December 9, 2019 Marketing Material

You have to take risks if you want return

We expect little movement in bond yields. It's again in corporates and emerging markets that we look for potential returns.

_ We expect neither the Fed nor the ECB to cut or raise rates in 2020.

_ Euro corporate bonds and emerging-market bonds offer a good risk-return profile.

_ We also expect little movement in currencies. We think it's too early to call for a lasting resurrection of the euro.

Jörn Wasmund
Head of Fixed Income/Cash

From a fixed-income investor's point of view, 2019 was much more exciting than expected. Exactly one year ago we were assuming the U.S. Federal Reserve (the Fed) would carry out another two rate hikes and that the European Central Bank (ECB) would shave a few basis points off its negative deposit rate. Things came out quite differently, and not just to our surprise. Fed Chairman Jerome Powell skipped the hikes and cut rates three times instead, and the ECB loosened policy meaningfully. The turnaround by the Fed proved explosive in financial markets. A little bit of defusing of political tension may have been a factor, too: the U.S.-Chinese trade dispute stopped getting worse. The results were clear: more bond- and equity-market bullishness, driven, more than anything, by loose monetary policy.

What ultimately drove the Fed to replace the two planned rises with three cuts is debatable. Was its decision influenced by the almost 20 percent decline of the stock market in the fourth quarter of 2018? Or by U.S. President Donald Trump's verbal attacks?

But after this dramatic and surprising year the question that remains is what may follow in 2020. Having taken what might be seen as a major pre-emptive step to ward off economic weakness, the Fed can now be more data-dependent. Given the economic developments we expect, this is likely to mean that interest rates remain static next year, in the U.S. and probably in Europe, too, though we certainly don't completely rule out moves up or down. A significant rise in U.S. inflation, which might be generated by (higher) tariffs on Chinese imports, would lead to a rise in rates. A rate cut or cuts could follow further signs of economic weakness. And the downside risks are there. Corporate leaders are nervous. If they hold back on capital investments and fiscal impetus fades, as we would expect, growth may suffer. The approaching election would not make the Fed hesitate. Contrary to popular opinion, it has acted in election years on a number of occasions in the past. However, the election campaign itself could be a cause of major market fluctuations. Wall Street is wary of Democrat Elizabeth Warren and might react nervously if her campaign for the party candidacy looks likely to succeed.

Overall, the low-interest world seems set to continue. The central banks will most probably continue to provide support through their renewed purchases of securities and we do not expect a recession, any further escalation in the U.S.-China trade dispute, or a hard Brexit. Nor do we expect yields on

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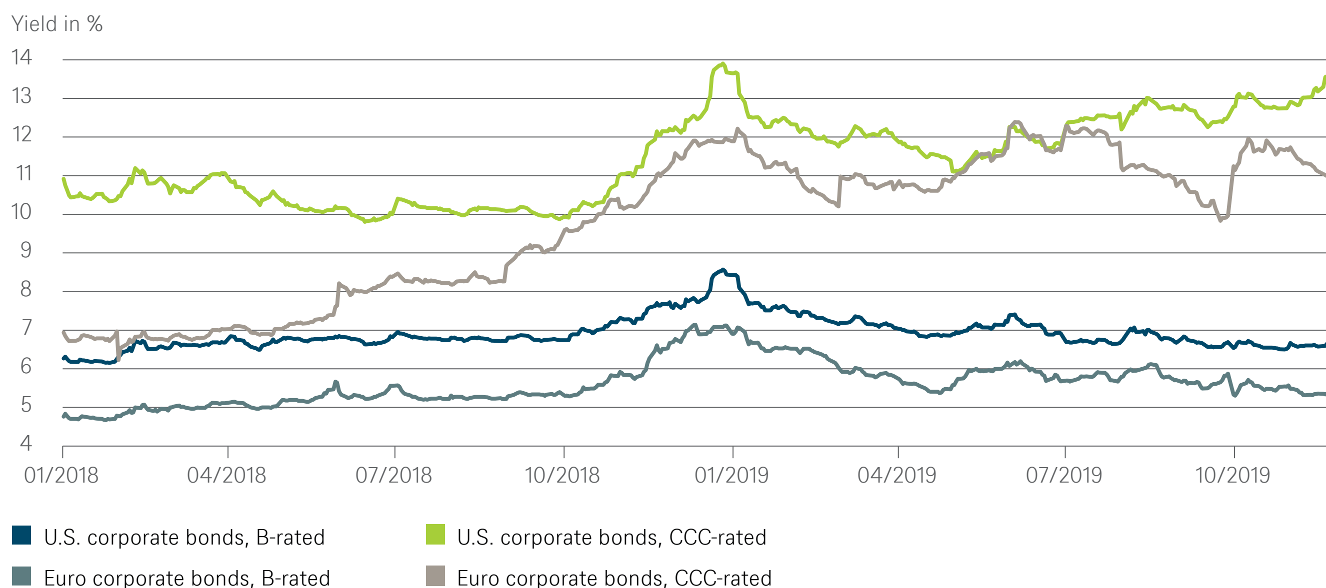
government bonds to return to their lows of 2019. Anyone wishing to generate a return in 2020 must be prepared to take a risk.

What may this mean in concrete terms for the individual regions and bond types? We expect little from government bonds. In Europe and Japan, we forecast total returns to be close to zero - after all, we should no longer expect bond prices to rise as they had in 2019. Even U.S. Treasuries appear to actually only be attractive for dollar investors. The emerging markets, where we believe total returns on government bonds could exceed five percent in dollar terms, are, however, becoming more interesting. They are benefiting from lower U.S. interest rates and the prospect that the dollar will not strengthen further. In addition, their central banks still have room for maneuver to support economies if necessary.

ALL CALM IN INVESTMENT GRADE, WHILE HIGH-YIELD BONDS ARE SHAKING

Euro and U.S. investment-grade corporate bonds have moved similarly – barely at all. In the high-yield segment, however, there have been some slick moves as investors differentiate more.



Sources: Refinitiv, DWS Investment GmbH as of 11/25/19

For corporate bonds, moderate economic growth and low inflation are beneficial. And TINA and FOMO are on their side: There Is No Alternative (TINA) to corporate bonds given low or even negative government-bond yields; and Fear Of Missing Out (FOMO) keeps investors coming in the hopes of yet another bond rally.

Risk-adjusted, we currently consider euro corporate bonds from investment-grade issuers to be particularly attractive. In addition, we see opportunities in other sub-segments, i.e. in the euro high-yield segment, as well as in the U.S. and emerging markets. Euro bonds should again be supported by the ECB's purchases, while in the U.S. the previous concerns about balance-sheet quality have not been substantiated. In any case, a broad slide by BBB bonds into the high-yield segment did not happen. What we see since the summer, however, is a widening gap between high-yield bonds with lower ratings (CCC, see chart) and those with better ratings. This is due not only to the disproportionately high representation of energy stocks in the U.S. high-yield segment, but also because bonds issued by companies in difficult sectors or with a difficult business model (e.g. classic retail) are being shunned more than in the past. We expect the spread between issuers to increase further.

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In currencies we are sticking more or less to our previous forecasts, which have held up well thus far in 2019. We see the dollar/euro pairing as being in balance at 1.15 dollars per euro, even if momentum may gradually be shifting towards the euro. However, we believe it is too early to start looking for a sustainable and substantial euro recovery. We continue to see the yen as a good hedging instrument to consider for the market's more turbulent days.

We are aware that our yield forecasts sound unexciting. They do correspond, however, with our current economic and political outlook for 2020. We are well aware that the U.S. presidential election, Brexit or even political hot spots like Iran or Hong Kong may provide reasons for our core scenario not to happen. But the graph below shows that historically only in times of restrictive monetary policy or strongly rising inflation expectations have U.S. government bonds returned negative yields. We do not expect that to happen either.

NO FIXED RETURNS IN FIXED INCOME

Total annual returns on German and U.S. government bonds are seldom as boring as might be expected from fixed-income bonds.

Sources: Refinitiv, DWS Investment GmbH as of 11/25/19

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GLOSSARY

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

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

A bull market is a financial market where prices are rising – usually used in the context of equities markets.

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 (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.

A hedge is an investment to reduce the risk of adverse price movements in an asset.

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.

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

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).

A rating is a standardized assessment of the creditworthiness of the issuer and its debt instruments by specialized agencies. The main three rating agencies are the Moody's (Aaa over Baa1 to C, best to worst) , S&P (AAA over BBB+ and CCC to D, best to worst) and Fitch (AAA over BBB+ to D, best to worst).

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

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

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