June 27, 2019

Reduce risk, increase flexibility

We are less gloomy on the outlook than bond markets. In our view, equity markets have to correct before offering opportunities for entry.

_ After a strong start to the year for most asset classes, returns have faded and diverged. For multi-asset managers, however, both periods were similarly challenging.

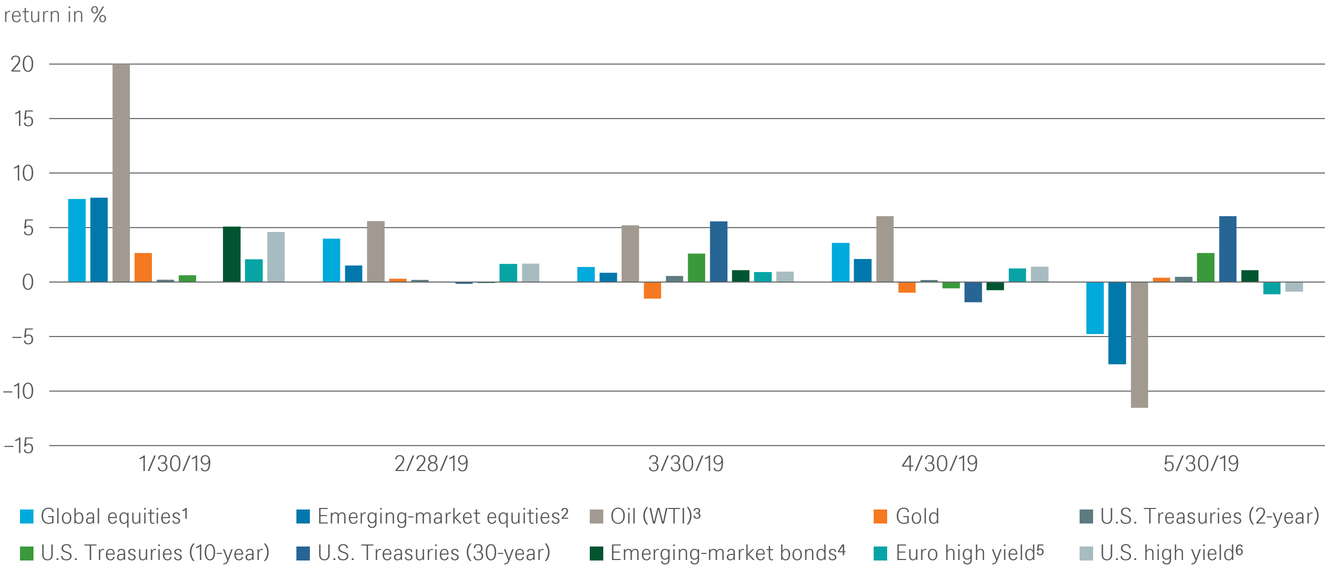
_ The escalation in the trade conflict, lower interest rates and rich stock-market valuations lead us to enter the summer with a more defensive allocation.

Christian Hille
Head of Multi Asset

When can multi-asset managers actually show their worth? Let's take a look at the first five months of this year. As the chart shows, the timeframe can roughly be divided into two phases. In the first three months it went well for almost all asset classes. But results were mixed in April and in May as almost everything that was not labelled "long-term government bond" crashed. Some people might think that having the right asset mix was unimportant in the first three months of the year, as almost every asset class yielded good returns anyway. And that, by contrast, in April and May, multi-asset managers might have proven their worth as it took the right hand to reap a good harvest.

A DIVERSE YEAR

As the returns on various asset classes declined sharply over the period, the divergence in returns between the individual asset classes increased sharply.

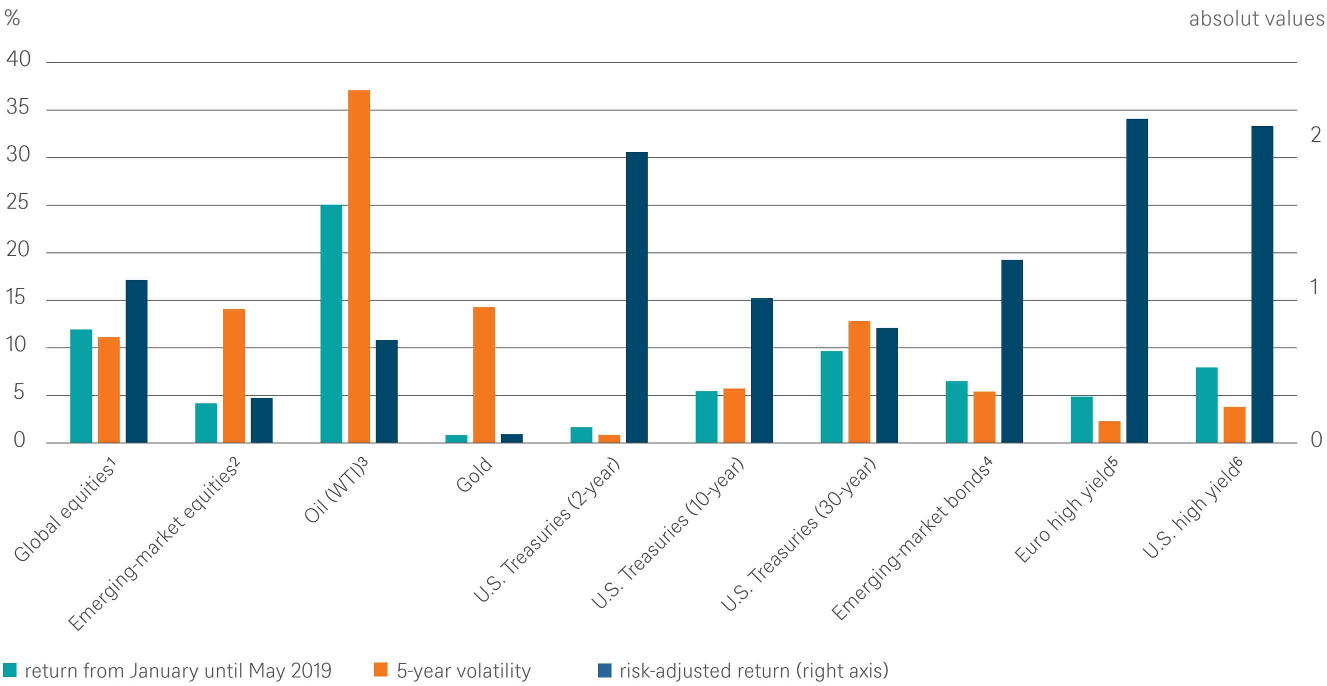


[1] MSCI World Index; [2] MSCI Emerging Markets Index; [3] West Texas Intermediate; [4] J.P. Morgan Emerging Market Bond Index; [5] Markit iBoxx EUR Liquid High Yield Index; [6] ICE BofA Merrill Lynch US High Yield Index; Sources: Refinitv, DWS Investment GmbH as of 6/18/19

The argument above, however, is not quite right, in our view. We believe that multi-asset funds have the potential to be the better option in good as well as bad market environments. Returns on different asset classes, even if they are the same, can be of different quality. In this case, quality means risk, which is commonly expressed in capital markets by volatility. The more the returns on an investment fluctuate, i.e. the higher its volatility, the more investors want to be remunerated for holding it. This explains the attraction of government bonds from industrialized countries or even the preference of some households for cash. As well known as the low-volatility appeal of bonds and cash is, it is often forgotten when the performance of different asset classes is compared. The second chart shows how over time, the ranking of the top-return-delivering asset classes changes if the question of risk or volatility is taken into account. It shows the risk-return profile of various investments by relating the return achieved from the beginning of the year to the end of May to historical volatility. What was perceived to be best in class, namely oil, plunges into a middle ranking when adjusted for risk, while the previously thought to be rather poorly ranking U.S. and euro high-yield bonds take the lead – ahead of the long-term risk-return king, 2-year U.S. government bonds. So even if the markets march uniformly in one direction, it is still a matter of choosing the right investments, i.e. those with a better risk-return profile. And the job of the multi-asset manager is to select the right investments in each market phase and put them together with the right weighting.

THERE IS ALMOST NO RETURN WITHOUT RISK

The performance ranking changes quite a bit when adjusting returns for risk.



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Good multi-asset management depends on finding the assets with the best risk-return profile within different asset classes. And then, finding the most suitable collective mix of these types of assets. Depending on how strongly individual asset classes are correlated, the weightings of multi-asset funds can be determined in such a way to provide exposure to the lowest level of risk for a given target return. Or, to put it another way, seek the maximum return for a certain targeted level of risk. We discussed this briefly in our last Quarterly CIO View (Strength through length as of 3/15/19) and at greater length in our January study (Multi-Asset Long View as of 1/31/19).

Even if quantitative models play a major role in portfolio optimization, we believe the basis for investment decisions remains the qualitative analysis of the economy and politics, which brings us to our past and present portfolio construction. Given our view of the global economy we believed that the market setback in December was exaggerated and was partly triggered by non-fundamental issues. This meant that staying invested in risk assets was recommendable and it proved to be the right choice as the recovery started at the beginning of the year. The price declines were more severe than we believed justified, given our view of the economy. For our current portfolio construction, we are guided by two basic macroeconomic assumptions: 1. The market is too optimistic in the short term, which is reflected in high valuations; 2. We believe that a recession will not occur this year and will be only a risk in 2020, but even then it will not be our base case. For this central scenario to hold, we believe the U.S. administration will have to refrain from exacerbating its conflict with China or opening up any further fronts in its trade disputes with the rest of the world. As this scenario is far from being certain, we have recently recommended to take some profits. And to keep some powder dry (cash) in order to be able to expand risk positions again (see our model portfolio in the chart) in the event that asset prices fall heavily to attractive re-entry levels. We think prices could easily suffer a serious summer meltdown. It will not, in our view, be troubles in Europe such as Brexit and the Italian budget, nor fresh tanker fires in the Persian Gulf, that will cause it. Three other issues have, we believe, far more explosive potential: 1. A worsening of the conflict between China and the United States, dragging on well beyond the G20[1] summit; 2. A U.S. Federal Reserve (Fed) which fails to satisfy markets having delivered such a dovish statement on June 19 – perhaps because of a surprisingly strong economy; 3. Or, on the contrary, there are signs that the economies in the United States, Europe or Asia are developing weaker than the market expects.

If there were to be major price setbacks without us having to revise our medium-term macroeconomic outlook, we would be buyers in the market. Therefore, our current allocation is defensive and diversified. We have significantly reduced our equity exposure in our allocation. Some stock markets are not far from their historic highs, boosted recently by the "Powell Put,"[2] at least, as perceived by the market. We prefer emerging markets and the United States strategically, even though we might still face setbacks in individual companies and sectors in the short term as a result of the trade war. We currently see no reason why Japan and Europe should outperform over the summer months.

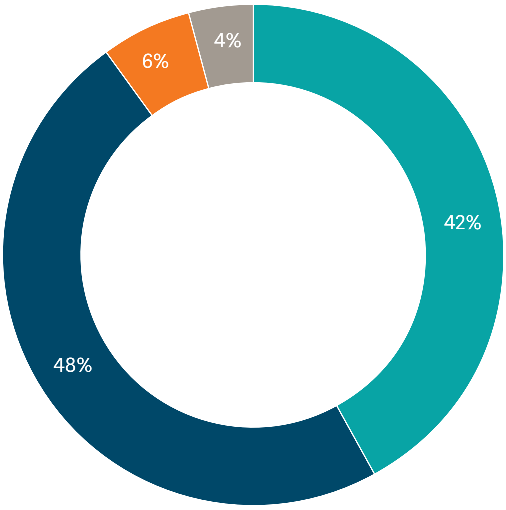
We have topped up bonds in our multi-asset mixture. We assume that government-bond yields will remain low for longer and that we will have seen the peak in the cycle of interest-rate hikes in the United States. Though markets seemed a bit ahead of themselves in recent weeks when they pushed down yields so far, the moves were justified by central-bank actions. In Europe, we are increasingly focusing on corporate bonds because they offer a good mix of security, diversification and yield. Of course, the cash position, which we have also expanded, always offers the greatest security and agility to re-enter the market.

Buy-and-hold is not likely to be an appropriate investment strategy over the summer. We will react in an agile way to steps forward or back in the markets in response to the trade disputes and to signals from the Fed. At the same time, we will look for points where the market has anticipated too much in one direction or another in order to adjust our allocation in our model portfolio (see chart). The recent confirmation of the structural low-yield environment by central banks is one more reason why we believe that risk assets such as equities should be added in periods of market weakness.

1 This year the G20 meeting is taking place in Osaka on June 28 and 29.
2 In reference to the "Greenspan Put," the market is now also talking about the "Powell Put" after the clear rhetorical turn of Fed Chairman, Jerome Powell, at the end of 2018. This refers to the central bank's willingness to intervene with an expansive monetary policy in the event of a sharp fall in stock markets.

MULTI-ASSET ALLOCATION FOR EUROPEAN INVESTORS

Broadly positioned with less risk and more cash to be prepared for the opportunities in summer.

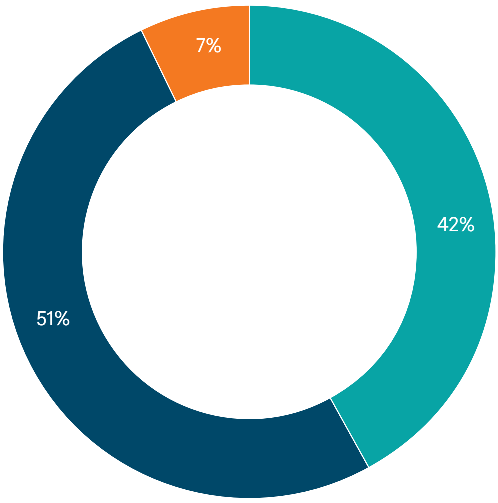


Equities	42%
Equities United States	23%
Equities Europe	5.5%
Equities emerging markets	5%
Equities Global Style	5%
Equities Japan	3.5%
Fixed Income	48%
Euro investment grade	13%
Eurozone sovereigns	13%
U.S. Treasuries	8%
Emerging-market (hard currency) bonds	7%
Euro high yield	5%
U.S. high yield	2%
Alternatives	6%
Commodities	3%
Convertibles (euro-hedged)	3%
Cash	4%

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 5/31/19

MULTI-ASSET ALLOCATION FOR ASIAN INVESTORS

We have reduced the equity and alternatives exposure and increased the bond allocation.



Equities	42%
Equities United States	24%
Equities Asia ex Japan	7%
Equities Europe	7%
Equities Japan	4%
Fixed Income	51%
U.S. Treasuries	18%
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 5/31/19

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Rough weather conditions

All three indicators currently paint the same picture.

And it is none too rosy. Therefore caution is advisable, in our opinion. All three DWS indicators have been unanimously indicating a negative environment for a good three weeks now. The macro indicator is at its lowest level since 2009 and shows little sign of improving. The risk indicator shows investors' risk appetite is low and the surprise indicator reflects the fact that most analysts' expectations are being disappointed. The current escalation of geopolitical risks, especially the trade dispute between the United States and China, seems to explain this gloomy picture.

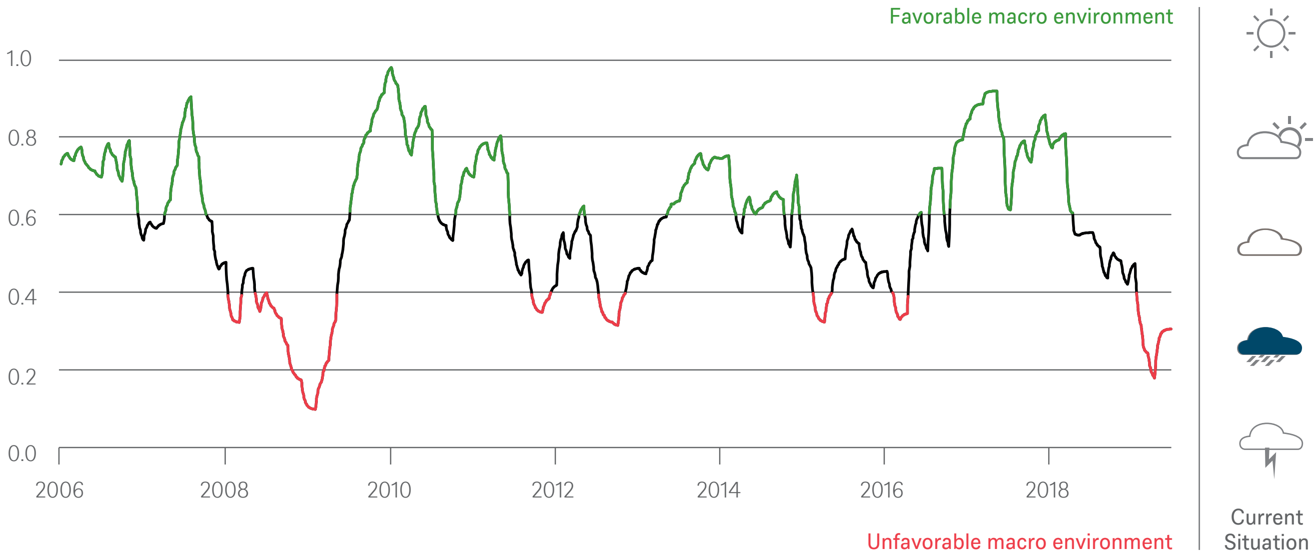
And yet, despite this dark backdrop, the capital markets are almost bewilderingly sunny. All major stock indices are within reach of their annual highs. In the case of U.S. stock markets, they are even within striking distance of their historic highs.

The very dovish attitude of the central banks seems to have fuelled this divergence. The market now expects the U.S. Federal Reserve (Fed) to cut interest rates almost three times this year. Our indicators point to the unique fragility of the market environment. Should the Fed fail to deliver the priced-in rate cuts, a correction in the equity market can probably be expected.

If one considers that economic growth in the United States in the first quarter was at an annualized rate of over 3% and that nearly full employment prevails, disappointment in the hopes for an interest-rate cut soon can certainly not be ruled out. Or are the central banks seeing something approaching of which the stock market may not yet be aware?

MACRO INDICATOR / Condenses a wide range of economic data

In April, the macro indicator recorded its lowest level since 2009. Thenceforth, it has recovered somewhat but remains deep in the red zone. The global purchasing managers' indices and sentiment in the manufacturing sector are particularly depressed.



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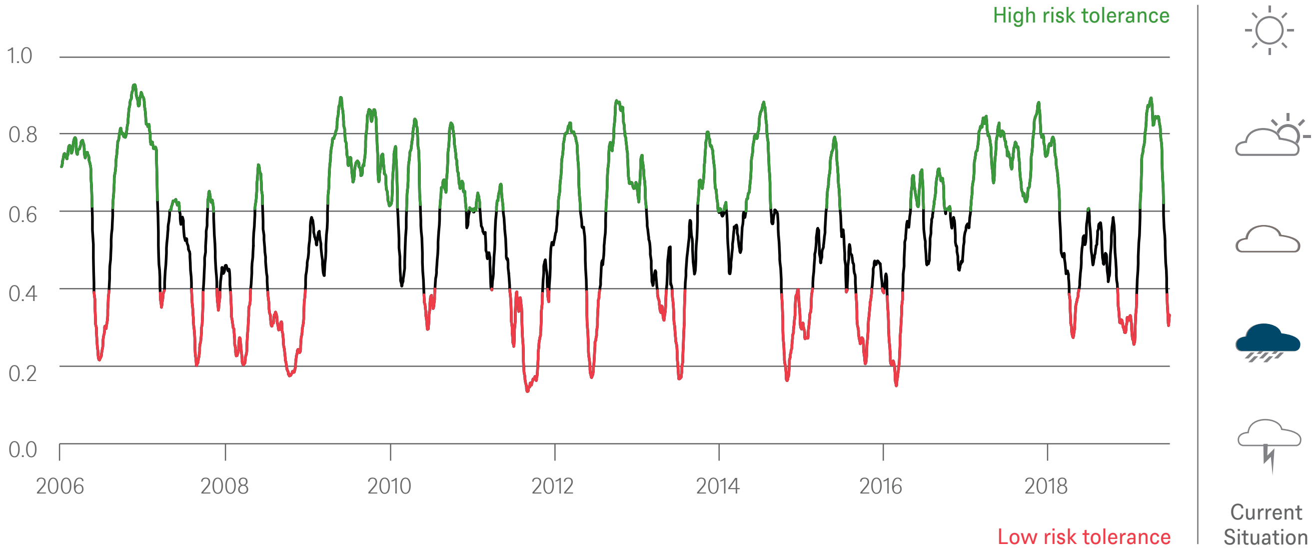
DWS Investment GmbH

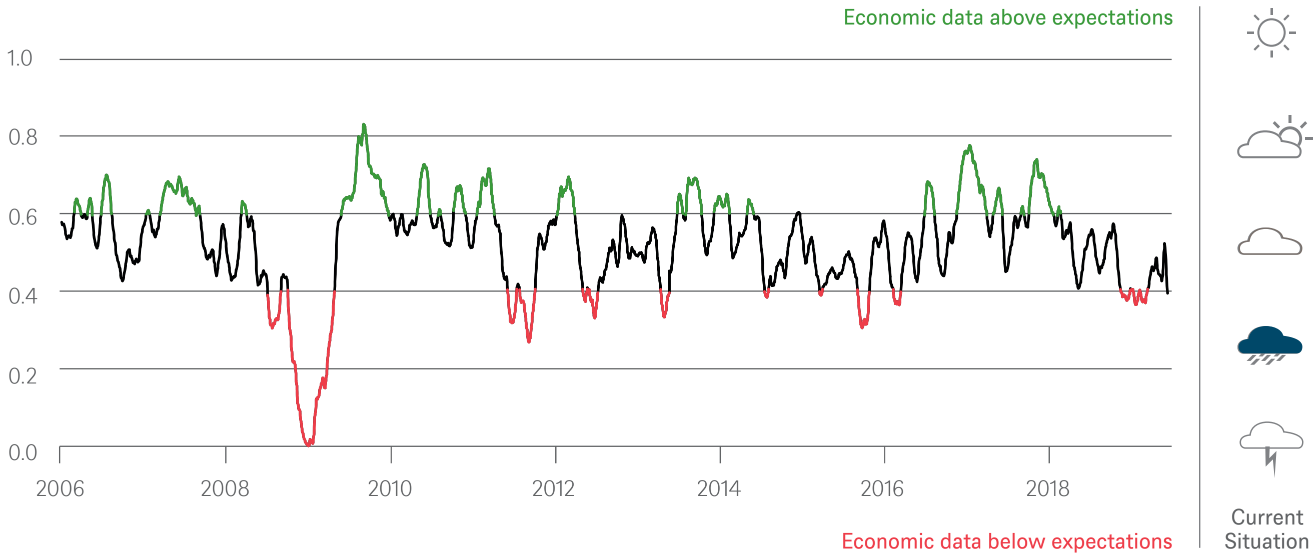
RISK INDICATOR / Reflects investors' current level of risk tolerance in the financial markets

After the recovery in the risk indicator in the first quarter, the spontaneous intensification of trade-war rhetoric on the part of the United States very quickly clouded risk sentiment. In mid-May, the risk indicator fell back into negative territory and is currently roughly at the very low level of late 2018.



SURPRISE INDICATOR / Tracks economic data relative to consensus expectations

The surprise indicator has been in the red for most of the year. But regional sub-indicators have been quite divergent. Recently, however, all the main regions (United States, Europe and Asia) have been in the negative zone at the same time. Expectations within these regions are therefore regularly disappointed.



Source: DWS Investment GmbH as of 6/10/19

GLOSSARY

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

A central bank manages a state's currency, money supply and interest rates.

A correction is a decline in stock market prices.

Correlation is a measure of how closely two variables move together over time.

Doves are in favor of an expansive monetary policy.

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

The Euro Stoxx 50 is an index that tracks the performance of blue-chip stocks in the Eurozone.

The Group of 20 (G20) are the largest industrialized and emerging economies in the world.

Government (sovereign) debts/bonds are debt/bonds issued and owed by a central government

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

The ICE BofA Merrill Lynch US High Yield Index tracks the performance of dollar-denominated below investment grade, including zero-coupon and payment-in-kind (PIK) bonds.

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 J.P. Morgan Emerging Market Bond Index (EMBI) are a set of three bond indices to track bonds in emerging markets operated by J P Morgan. The indices are the Emerging Markets Bond Index Plus, the Emerging Markets Bond Index Global and the Emerging Markets Bond Global Diversified Index.

The Markit iBoxx EUR Liquid High Yield Index consists of liquid euro sub-investment-grade-rated bonds, selected to provide a balanced representation of the Markit iBoxx EUR Core High Yield Index.

Multi asset determines investing in more than one asset class, thus creating a group or portfolio of assets with varying weights and types of classes. The diversification of an overall portfolio is thus increased, and risk (volatility) reduced.

The MSCI World Index tracks the performance of mid- and large-cap stocks in 23 developed countries around the world.

The MSCI Emerging Markets Index captures large- and mid-cap representation across 23 emerging-market countries.

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 United States Congress is the legislature of the federal government. It is comprised of the Senate and the House of Representatives, consisting of 435 Representatives and 100 Senators.

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

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm's stock price in relation to its earnings.

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.

West Texas Intermediate (WTI) is a grade of crude oil used as a benchmark in oil pricing.

Yield is the income return on an investment referring to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

PERFORMANCE / Overview

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

	05/14 – 05/15	05/15 – 05/16	05/16 – 05/17	05/17 – 05/18	05/18 – 05/19
ICE BofA Merrill Lynch US High Yield Index	1.8%	−0.9%	13.9%	2.3%	5.4%
J.P. Morgan Emerging Market Bond Index	0.5%	6.3%	8.9%	−3.7%	6.2%
Markit iBoxx EUR Liquid High Yield Index	3.6%	0.1%	7.4%	0.8%	2.2%
MSCI Emerging Market Index	−2.3%	−19.6%	24.5%	11.5%	−10.9%
MSCI World Index	3.7%	−5.9%	14.2%	9.5%	−2.2%
US-Staatsanleihen (10 Jahre)	5.0%	4.4%	−0.4%	−2.4%	8.6%
US-Staatsanleihen (2 Jahre)	0.8%	0.7%	0.6%	−0.1%	3.5%
US-Staatsanleihen (30 Jahre)	9.7%	8.4%	−1.6%	0.1%	11.0%

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 5/31/19.

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