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Back to normal. But what is normal?

The record market slide has been followed by record-breaking stimulus – and a superfast rally. The economy is yet to follow.

" The Coronavirus crisis has further increased the influence of governments and central banks. Many market mechanisms have been suspended. This poses long-term risks. In the short term, investors should be able to take advantage of the rescue packages' positive effects on markets. "

Stefan Kreuzkamp
Chief Investment Officer

Coronavirus and its repercussions continue to dominate people's lives, the economy and stock markets. The calming in continental Europe's former virus hotspots and the increasing speed with which lockdowns are being eased should not obscure the fact that the virus continues to rage worldwide. In addition to new hotspots, especially in Latin America, the persistently high number of new infections in Great Britain and the United States is also striking. Nevertheless, these governments too are pressing vehemently for a return to business as usual.

The reason why many Americans still have to stay at home is no longer quarantine but curfew. The violent death of an African American, George Floyd, at the hands of the police has sparked weeks of protests in numerous U.S. cities. How President Trump's response to both the protests and the pandemic may affect the presidential elections is likely to be on investors' minds during the summer.

In our forecasts we assume that most countries experienced their economic trough in April, or in May at the latest. Even though we expect some countries and regions to suffer further flare ups in infection rates, we do not expect the broad global lockdown of the spring to be repeated. Normalization is coming, and we expect it to be fast at first, but then gradual, so that global economic output will not return to its late-2019 level until the end of 2022.

But the term 'normalization' should be used with caution. Despite advances in treatment and more experience in dealing with the virus, it may well continue to frighten many people and have a major impact on economic and social life for some time to come.

For the economy, too, normalization looks difficult. We should not forget just how extraordinary the fall was. Whether in transport, car sales or tourism, drops in activity of 80% or more were recorded. As a result, in the second quarter, industrialized countries are likely to have suffered the biggest economic decline in percentage terms in their history: more than 10% down on a year earlier. The outlook for 2020 as a whole is not much better. We expect the Eurozone economy to contract by 7.5% on a year earlier and the U.S. by 5.7%. Added to this is the longer-term uncertainty as to how unemployment, which has soared to unprecedented highs, especially in the U.S., will be brought back down.

There are further negative factors. Protectionism and de-globalization have been further intensified by the crisis. More positively, so too has digitalization. The extraordinary increase in government intervention in the economy, meanwhile, is highly problematic. Together with the new record-high levels of national debt, it threatens to create distortions that would have a long-term negative impact on potential growth.

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For central banks, too, normality seems a long-forgotten concept. Since the turn of the millennium, they have built up expectations that they will be willing and able to run to investors' rescue and absorb any capital-market turbulence or economic dips rapidly. It is hard to argue that the record aid packages to alleviate the coronavirus crisis were not logical. Interest rates were cut, packages worth billions were turned into trillions, securities bought in more and more market segments, and the Federal Reserve's balance-sheet total alone could rise from four to over ten trillion dollars this year. But the consequences are going to be complex.

Against this background, what does normality look like on the capital markets? On the bond side, the pre-crisis trends seem to be hardening and significant increases in government-bond yields have disappeared off the horizon for now: They are staying low. And yet the "for now" must be emphasized more strongly than before the crisis. The huge fiscal stimulus programs and surges in debt make a significant rise in inflation a less fanciful idea than at the end of 2019.

Inflation-linked bonds should benefit in this environment. We believe that with good selection, companies and emerging markets can also be expected to yield adequate returns again. We see opportunities particularly in Asia, which has so far coped better than other regions with the virus and continues to benefit from the low oil price. Overall, we believe the risk-return profile of high-yield bonds in particular has improved substantially in the wake of the strong rise in yields provoked by the crisis.

What about the risk-return profile of equities? As measured by the MSCI AC World Index, they are already trading back at the November 2019 level and the Nasdaq is now up again since the beginning of the year.[1] This once again reflects the triumph of technology stocks. Coronavirus, meanwhile, has made the healthcare sector another star of the equity universe. And from a relative perspective these sectors remain our favorites. From an absolute perspective, however, it is hard to justify the current valuations – and this also applies to the market as a whole. Assuming the same earnings level in 2022 as in 2019 and discounting that to the present, the valuation (price-to-earnings ratio) for the S&P 500 for example is above the pre-crisis level. That would normally be seen as expensive. But what is normal? The economic cycle is more uncertain than ever and it is unclear what might plague us in the not too distant future: inflation, or deflation. In addition, central banks are continuing to expand their balance sheets apace. In these extraordinary circumstances, more and more investors seem to be coming to the conclusion that inflation-resistant assets such as equities would be the preferable choice. While medium-term returns for equities might be moderate, we still expect some sectors to profit from mega trends such as further digitalization and automation and smart urbanization. Cash-distributions are another important issue as slow-to-recover earnings test high valuations. Dividend-oriented strategies have suffered as many investors doubt the ability of companies to pay dividends as a result of the crisis. But good dividend-stock selection made it possible to come through the turmoil surprisingly well. We believe attention was and is needed to be paid not only to the quantity but also to the quality of the pay-outs, or, put differently, the ability of the company to generate the necessary cash flows for the dividends. And now that some degree of economic recovery is likely, selected cyclical stocks have also become interesting again. We are looking at mining and selected material stocks.

Even though we expect low-single-digit returns on equities, selected bonds and alternative investments over the next twelve months, many imponderables – including the Coronavirus, the U.S.-Chinese trade dispute, de-globalization, the completely abnormal economic trends, and also the U.S. election – argue in favor of broad positioning and a portfolio cushioned against possible further turbulence by adding gold, real-estate investments or the yen.

[1] Refinitiv Datastream as of 6/4/20

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GLOSSARY

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

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

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.

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.

An inflation-linked bond is a bond where the principal and/or coupon is indexed to the consumer price index.

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

The MSCI AC World Index captures large- and mid-cap companies across 23 developed- and 24 emerging-market countries.

The Nasdaq 100 is an equity index which contains the 100 biggest common stocks listed on the Nasdaq composite index.

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

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

PERFORMANCE / Overview

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

	05/15 - 05/16	05/16 - 05/17	05/17 - 05/18	05/18 - 05/19	05/19 - 05/20
MSCI AC World Index	–7.4%	15.2%	9.7%	–3.3%	3.5%
Nasdaq 100 Index	1.7%	29.5%	21.7%	3.4%	35.4%
S&P 500	1.7%	17.5%	14.4%	3.8%	12.8%

Past performance is not indicative of future returns. DWS Investment GmbH; Source: Bloomberg Finance L.P. as of 5/29/20

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