September 30, 2019

Ready for sideways trading

Central banks have pushed valuations up, leaving little upside potential. We stick to equities and hedge portfolios.

- Economic data, interest rates, central-bank policies and equity valuations, all give little hope of high returns, even in the absence of recession.
- In this environment we stick to equities and higher-yielding bonds, while waiting for tactical opportunities.

Christian Hille
Head of Multi Asset

Expansive central banks continue to dominate global markets. Bonds in total worth more than 15 trillion U.S. dollars currently yield negatively worldwide. Fewer and fewer investment-grade bonds are being issued with positive yields. But negative interest rates at the long end and the inversion of the U.S. yield curve point to economic concerns that have also been keeping interest rates low. The unhappy word "recession" has made the rounds in the last quarter, especially in mid-August, according to data on online search queries. Some of the macro data, too, is negative. According to Purchasing Managers' Indices (PMI), the industrial sector has been contracting for some time in many industrialized countries. In Germany, the composite PMI[1] in September fell to its lowest level in seven years. In addition, a near-term revival in capital spending looks unlikely. The continuing trade conflicts between the United States and China and the United States and Europe, together with Brexit, continue to be big disincentives to investment. The attack on two important Saudi Arabian oil plants was a further setback for global confidence. It showed the fragility of vital energy infrastructure and how quickly major supply shocks can occur.

In terms of inflation the threat of such attacks are not the desirable demand-pull kind that would alleviate deflationary worries. Rises in oil prices caused by a supply shock would simply hurt consumers and deter spending, adding to the downward pressures on growth.

Inflationary risks, however, have almost been forgotten at present. No amount of money printing appears to drive consumer prices up. But it has contributed to inflation in asset prices. The return on many bonds in recent years has come primarily from price increases rather than coupons. More than 85% of the return on 10-year German government bonds in the past five years has come from rising prices. Now with 10-year Bunds trading with negative yields and assuming yields won't fall further, bond investors would seem to be faced with two possible future scenarios. Either stable yields, giving little to no further return from price increases and therefore a negative total return; or rising yields and a painful fall in bund prices – and therefore again a negative total return[2]. Either way, it doesn't look good.

[1] Purchasing Manager Index from IHS Markit
[2] Given a relatively flat yield curve, otherwise some return could be achieved through the "roll-down" effect. See also: https://dws.com/insights/cio-view/charts-of-the-week/cotw-2019/chart-of-the-week-20190802

GOLD IS PROFITING FROM LOW REAL YIELDS

Lower opportunity costs and economic expectations are reflected in lower real yields that are likely to benefit the gold price.

Sources: Refinitiv, DWS Investment GmbH as of 9/23/19

What about other asset classes? Gold, which tends to be popular with nervous investors in turbulent times, and especially at a time of low real yields (see chart above) for its potential to reduce the opportunity cost of holding the non-interest-bearing yellow metal, is trading at an 8-year high. The Japanese yen, often used as a safe-haven currency, has been appreciating for about a year. Even the most prominent of all cryptocurrencies has had a strong year, reaching its year-to-date high at the end of June, before economic worries peaked and the U.S. yield curve of 10- and 2-year Treasuries inverted. And equities? The S&P 500, is prancing around at its historic high of just over 3000 points. The consensus view is that earnings per share (EPS) will grow by just over 10% next year.[3]

We expect only half that. And while the S&P 500 is already at twice its last high before the financial crisis, the MSCI AC World ex USA Index is only slightly higher than in mid-2007, thanks to dividends. Even in the American market there is a fly in the soup: in the past 12 months, only the big caps were on the up: the S&P 500 gained 2.5%, the smaller-cap Russell 2000 lost 8.6%.[4]

Longer-term structural developments have also remained a constant worry for the markets: frailer growth, modest productivity gains, record global debt (319% of GDP in the first quarter) and an aging population in big parts of the world. But calls for fiscal stimulus, which would mean more debt, are getting louder. For the capital markets the implications have been worrying. The conundrum for investors is to generate a positive real rate of return when the 10-year real government yields of all the major industrial nations are negative: Japan at -0.7%, the United States at -0.9% and Germany at -2.1%. Where is yield supposed to come from, the desperate asset manager might ask the equally desperate client?

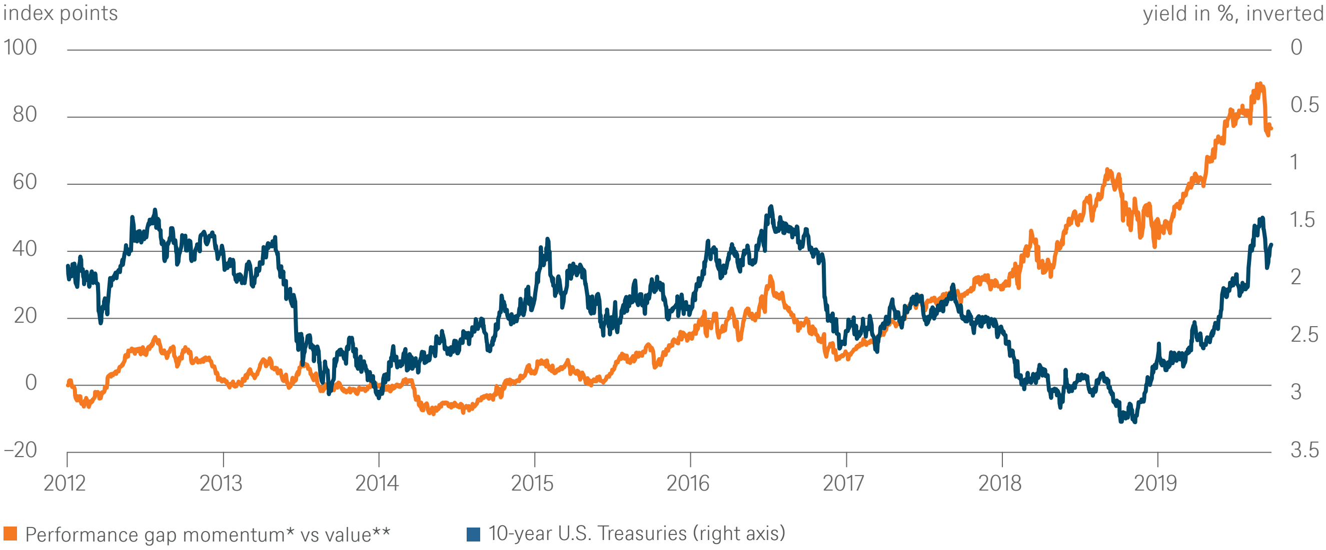
There is, however, a lot going on below the surface of the main equity indices, within commodities and in different bond maturities and rating classes. We believe the active portfolio manager may have some leeway to tickle a little more yield from the market after all. Equity markets, for example, have been displaying for some time a twofold split in valuations across sectors. Companies seen as having little to offer have a price-earnings (P/E) ratio of around 5, while others trade

[3] Refinitiv, data as of 9/24/19
[4] As of 9/23/19

above 20. The winners keep on winning, the losers are sold on. As a result, the valuation premium of growth stocks over value stocks surpassed July 70% for the first time in July – higher than at the previous peak, in the year 2000.[5] The valuation premium of momentum versus value stocks, which was still at 30% at the end of 2017, is now approaching the 100% mark. As the following chart shows, this year in particular the sectoral trend was highly correlated with 10-year U.S. Treasury yields. The correlation was also evident at the beginning of September, when both curves suddenly reversed. Momentum stocks, which had previously performed extremely well, suffered one of their biggest declines in a few sessions compared to value stocks in a violent rotation of sectors and styles.

LOW YIELDS ARE OF LITTLE USE FOR VALUE STOCKS

While the correlation isn't always perfect, this year has shown how much growth and momentum stocks are profiting from lower yields, unlike value stocks.



* MSCI World Momentum Index
** MSCI World Enhanced Value Index
Source: Refinitiv and DWS Investment GmbH as of: 9/23/19

[5] MSCI World Growth Index and MSCI World Enhanced Value Index

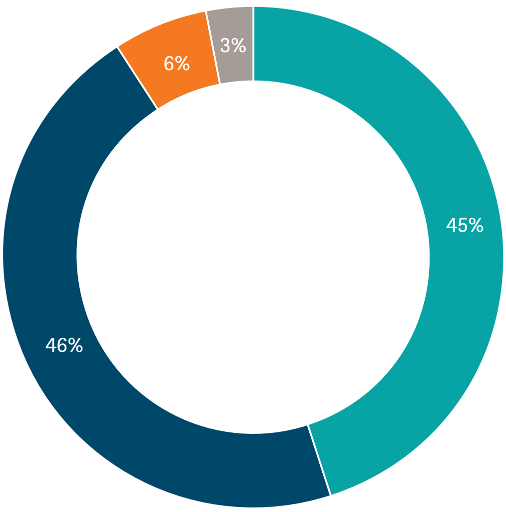
What does this mean for asset allocation?

Has the turnaround come? We don't think so. The above-mentioned sector rotation came to a standstill in mid-September and government bond yields tended to weaken again after two surprisingly strong weeks. We assume interest rates will trade sideways over the 12-month horizon and do not expect further violent rotations of sectors or styles while the stock rally persists. Our base scenario remains that we do not expect a recession in the coming twelve months, nor a marked revival in economic growth. In an interest-rate environment characterized by "lower for longer", we believe there is still no way past equities. However, the shaky global economy, unpredictable trade conflicts and Brexit are likely to continue to cause volatility. Our regional preferences remain the developed markets, especially the United States and Eurozone. In the United States we favor growth and quality stocks, in the Eurozone cyclical ones, making our overall portfolio balanced.

For bonds, the situation is clearer after the latest central-bank meetings, but the U.S. Federal Reserve (Fed) continues to have scope to loosen policy further if it chooses. The search for positive yields remains challenging. We see that as an argument for emerging-market hard-currency government bonds. In corporates we prefer euro- to dollar-denominated bonds, not least because the European Central Bank (ECB) is now once again a price-insensitive buyer in the European market. U.S. government bonds and, on the currency side, the Japanese yen for diversification purposes could eventually be considered to be worth contemplating about. Given the low real yields, gold remains a potential portfolio hedge.

MULTI-ASSET ALLOCATION FOR EUROPEAN INVESTORS

Profiting from ongoing trends, seeking opportunities and watching for risks

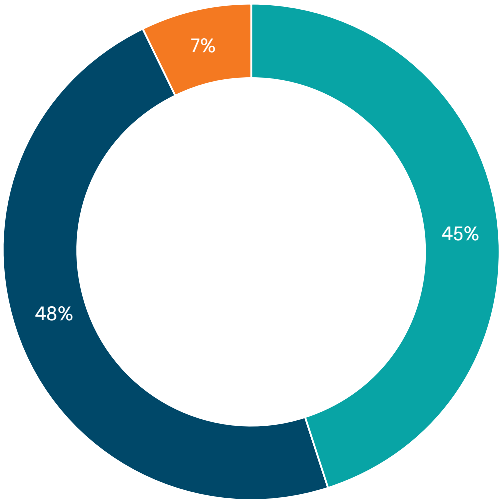


Equity	45%
Equities United States	25%
Equities Europe	6.5%
Equities emerging markets	5%
Equities Global Style	5%
Equities Japan	3.5%
Fixed Income	46%
Euro investment grade	13%
Eurozone sovereigns	11%
U.S. Treasuries	8%
Emerging-market (hard-currency) bonds	7%
Euro high yield	5%
U.S. high yield	2%
Alternatives	6%
Convertibles (euro-hedged)	3%
Commodities	3%
Cash	3%

The chart shows how we would currently design a balanced, euro-denominated portfolio for an European investor taking global exposure. This allocation may not be suitable for all investors and can be changed at any time without notice. Alternative investments involve various risks and are not necessarily suitable for all clients or for every portfolio. Source: Multi Asset Group, DWS Investment GmbH as of 9/10/19

MULTI-ASSET ALLOCATION FOR ASIAN INVESTORS

Profiting from ongoing trends, seeking opportunities and watching for risks



Equity	45%
Equities United States	27.5%
Equities Europe	7.5%
Equities Asia ex Japan	6%
Equities Japan	4%
Fixed Income	48%
U.S. Treasuries	15%
Asia Credit	14%
Emerging-market (hard-currency) bonds	10%
U.S. high yield	5%
U.S. investment grade	4%
Alternatives	7%
Convertibles	4%
Commodities	3%

The chart shows how we would currently design a balanced, dollar-denominated portfolio for an Asian investor taking global exposure. This allocation may not be suitable for all investors and can be changed at any time without notice. Alternative investments involve various risks and are not necessarily suitable for all clients or for every portfolio. Source: Multi Asset Group, DWS Investment GmbH as of 9/10/19

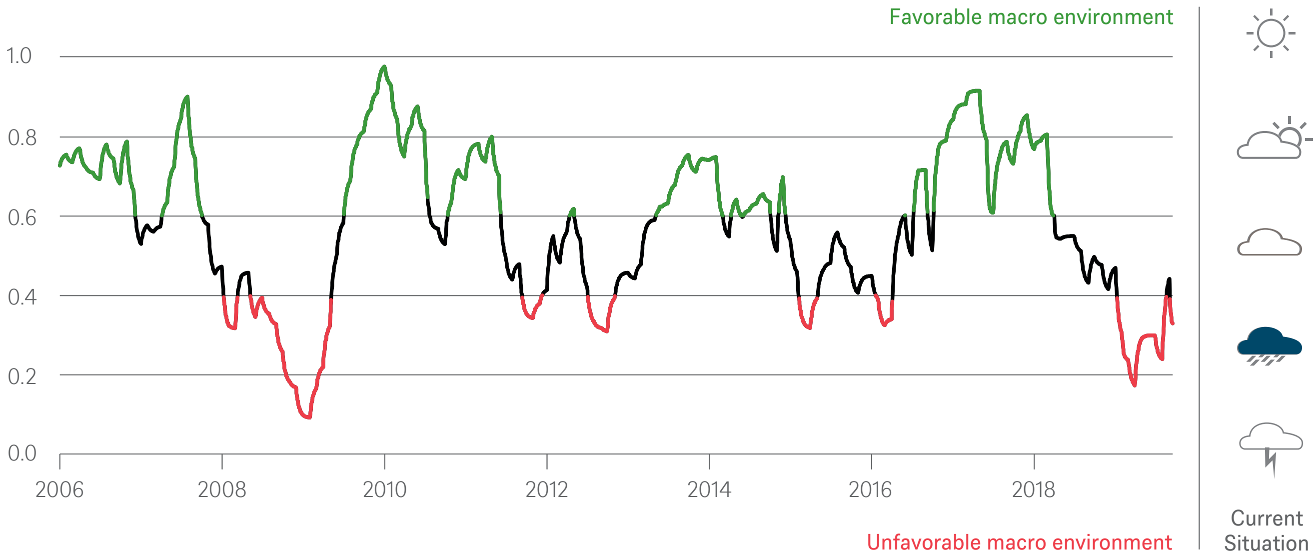
Prospects remain rather bleak

All three indicators show rather gloomy prospects.

For some time now, all three DWS indicators have been almost unanimously pointing to a negative environment. The brightening at the beginning of the second quarter proved to be no more than temporary. The macro indicator has improved a bit but is still negative – for the twelfth consecutive month. The surprise indicator suggests that analysts' expectations for 2019 as a whole were too optimistic and the risk indicator reflects investors' currently low risk appetite. The escalating trade disputes between the U.S. and China are further depressing investor sentiment. Despite some occasional temporary concessions, there are few signs that this serious trade-conflict episode is going to be resolved soon. Even if the tariff dispute between the two largest economies is resolved there is risk of the U.S. targeting Europe next. Further monetary-policy easing by global central banks may be one consolation for capital markets. But for now the bottom line is that the indicators point to a particularly fragile market environment.

MACRO INDICATOR / Condenses a wide range of economic data

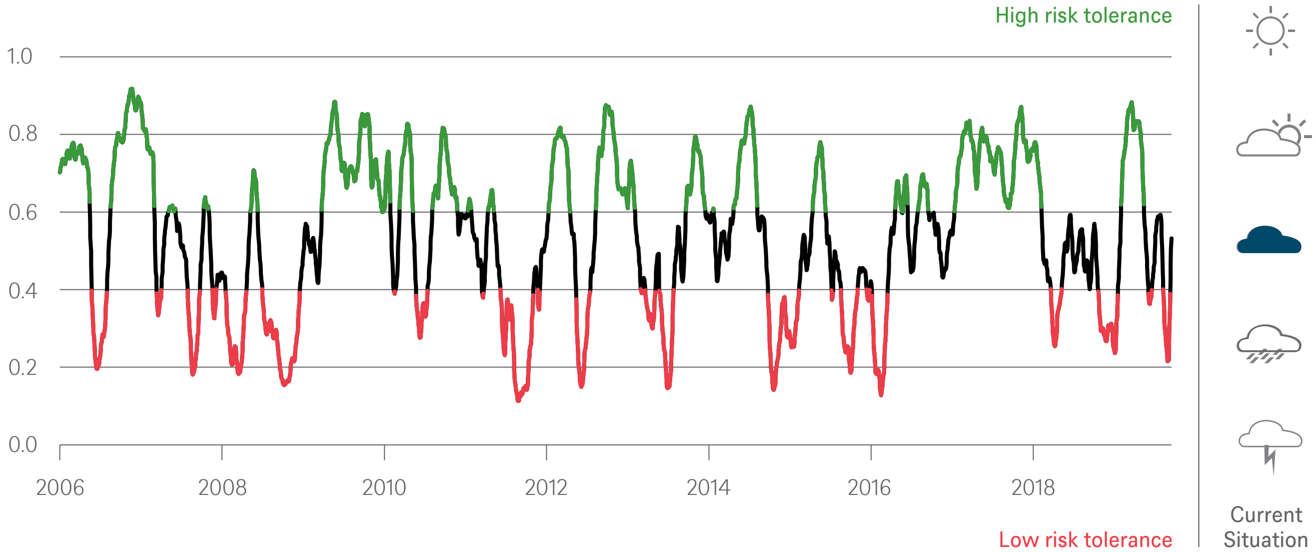
The macro indicator recovered somewhat in August, but remains in negative territory in absolute terms. A slight recent worsening suggests a degree of caution is still required. The macro-indicator traffic light has now been red for more than 12 months.



Source: DWS Investment GmbH as of 9/19/19

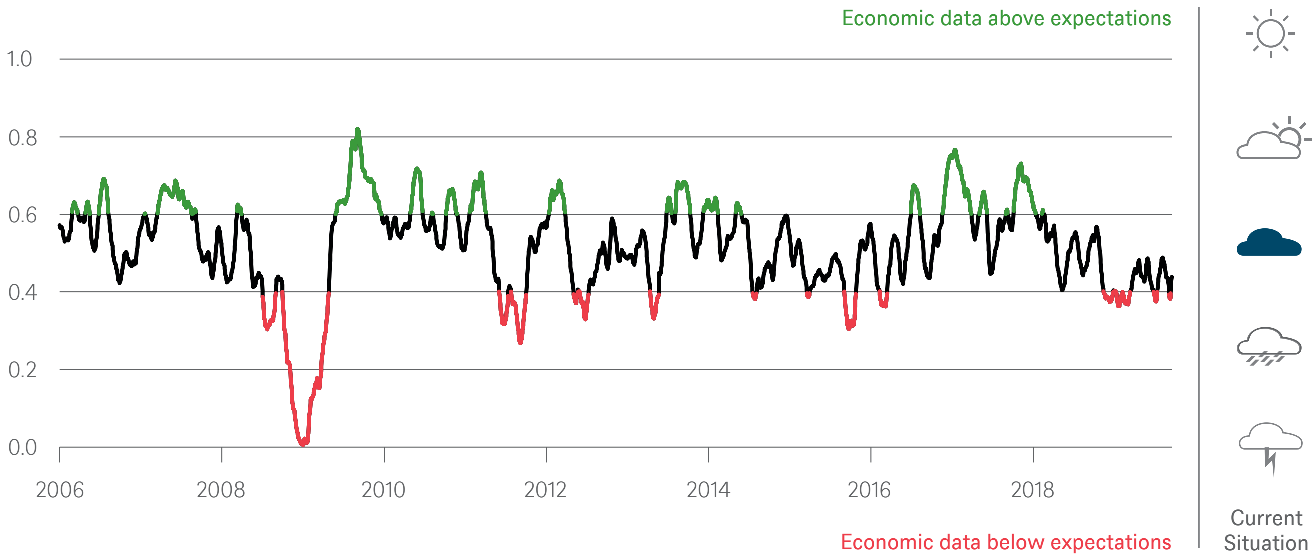
RISK INDICATOR / Reflects investors' current level of risk tolerance in the financial markets

The risk indicator has deteriorated significantly since the beginning of the year. The escalation in the trade conflict between the U.S. and China and the deadlines set by the U.S. in the trade conflict with Europe are just two contributing reasons. Continuing uncertainty over Brexit is another. The fact that there has been no marked further worsening of the trade dispute and yet more largesse from the ever generous central banks might explain the indicator's recent recovery: it is now just in green territory. But the recent attack on Saudi oil assets is not yet reflected in these figures.



SURPRISE INDICATOR / Tracks economic data relative to consensus expectations

The surprise indicator has been red for most of the year. But the regional sub-indicators have diverged substantially. The regions keep changing from negative to positive and vice versa, so that no consistent regional picture can be drawn.



Source: DWS Investment GmbH as of 9/19/19

GLOSSARY

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

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

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.

Coupons are interest rate payments made on a bond.

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.

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

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.

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.

A fiscal union is the integration of the fiscal policy of several nations. Decisions about the collection and expenditure of taxes are taken by common institutions.

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.

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

A hard currency is any globally traded currency that is considered as historically stable and can be exchanged easily.

IHS Markit is a listed company providing market data and information services for a variety of industries.

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 ISM Purchasing Manager Index, published by the Institute for Supply Management, measures economic activity by assessing the sentiment among purchasing managers. It is an important indicator of the economic health.

The Japanese yen (JPY) is the official currency of Japan.

Momentum refers to the rate of growth of an index or security's price. Momentum investors believe that strong growth is likely to be followed by further gains.

The MSCI AC World ex USA Index captures large- and mid-cap companies across 22 developed- and 23 emerging-market countries, excluding the United States.

The MSCI World Enhanced Value Index captures large- and mid-cap securities across 23 developed markets. The index is designed to represent the performance of securities that exhibit higher value characteristics relative to their peers.

The MSCI World Momentum Index captures large- and mid-cap companies with high price momentum across 23 developed market countries.

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

The Purchasing Managers Index (PMI) is an indicator of the economic health of the manufacturing sector in a specific country or region.

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 Russell 2000 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.

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

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).

A valuation premium is the excess a buyer is willing to pay for one asset relative to other assets.

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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Publisher: DWS Investment GmbH, Mainzer Landstraße 11-17, 60329 Frankfurt am Main, Germany

Publisher: DWS Investment GmbH, Mainzer Landstraße 11-17, 60329 Frankfurt am Main, German

CRC 070782 (09/2019); CRC 070771 (09/2019)