

# Crisis makes even stronger case for equities

How deep the crisis could be remains uncertain. The size of many aid packages, however, is rather concrete. Equities should be among the relative winners.

- \_ The size of the crisis is already historic, and its end is not yet in sight.
- \_ In uncertain times, people tend to turn to government bonds. But low yields and record levels of government debt are leading to greater skepticism.
- \_ In this environment, we believe equities are becoming more attractive from a strategic point of view.



Klaus Kaldemorgen  
Fund manager

How would we have positioned ourselves if we had known ahead of time which topics markets would be confronted with this year?

- \_ Would we have bet on a strong start, even though China and the United States had only signed a lukewarm ceasefire and the U.S. President was facing an impeachment trial?
- \_ Would we have bet on Chinese stocks holding up so well in February, when China was the focus of attention for the new coronavirus, SARS-CoV-2?
- \_ Would we have bet that European and U.S. stock indices would reach record highs in mid-February, when it was already foreseeable that the virus would develop into a global pandemic?
- \_ Would we have expected gold and U.S. government bonds to fall at the height of the market stress at the beginning of March?
- \_ Would we have expected the U.S. market to recover by almost 30% from mid-March, while U.S. unemployment was soaring at unprecedented speed and the U.S. was turning into the epicenter of the pandemic?

Of course, some of these seemingly unusual developments and synchronized movements in different asset classes can be explained by the fact that when the market stress is greatest, cash is king – and some investors have to part with gold, U.S. dollars or U.S. government bonds in order to get the liquidity they need. The parallel recoveries in markets can also be explained in part by the U.S. Federal Reserve (Fed) rescue packages, since the newly created liquidity (the Fed balance sheet has expanded by almost \$2 trillion since the end of February alone, to over \$6 trillion by now) has to flow somewhere. The Fed pushed further into what had previously been a taboo zone on Thursday, April 9, when it announced that under specific circumstances it would now also buy U.S. high-yield bonds. This takes pricing in the capital markets a little further into the realm of absurdity, with negative impacts on efficient capital allocation in the longer term. In the short term, however, there is a simpler and familiar lesson from the past: Don't fight the Fed. The Fed is representative of many central banks that in recent weeks have put together monetary rescue packages more quickly and boldly than ever before.

But what we believe the above examples illustrate above all is the difficulty of "timing" the market. To catch the highs and lows for entry and exit would have been difficult in some cases even with a crystal ball that could look into the future. History

has shown that in times of crisis you can do more harm than good with short-term trading. What this also argues against is major over- and underweights in portfolio allocation. What it argues for is broad diversification, which should help to withstand sudden market storms relatively well.

Nonetheless, a major exogenous shock like the virus gives rise to a number of long-term shifts that one can and should prepare for. The virus will affect economies for much longer than we could have imagined at the beginning of the year. And the aid packages from governments and central banks will also leave a lasting mark. Debt levels will reach new record levels

in many nations (not only in absolute terms but also as a percentage of gross domestic product (GDP)). In addition, financing of the government by central banks, by now indirect in name only, is likely to create a familiar dilemma: many central banks won't be able to tolerate substantial and sustainable interest-rate increases. Therefore, they will probably switch to some form of yield-curve control (YCC). However, this likely means that inflation can only be avoided in the short term. Long-dated government bonds have therefore lost much of their appeal, while equities have become even more attractive, especially from a longer-term perspective.

### THE EVER-GROWING INFLUENCE OF CENTRAL BANKS

Total balance sheet of central banks as percentage of GDP in the G4 economies (United States, UK, Japan and the Eurozone)  
% of GDP



#### ■ Total central-bank assets

Sources: Refinitiv, DWS Investment GmbH as of 4/15/20

Given the high degree of uncertainty regarding the length and extent of the economic downturn, companies with strong balance sheets from defensive sectors such as healthcare and communication services remain our preference, complemented by technology stocks that also enjoy strong balance sheets and which should be among the relative beneficiaries of the crisis. Digitalization, and especially the use of artificial intelligence, is likely to be a positive factor. ESG (environmental, social and governance) is also a long-term trend that should be kept in mind when selecting stocks.

In our opinion, government bonds have lost some of their overall attractiveness in a multi-asset context as a result of the crisis. Ever lower yields for developed-country government bonds – provided the government's finances are relatively sound – seem set to remain in place for at least a year or two. Corporate bonds are thus moving somewhat more into focus, especially investment-grade corporate bonds in Europe and the U.S. However, in certain sectors, we consider the more pronounced spread widening to be appropriate in view of the higher probability of default. This crisis has also highlighted two weaknesses in the corporate-bond segment: low liquidity on turbulent days and little scope for diversification com-

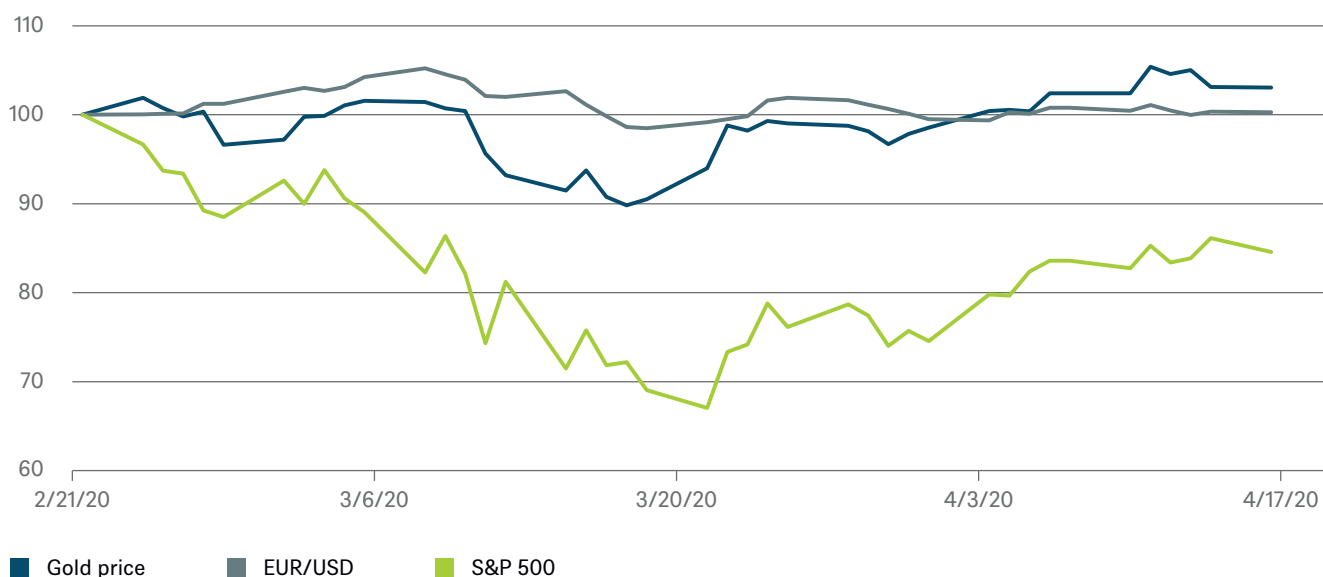
pared to equities, as both fell in tandem. On the other hand, corporate bonds from the U.S. and Europe are now benefiting directly from central-bank purchases – unlike bonds from emerging markets. In addition, many emerging-market countries are struggling with the stronger dollar, lower commodity prices and the severe impact of the coronavirus lockdown on global trade and tourism. We are therefore selective with regards to countries and opt for hard-currency, not local-currency, bonds.

In view of the lingering uncertainty over how quickly the virus can be contained and how great and long-lasting the damage will be before the economic recovery begins, we expect volatility to remain high and cannot rule out further setbacks and corrections. To help stabilize portfolios, we continue to prefer gold as well as the yen and the Swiss franc as classic crisis currencies. While in the short term the dollar should continue to be in demand on troubled days, we take a somewhat more critical view of it in the medium term. The record-high level of new U.S. debt as well as the way the coronavirus pandemic is being handled in the United States might well have undermined trust in the greenback.

### UNEXPECTED MOVES AT TIMES OF MARKET STRESS

When markets get tough, even so-called safe havens can suffer from the rough seas. Immediate liquidity needs weighed on both the dollar and gold.

indexed: 2/21/20 = 100



Sources: Refinitiv, DWS Investment GmbH as of 4/21/20

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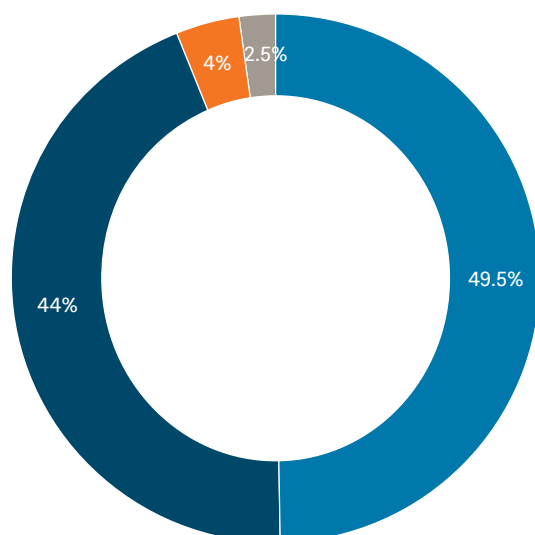
## Not getting too defensive

Markets have moved fast in both directions, but we are staying the course.

### MULTI-ASSET ALLOCATION FOR EUROPEAN INVESTORS

In view of the medium-term prospects, our model portfolio retains its preference for equities and bonds with risk premiums, as well as commodities. We made minor adjustments to express a small preference for equities in the U.S. (reflecting quality and structural growth themes) and emerging markets, where China in particular should be the first to overcome the

coronavirus. In the bond segment, we believe building up a small position in U.S. investment-grade corporate bonds at the expense of similar securities from the Eurozone could be appropriate. We would also prefer a higher degree of liquidity in the current market environment, which can also be expressed in having a slightly increased money-market position.



<b>Equities</b>	<b>49.5%</b>
Equities United States	27.5%
Equities Europe	8%
Equities emerging markets	6.5%
Equities Global Style	5%
Equities Japan	2.5%
<b>Fixed Income</b>	<b>44%</b>
Euro investment grade	12%
Eurozone sovereigns	10%
Emerging-market (hard-currency) bonds	7.5%
U.S. Treasuries	7%
Euro high yield	3.5%
U.S. high yield	2%
U.S. investment grade	2%
<b>Alternatives</b>	<b>4%</b>
Commodities	4%
<b>Cash</b>	<b>2.5%</b>

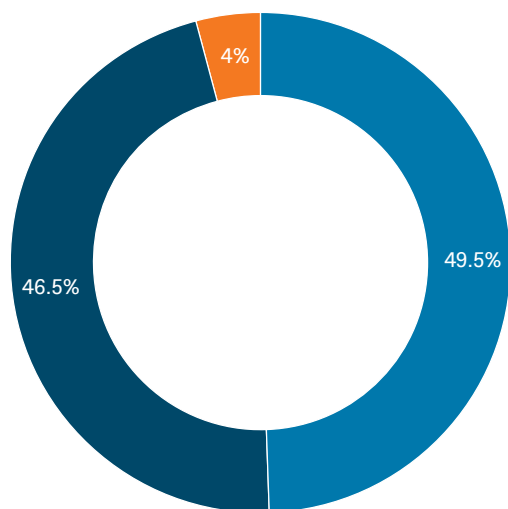
The chart shows how we would currently design a balanced, euro-denominated portfolio for a European investor taking global exposure. This allocation may not be suitable for all investors and can be changed at any time without notice. Alternative investments involve various risks and are not necessarily suitable for all clients or for every portfolio. Source: Multi Asset Group, DWS Investment GmbH as of 4/8/20

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### MULTI-ASSET ALLOCATION FOR ASIAN INVESTORS

In view of the medium-term prospects, our model portfolio retains its slight preference for equities and bonds with risk premiums, as well as commodities. We made minor adjustments to express a small preference for equities in the U.S. (reflecting quality and structural growth themes) compared

to European equities. We also added to Asian emerging markets, while reducing export-driven Japanese equities. In the bond segment, we made no changes and also left the cash position unchanged.



<b>Equity</b>	<b>49.5%</b>
Equities United States	30.5%
Equities Europe	9%
Equities Asia ex Japan	7%
Equities Japan	3%
<b>Fixed Income</b>	<b>46.5%</b>
Asia Credit	14%
U.S. Treasuries	13.5%
Emerging-market (hard-currency) bonds	10%
U.S. high yield	5%
U.S. investment grade	4%
<b>Alternatives</b>	<b>4%</b>
<b>Commodities</b>	<b>4%</b>

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 4/8/20

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# Stormy!

The prospects shown by the three indicators are quite bleak.

Trade conflict between the United States and China dominated 2019. In 2020 the rapid spread of the new coronavirus, SARS-CoV-2, has been the only game in town. The measures taken by governments to contain it are the main driver for capital markets, and especially equities. No one can say at the moment when the health crisis will have peaked but all investors seem to be aware that the economic consequences are serious.

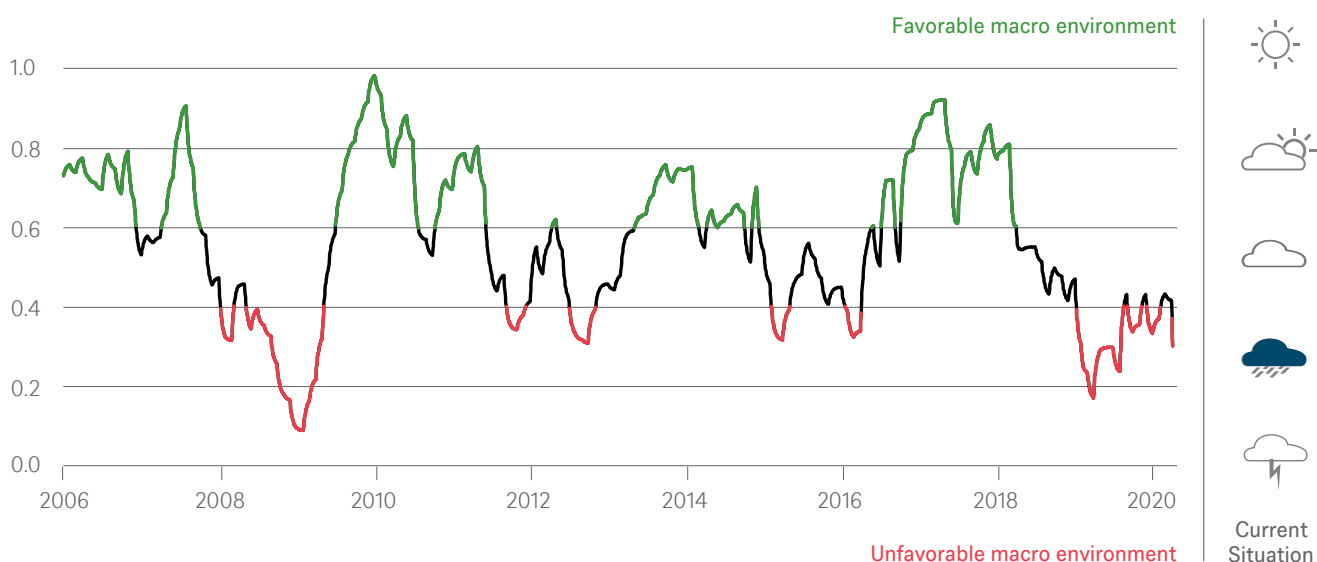
The macroeconomic picture sickened a little even before the emergence of the coronavirus. The DWS macro indicator pointed to a significant weakening in the global economy in early 2018. There were signs of slight improvement since autumn 2019 and a stabilization afterwards, but the economic slump that the pandemic has begun to provoke pushed the indicator down to very low levels again this month.

The DWS risk indicator also paints a negative picture. At the end of February, shortly after some stock markets had reached new record highs, the risk indicator fell into negative territory and has since been urging extreme caution.

Currently, the only ray of hope is the DWS surprise indicator, at least if you take the data at face value. It turned positive in mid-January and has remained stable at a very high level ever since. This suggests that the expectations of the analysts have become too negative too quickly so that the published economic data has repeatedly provided positive surprises for almost three months. However, it may also be partly due to the fact that much of the data was collected before the outbreak of the virus, while market expectations already fully reflect the likely impact of the crisis.

## MACRO INDICATOR / Condenses a wide range of economic data

In recent months, the macro indicator seemed to be recovering. Recently, however, it has fallen back to the bottom third. The weakness now extends to all sub-indicators, with one exception: South Korean exports have already turned around and are in positive territory.

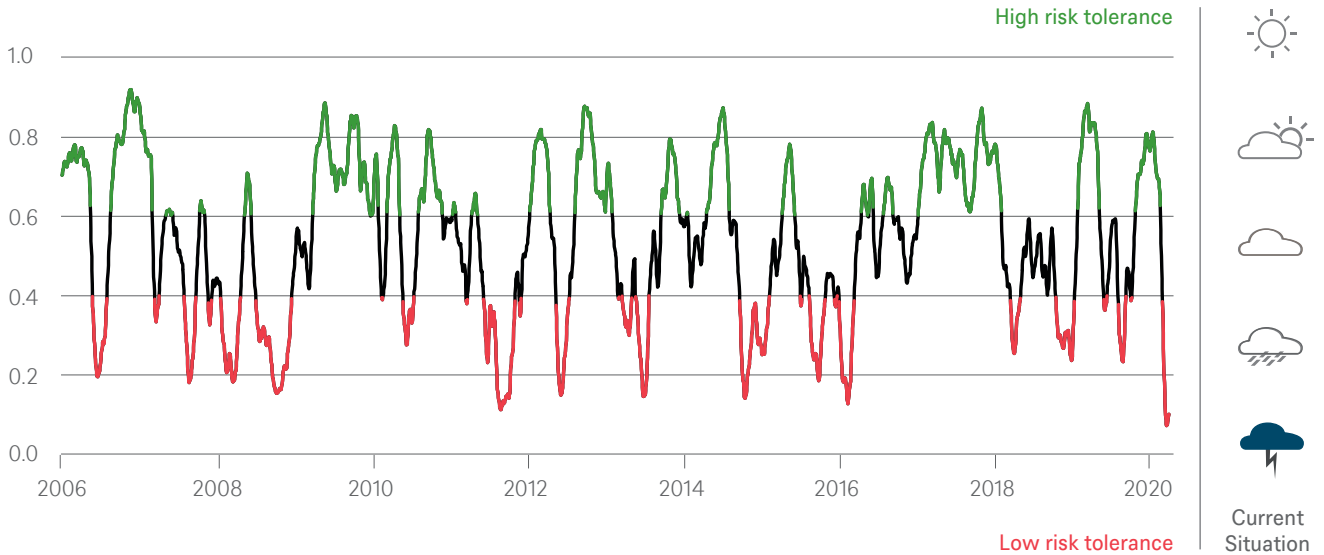


Source: DWS Investment GmbH as of 4/6/20

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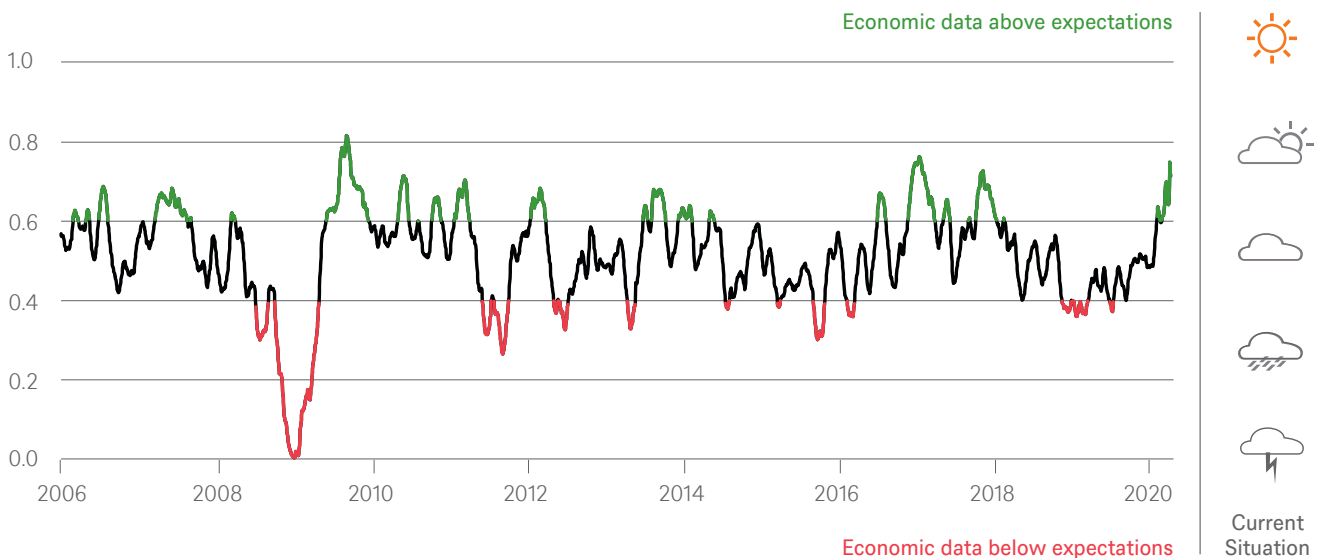
**RISK INDICATOR /** Reflects investors' current level of risk tolerance in the financial markets

According to the risk indicator, investors' appetite for risk disappeared completely soon after the record highs on the stock markets. Without exception, all sub-indicators are deep in the red zone.



**SURPRISE INDICATOR /** Tracks economic data relative to consensus expectations

The surprise indicator has been in positive territory since mid-January, although the picture is not uniform globally. The regional sub-indicators are subject to a certain degree of rotation. Currently, positive surprises predominate in Europe and Asia, while negative surprises dominate in the United States. However, much of the European data reflects a snapshot of the situation at a time when the crisis had not yet fully materialized.



Source: DWS Investment GmbH as of 4/6/20

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## GLOSSARY

A **correction** is a decline in stock market prices.

**Default** is the failure to meet the legal obligations of a loan, for example when a corporation or government fails to pay a bond which has reached maturity. A national or sovereign default is the failure or refusal of a government to repay its national debt.

**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.

**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.

Investors increasingly take **environmental, social and governance (ESG)** criteria into account when analyzing companies in order to identify non-financial risks and opportunities.

The **G4 economies**, group of the world's four biggest developed economic regions: Eurozone, Japan, United Kingdom, United States.

**Greenback** is a commonly used expression for the U.S. dollar.

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.

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

**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 bonds** are all bonds with a good to very good credit rating

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

**Liquidity** refers to the degree to which an asset or security can be bought or sold in the market without affecting the asset's price and to the ability to convert an asset to cash quickly.

**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 **risk premium** is the expected return on an investment minus the return that would be earned on a risk-free investment.

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

The **Swiss franc** is the currency used in Switzerland.

The **U.S. dollar (USD)** is the official currency of the United States and its overseas territories.

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

**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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