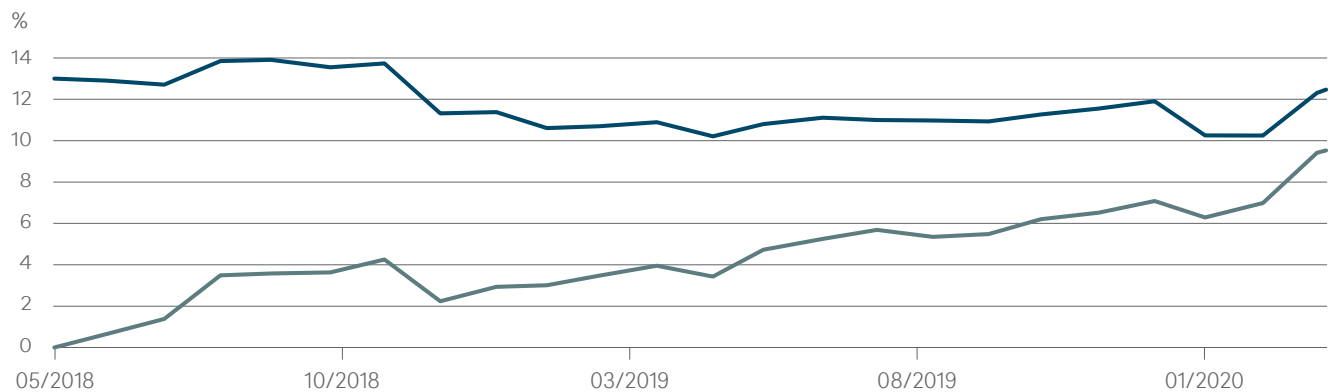
Sources: Refinitiv, DWS Investment GmbH as of 4/28/20

## Valuations overview

### UNITED STATES: NEUTRAL (NEUTRAL)\*

Due to the outsized U.S. fiscal stimulus, the recession in the United States looks set to be shallower and shorter than in the Eurozone. U.S. markets have certainly moved on swiftly from the initial panic phase. For the moment, investors appear determined

to look through the crisis – increasing the scope for temporary setbacks. After all, U.S. equity markets are once again trading at valuations which would have looked frothy not so long ago, even in the absence of a global pandemic.



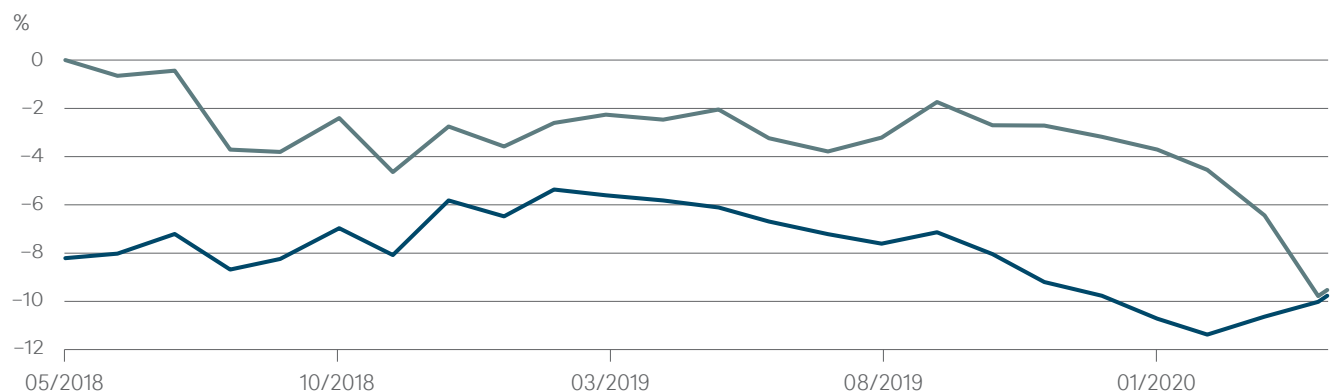
■ Relative valuation (P/E ratio): S&P 500\* vs. MSCI AC World Index\*\*

■ Relative performance: S&P 500 (in dollars) vs. MSCI AC World Index (in local currency)

### EUROPE: NEUTRAL (NEUTRAL)\*

With few technology stocks, and relatively few growth stocks of any sort, European equities have already had a relatively weak performance over the past decade. Covid-19 looks unlikely to change that. The heavy weighting of oil stocks in some country

indices could further delay their recovery. Of course, predicting how investors will value extremely volatile earnings streams during the coming 12 months is highly speculative. Renewed market turbulence could present stock-picking opportunities.



■ Relative valuation (P/E ratio): Stoxx Europe 600\* vs. MSCI AC World Index\*\*

■ Relative performance: Stoxx Europe 600 (in euros) vs. MSCI AC World Index (in local currency)

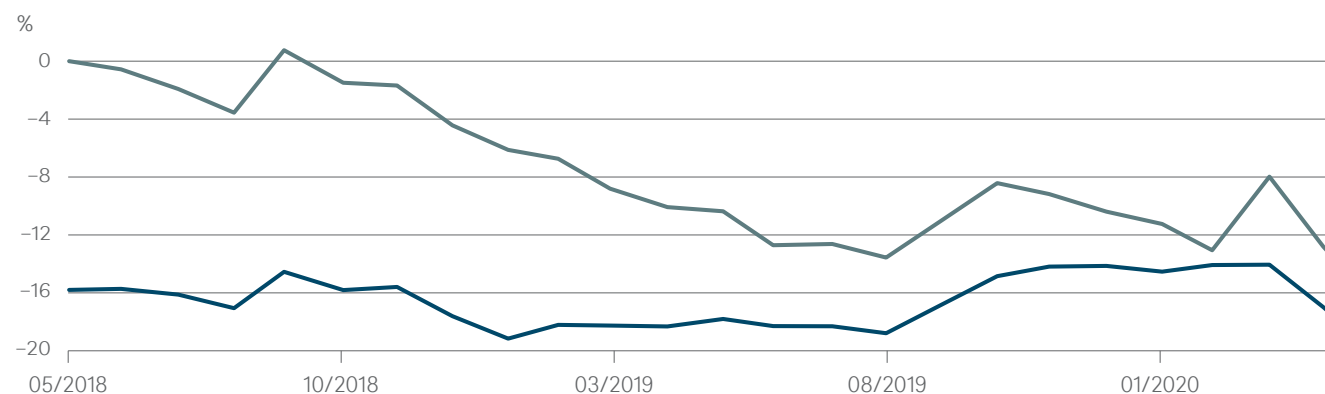
\* Our assessment is relative to the MSCI AC World Index, the last quarter's view is shown in parentheses.  
Sources: FactSet Research Systems Inc., DWS Investment GmbH as of 4/30/20

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### JAPAN: NEUTRAL (NEUTRAL)\*

In theory, trade-dependent Japan should benefit from any signs of the world economy rebounding. Balance sheets are solid and the political environment is stable. Corporate governance and returns on capital have improved since the last financial crisis. When the time comes, all of this might make Japanese stocks

an attractive way to benefit from a global recovery. Meanwhile, however, a deteriorating economic backdrop or any renewed tensions between the U.S. and China could dampen investor enthusiasm.



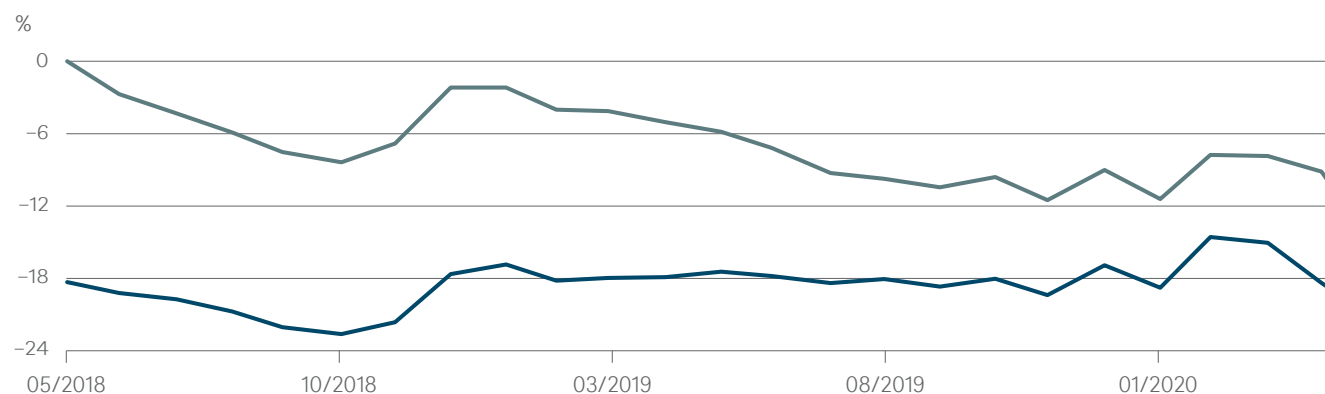
■ Relative valuation (P/E ratio): MSCI Japan Index\* vs. MSCI AC World Index\*\*

■ Relative performance: MSCI Japan Index (in yen) vs. MSCI AC World Index (in local currency)

### EMERGING MARKETS: NEUTRAL (NEUTRAL)\*

In the aftermath of various trade conflicts, many emerging markets entered the 2020s in a weakened state. Instead of the hoped-for recovery, Covid-19 is cruelly unveiling many previously existing weaknesses, notably in Turkey, South Africa

and Mexico, but also in Brazil, India and Russia. But many of the risks appear to have been priced in already. China, which was hit first by the virus, has seen its equity market recover. Differentiation at the industry and country level remain key.



■ Relative valuation (P/E ratio): MSCI Emerging Markets Index\* vs. MSCI AC World Index\*\*

■ Relative performance: MSCI Emerging Markets Index (in dollars) vs. MSCI AC World Index (in local currency)

\* Our assessment is relative to the MSCI AC World Index, the last quarter's view is shown in parentheses.

Sources: FactSet Research Systems Inc., DWS Investment GmbH as of 4/30/20

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## GLOSSARY

**Brexit** is a combination of the words "Britain" and "Exit" and describes the exit of the United Kingdom of the European Union.

**Capital expenditure (Capex)** are funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment.

The **CSI 300 Index** includes the 300 largest companies of the Chinese mainland, that is companies listed on the Shanghai and Shenzhen Stock Exchange (so called A-shares).

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

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

The **Eurozone** is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

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.

**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.

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

**Leverage** attempts to boost gains when investing through the use of borrowing to purchase assets.

**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.

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

A **multiple** is a ratio that is used to measure aspects of a company's well-being by setting various of the company's metrics against each other and thereby building indicative ratios.

**Profit Margin** is an accounting figure which describes profit in relation to revenue in percent.

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.

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

The **United States Senate** is a legislative chamber consisting of 100 Senators, with each state being represented by two Senators. Senators are elected for six year, overlapping terms in their respective state.

**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.

## PERFORMANCE / Overview

Performance in the past 12-month periods (in %)

	04/15 – 04/16	04/16 – 04/17	04/17 – 04/18	04/18 – 04/19	04/19 – 04/20
CSI 300 Index	–32.5%	11.4%	11.4%	6.6%	2.2%
Dax	–12.4%	23.9%	1.4%	–2.1%	–12.0%
MSCI AC World Index	–7.6%	12.9%	12.0%	3.0%	–6.8%
MSCI Emerging Market Index	–17.9%	19.1%	21.7%	–5.0%	–12.0%
MSCI Japan Index	–6.1%	10.5%	19.2%	–7.2%	–3.0%
S&P 500	1.2%	17.9%	13.3%	13.5%	0.9%
Stoxx Europe 600	–10.8%	17.2%	2.9%	5.2%	–10.2%

Past performance is not indicative of future returns. Forecasts are based on assumptions, estimates, opinions and hypothetical models that may prove to be incorrect. Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 4/30/20

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