DWS

Marketing Material

Long View Q1: The impact of country risks

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IN A NUTSHELL

- Return forecasts have moved higher over the quarter, driven by less challenging valuations and significant increases in nominal yields
- Emerging markets debt forecasts remain above other asset classes within the fixed income universe, but our analysis suggest that investors ought to assess the potential impact that poor democratic ratings have on sovereign ratings and credit quality

1 / Summary

Within this report, we present the DWS long-term capital market assumptions as of the end of March 2022 for major asset classes.

Over the first quarter of 2022, global markets remained under pressure, impacted by persistent inflationary fears and geopolitical risks. The prospect of monetary tightening across global central banks resulted in a historically weak quarter for fixed-rate assets, as both nominal and real yields across the fixed income complex repriced significantly higher in Q1. As at the 31st of March 2022, investors anticipated in the range of 8 Fed Funds hikes for the US for the next two year, which reflected in the sharp selloff in short term US Treasury yields. Equities and other risk assets also experienced declining valuations despite what remains a fundamentally strong earnings outlook over the next year.

While these market moves have resulted in challenging investment returns, the longer -term prospect for investment returns, particularly in the fixed income space, has improved if one assumes no further deterioration in inflation. Across developed market sovereign bonds markets, real interest rates have moved back toward, and in some cases, into positive territory, becoming less of a hurdle for real income generation for fixed income investors.

Still, return expectations for the next decade remain below historical averages, and, in some cases, still face trisks of the prospective of persistently higher levels inflation, which also has the potential to deteriorate real earnings growth.

Our models now estimate a forecasted return of 5.6% from the MSCI All Country World Index ("ACWI") annually for the next decade, versus 4.6% just a quarter ago. At an aggregate level, we estimate the forecasted rate of return on a diversified portfolio of assets is now 4.9%, up 1% from the level at the beginning of the year.

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FIGURE 1. DWS TEN YEARS ANNUAL FORECASTED RETURNS

	As of 31 Mar 2022	∆ since 31 Dec 2021
ACWI Equities	5.6%	1.1%
World Equities	5.5%	1.1%
EM Equities	6.3%	0.8%
US Equities	5.7%	1.0%
Europe Equities	5.3%	1.3%
Germany Equities	5.7%	1.6%
UK Equities	5.9%	0.0%
Japan Equities	3.5%	0.3%
EUR Treasury	0.3%	0.5%
EUR Corporate	1.5%	1.0%
EUR High Yield	3.9%	1.5%
US Treasury	2.4%	1.0%
US Corporate	3.1%	1.3%
US High Yield	4.1%	1.1%
EM USD Sovereign	5.7%	1.2%
EM USD Corporate	5.5%	1.3%
World REITS	3.7%	-0.1%
United States REITS	4.1%	-0.1%
Global Infra. Equity	5.4%	0.3%
US Infra. Equity	5.3%	0.3%
Private RE Equity US	7.1%	-0.4%
EUR Infrastructure IG	1.6%	1.0%
Private EUR Infra. IG	2.7%	0.8%
Hedge Funds: Composite	3.1%	0.6%
Broad Commodities Futures	0.4%	-0.2%

Source: DWS Investments UK Limited. Forecasts from of 31 March 2022 to 31 March 2032. Due to various risks, uncertainties and assumptions made in our analysis, actual events or results or the actual performance of the markets covered may differ materially from those described.

This information is intended for informational and educational purposes only and does not constitute investment advice, a recommendation, an offer or solicitation. The opinions and forecasts expressed are those of the authors of this report as of the date of this report and may not actually come to pass. This information is subject to change at any time, based on market and other conditions and should not be construed as a recommendation of any specific security or investment strategy.

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2 / Emerging markets debt forecasts

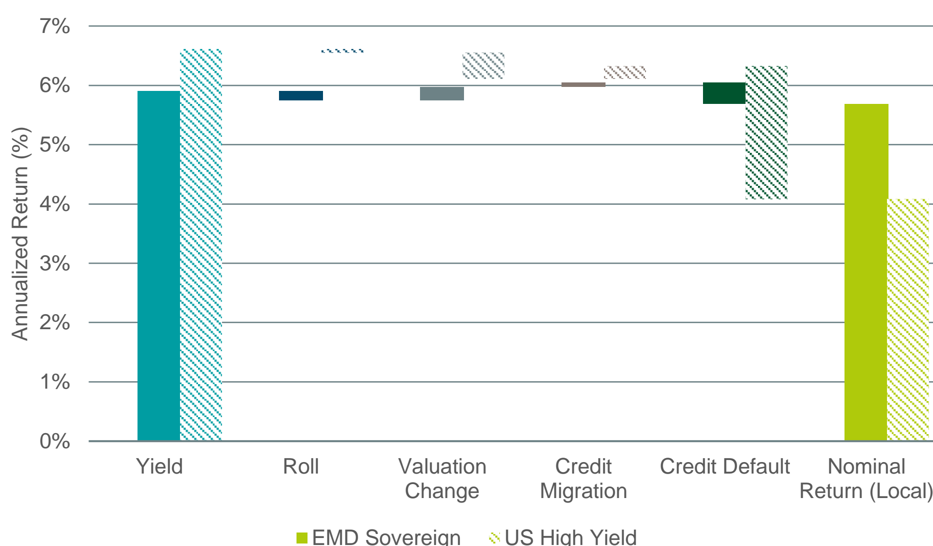
1. Emerging markets debt return pillars

Over recent quarters, key country risks have arisen across the universe of emerging markets countries. Russia's invasion of Ukraine, China's regulatory crackdown, and Qatar's human rights issues have dominated headlines. As these issues persist, investors allocating to emerging markets debt face increasing uncertainty as to the stability of these credits both fundamentally and on market sentiment. Particularly as governance becomes an increasingly important metric for asset allocators, monitoring these risks is becoming increasingly important.

Looking across our Long View forecasts, within the universe of fixed income assets, EM USD Sovereign and Corporate debt stand out as sources of healthier returns. With forecasted returns of 5.7% and 5.4%, respectively, EM hard currency fixed income forecasts outpace not only developed market sovereign bonds but also exceed US investment grade and high yield corporate securities.

This is despite better credit ratings of EM hard currency bonds versus the US High Yield bond index—the former being a blend of Investment Grade and High Yield-rated issuers—albeit with greater duration risk. Figure 2 shows the comparison of pillar contribution to 10 year forecasted returns between EMD USD Sovereigns and US High Yield.

FIGURE 2: EMD USD SOVEREIGN AND US HIGH YIELD: CONTRIBUTION TO 10 YEAR FORECASTED HYPOTHETICAL ANNUALIZED RETURNS



Source: DWS Investments UK Limited, Bloomberg Finance L.P. Data as of30 March 2022. Past performance, [actual or simulated], is not a reliable indication of future performance.

Comparing side-by-side, the most significant difference between EMD Sovereign and US High Yield forecasted returns is the credit default loss assumptions. While credit default losses are forecasted to be -2.2% per annum for US High Yield, credit default losses for Emerging Market sovereigns are forecasted at just -0.4% a year. In order to forecast default losses, we must utilize empirical data on default loss experience and combine this information with available fundamental credit ratings sourced from ratings agencies. Historical observation for emerging markets shows sovereign debt crises in Latin America in the 80s and Asia in the 90s, but predicting these outcomes going forward is a challenge without recent information.

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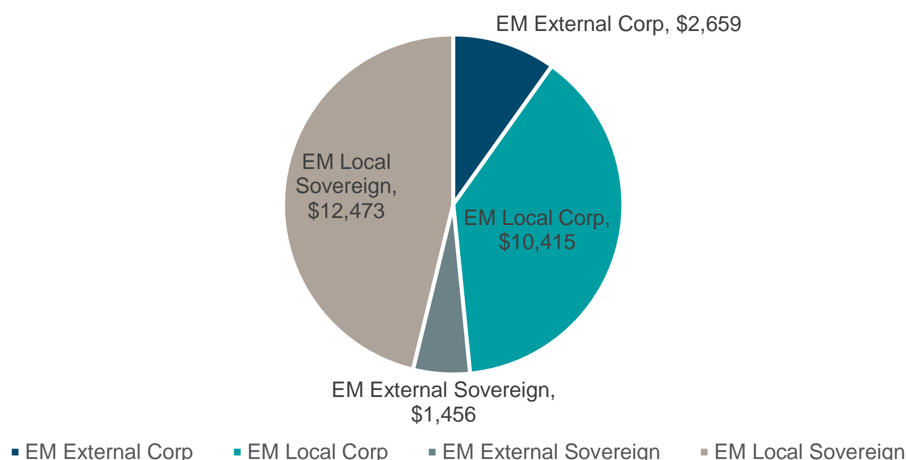
Over recent years, EM economies have generally growth wealthier and less reliant on foreign financing. Sovereign and corporate borrowing behavior has also shifted toward less dependency on external debt financing. EMs have reduced their dependency on external debt, with external corporates and sovereigns now making up around 15% of the total debt stock, as shown in **Error! Reference source not found.**.

FIGURE 3: TOTAL DEBT STOCK BY ASSET CLASS ($BN)



Source: DWS Investments UK Limited, JP Morgan CEMBI Monitor, April 2022. Past performance, [actual or simulated], is not a reliable indication of future performance.

2. Potential impact of poor or deteriorating democracy

Pivoting toward somewhat more qualitative evaluation of the Emerging Markets sovereign universe, we can look at measures of country risk based on measures other than empirical default losses and credit ratings. To start, we can look at the issuer composition to identify countries that may introduce risks to investors. Figure 4 shows the breakdown of the Bloomberg Barclays Emerging Markets Debt Index for the ten largest country issuers.

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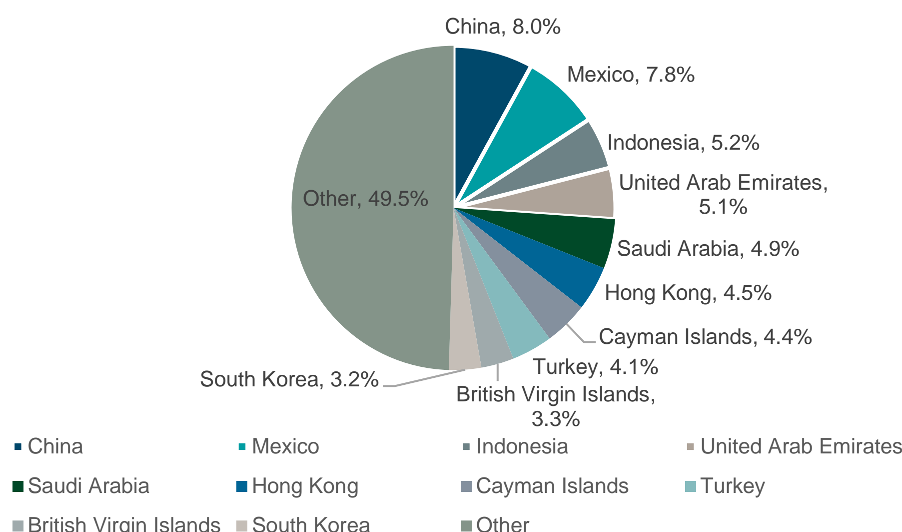
FIGURE 4: BLOOMBERG BARCLAYS EMERGING MARKETS DEBT INDEX COUNTRY WEIGHTS (%))



Source: DWS Investments UK Limited, Bloomberg L.P. Data as of 31 March 2022. Past performance, [actual or simulated], is not a reliable indication of future performance.

Within the EMD USD Sovereign index, the issuer composition shows allocations to sovereignties that rank poorly on the Economist's "Democracy Index 2020"[1]. Among the 10 largest constituents in the index, Saudi Arabia and China 156 and 151, respectively, out of the list of 167 countries. Both countries are categorized as "Authoritarian", scoring far below the cutoff for the next lowest category. Both countries have been consistently in the bottom tier of the Democracy Index as far back as it goes to 2006.

Apart from the social implications of constrained individual freedoms and civil liberties, poor social governance presents risks to capital allocations. Despite there being limited empirical support for linking political democracy and economic growth, a meta-analysis found democracy to have a "robust, significant, and positive indirect effects through higher human capital, lower inflation, lower political instability, and higher levels of economic freedom".

3. Country ceilings and regulatory risks

For investors, the profitability of companies and the risks associated with their country of domicile or economic exposure are inexorably linked. Particularly in stress periods, the concept of "country ceilings" becomes relevant for asset allocators. According to Moody's ratings methodology[2], "foreign country ceiling intends to capture the possibility that during a foreign currency crisis a sovereign nation may choose to limit all foreign currency payments by entities subject to its legal jurisdiction". Because the national government maintains the greatest flexibility to mobilitize its foreign exchange assets within its borders, the foreign currency country ceiling "constrains the ratings of nearly all foreign-currency obligations from issuers domiciled in a country because even a highly credit-worthy borrower would not be able to make payments to investors in such a situation". This ratings ceiling applies specifically to foreign currency issues, whereas domestic currency bonds can maintain higher ratings.

[1] Democracy Index 2020 (2021). The Economist Intelligence Unit.

[2] http://globalclearinghouse.org/InfraDev/assets%5C10/documents/Moody's%20-%20Piercing%20Foreign%20Currency%20Ceiling%20(1997).pdf

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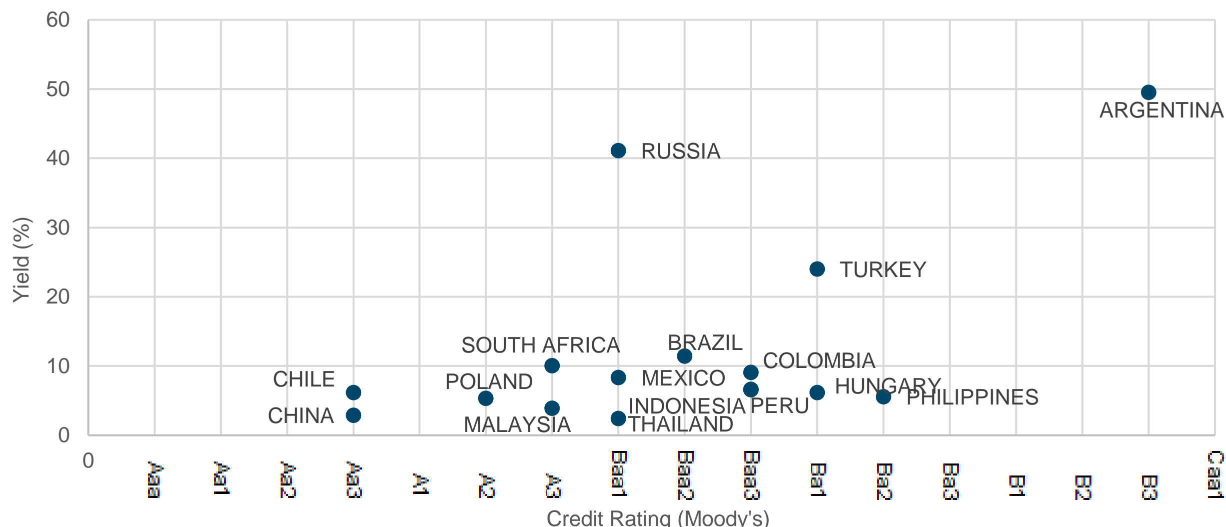
Comparing the sovereign credit ratings of individual countries against their respective local bond yields, we can observe this relationship. While credit ratings may not always capture credit stress with the immediacy investors desire, they remain a useful tool for monitoring fundamentals over long term periods. Figure 5 shows this relationship.

FIGURE 5: EMERGING MARKETS COUNTRY CREDIT RATINGS AND LOCAL SOVEREIGN BOND YIELDS



Source: DWS Investments UK Limited, JP Morgan, Moody's Corporation. Data as of 30 March 2022.

Perhaps somewhat obvious is that any unforeseen deteriorating in the credit ratings of emerging markets countries poses a risk to potential returns. However, it is worth highlighting the importance of social governance and democratic freedom in maintaining economic and political stability. Without stable or improving democratic freedom, countries risk deteriorating fundamental outlooks that may result in credit ratings impairment that may ultimately pose downside risks to investment returns.

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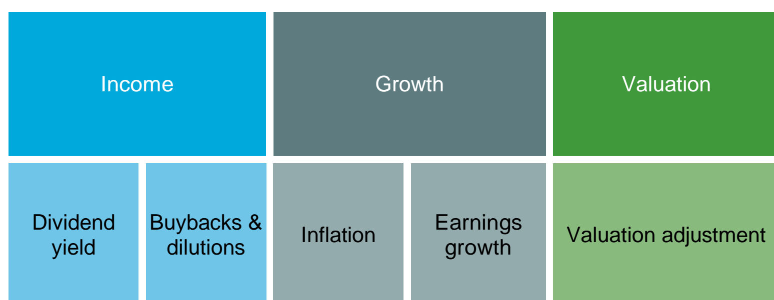
3 / Long View Forecasts

1. Equity Forecasts

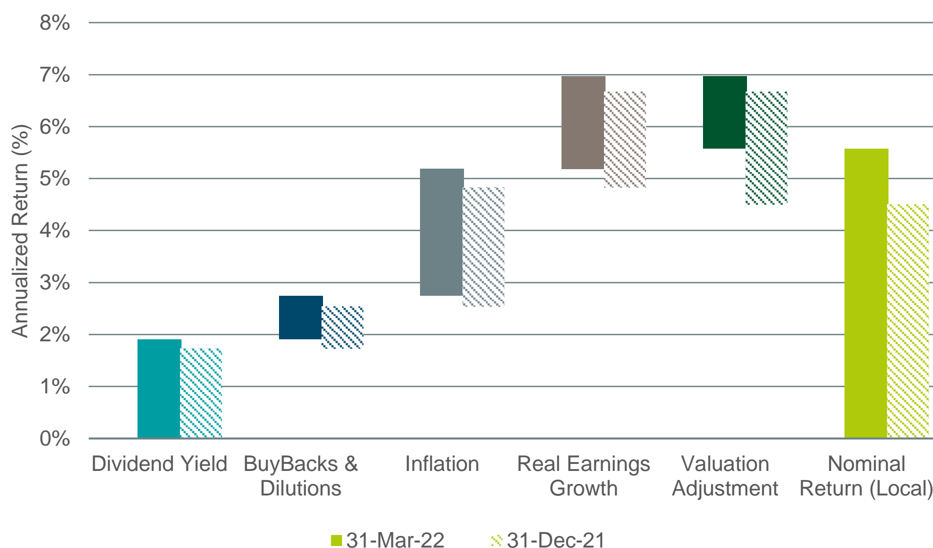
For our equity return forecasts, Figure 12 illustrates the changes to our return pillars for 10-year MSCI All Country World local currency return forecast. Our return forecast for global equities have increased to 5.6% from the 4.6% level at the end of December. The increase in the nominal return forecast is largely attributable to a reduced valuation hurdle.

FIGURE 6: PILLAR DECOMPOSITION FOR EQUITIES



Source: DWS Investments UK Limited.

FIGURE 7: MSCI ALL COUNTRY WORLD: CONTRIBUTION TO 10 YEAR FORECASTED HYPOTHETICAL ANNUALIZED RETURNS



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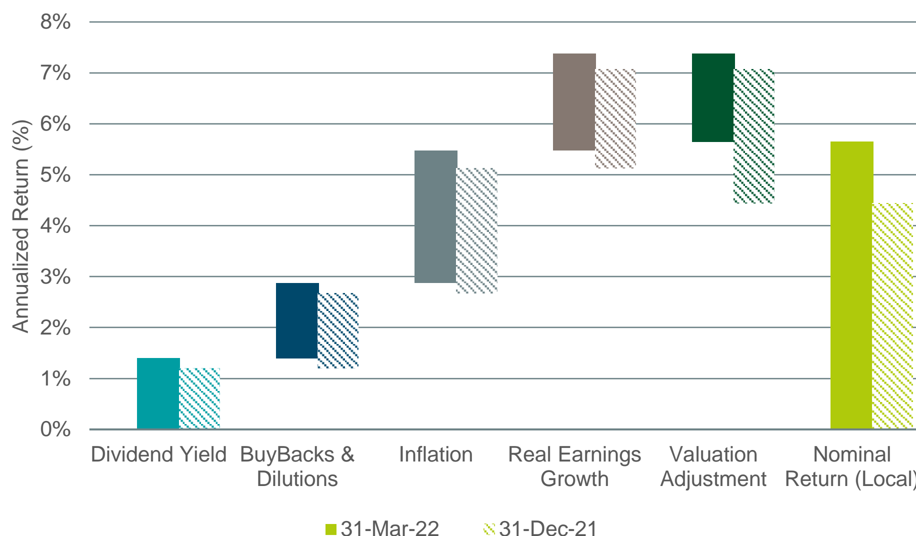
In the US, we see similar adjustments, with our return forecast for MSCI USA increasing from 4.4% to 5.6% in Q1. As with global equities, valuation adjustment, going from -2.6% to -1.7%, was the most significant driver of this increase in forecasted returns.

FIGURE 8: MSCI USA: CONTRIBUTION TO 10 YEAR FORECASTED HYPOTHETICAL ANNUALIZED RETURNS



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2. Liquid Real Assets Forecasts

Liquid Real Assets Forecasts

While REITs and Infrastructure both leverage very similar pillars to equities (see Figure 9), returns are derived largely from income via dividend distributions as shown in Figure 14 and Figure 15.

FIGURE 9: PILLAR DECOMPOSITION FOR REITS AND INFRASTRUCTURE

Asset Class	Income	Growth		Valuation
Listed real estate equity	Dividend yield	Inflation	Earnings growth	Valuation adjustment
Listed infrastructure	Dividend yield	Inflation	Earnings growth	Valuation adjustment

Source: DWS Investments UK Limited.

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Across liquid real assets, our return forecasts indicate a somewhat more constructive outlook. While valuations remain stretched in traditional equities, REIT dividend yields are less compressed relative to longer term averages. This provides advantageous levels on income contribution but also means a lesser headwind in terms of valuation normalization. Similarly, infrastructure returns embed a favorable income stream.

FIGURE 10: GLOBAL REITS: CONTRIBUTION TO 10 YEAR FORECASTED HYPOTHETICAL ANNUALIZED RETURNS

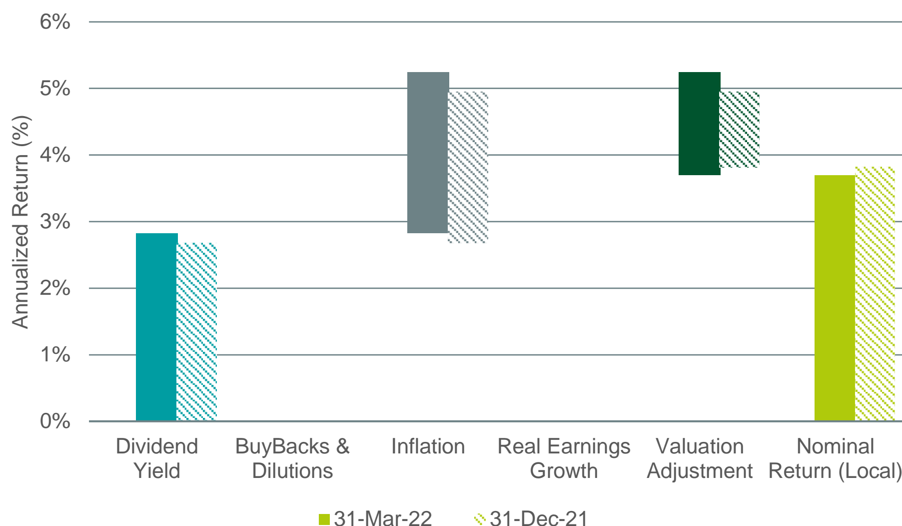

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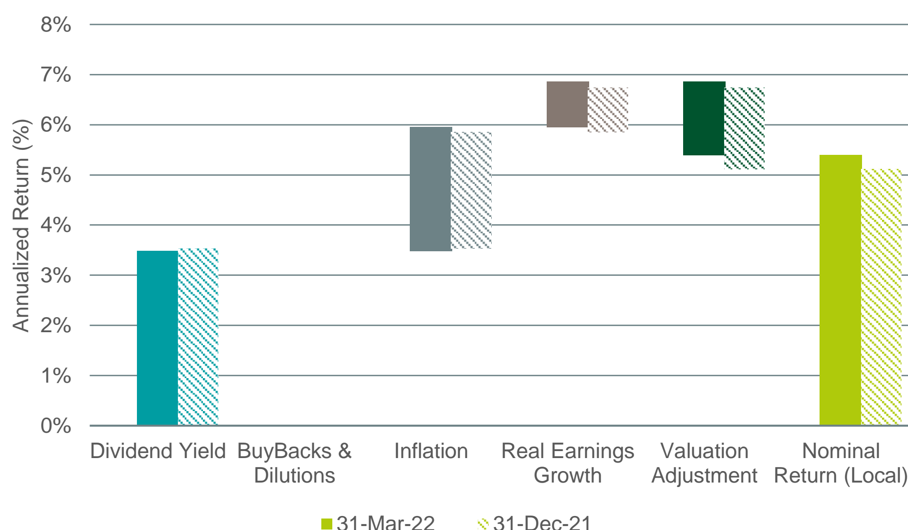
FIGURE 11: GLOBAL INFRASTRUCTURE: CONTRIBUTION TO 10 YEAR FORECASTED HYPOTHETICAL ANNUALIZED RETURNS



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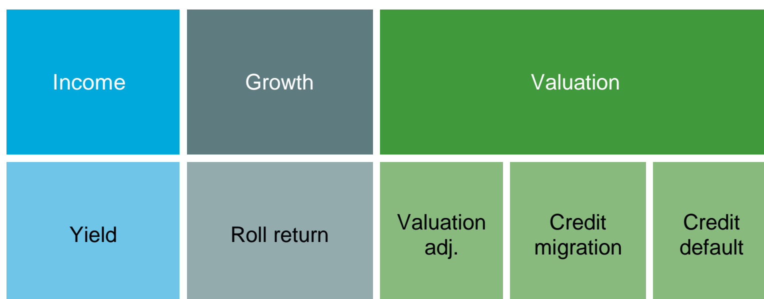
3. Fixed Income Forecasts

Fixed Income Forecasts

Since the beginning of the year, the fundamental return outlook across fixed income has changed materially. While structural issues remain (growing government deficits, elevated inflation expectations), the backup in fixed income yield and spread levels has increased starting yield levels significantly, both in nominal and real terms. Starting yield is by far the most important driver of return contribution in our building blocks shown in Figure 12.

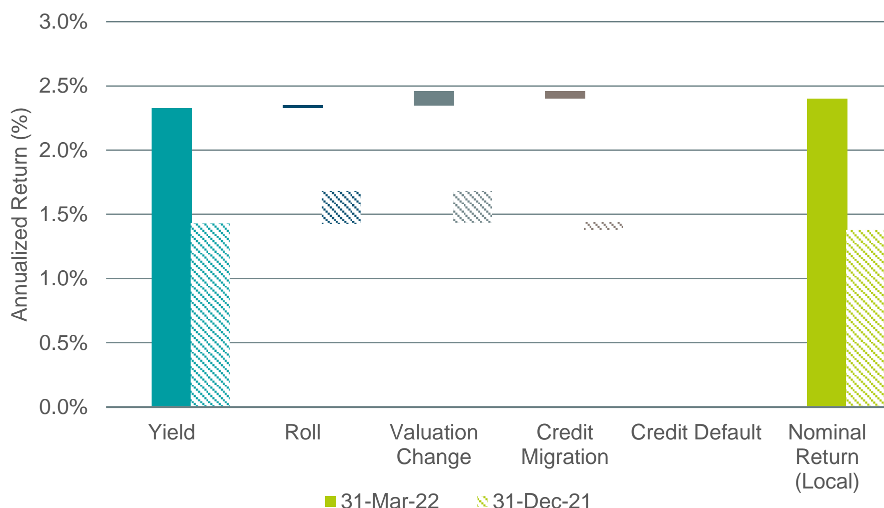
FIGURE 12: PILLAR DECOMPOSITION FOR FIXED INCOME



Source: DWS Investments UK Limited.

In Q1 alone, both shorter term and longer-term US Treasury yields repriced materially higher. The 10-year US Treasury yield moved from 1.51% to 2.34% to end March, which has significantly increased yield contribution to our nominal return forecasts shown in Figure 12.

FIGURE 13: US TREASURY BOND INDEX: CONTRIBUTION TO 10 YEAR FORECASTED HYPOTHETICAL ANNUALIZED RETURNS



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Corporate bond returns have similarly benefited from higher starting yield levels versus the previous quarter. Corporate credit spreads across both high yield (42bps increase) and high grade (24bps increase). Valuations commensurately look less expensive versus their history than they did to start the year. Figure 19 shows US High Yield return forecasts.

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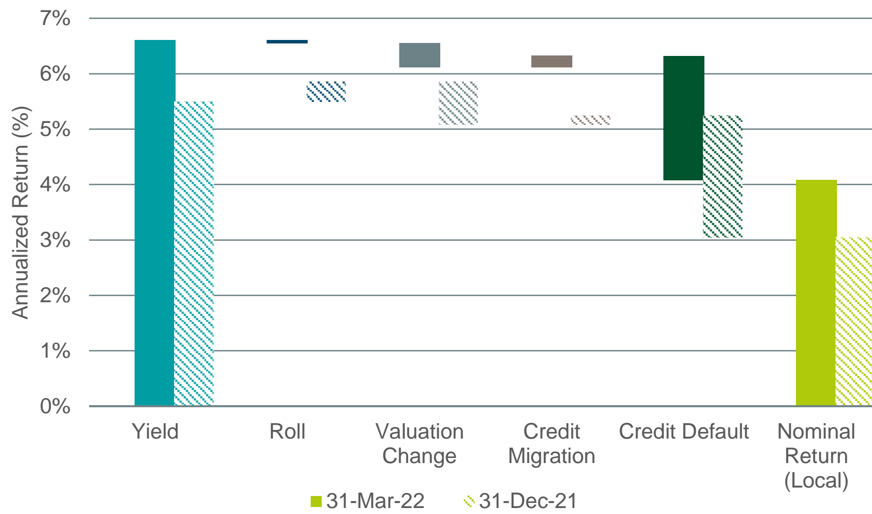
FIGURE 14: US HY BOND INDEX: CONTRIBUTION TO 10 YEAR FORECASTED HYPOTHETICAL ANNUALIZED RETURNS



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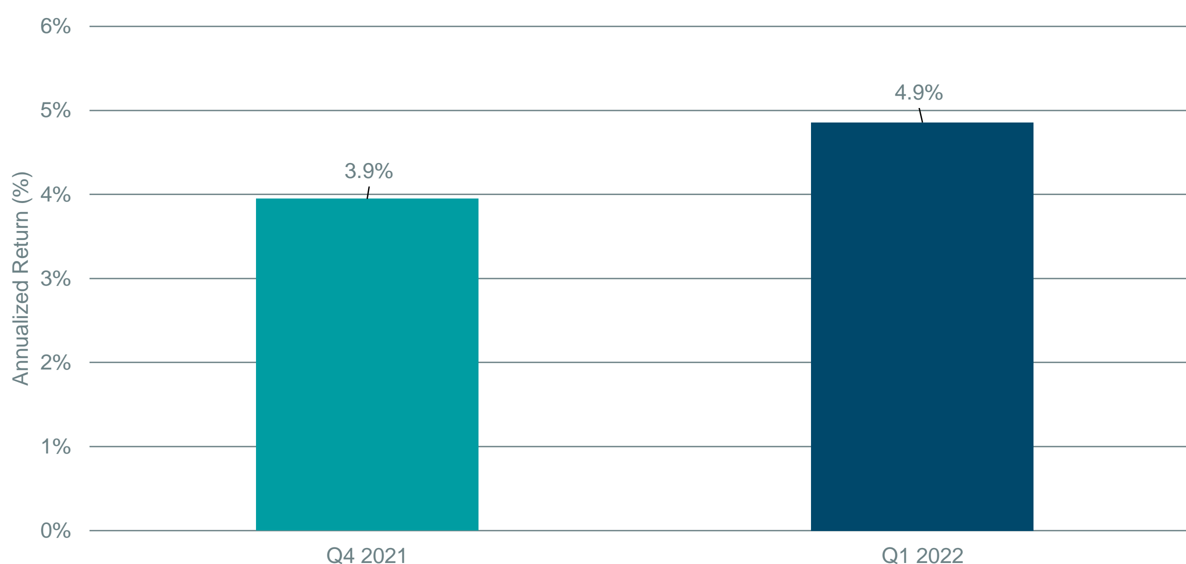
Conclusion

Macroeconomic turmoil throughout the first quarter of 2022 has repriced financial markets in a somewhat material way. Relative to the beginning of the year, equity and credit valuations are now less challenging relative to history, and more significantly, longer term interest rates are materially higher in both nominal and real terms. Inflationary risks remain; however, real interest rates have moved back toward, and some cases, into positive territory for the first time in years. As a result, despite shorter term market risks, our 10-year return forecasts have moved notably higher. Figure 15 shows how our 10-year return forecasts for a moderate strategic asset allocation multi-asset[3] have changed over the most recent quarter.

FIGURE 15: 10-YEAR FORECASTED HYPOTHETICAL ANNUALIZED RETURNS OF MODERATE STRATEGIC ASSET ALLOCATION



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[3] Moderate strategic asset allocation refers to a portfolio that targets annualized volatility of roughly 10%

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Appendix

Representative indices

TABLE 1: EACH ASSET CLASS IN THIS PUBLICATION IS FORECASTED AS PER ITS CORRESPONDING REPRESENTATIVE INDEX

Broad Asset Class	Asset Class	Representative Index
Equities	ACWI Equities	MSCI All Country World Index
Equities	World Equities	MSCI World
Equities	EM Equities	MSCI Emerging Markets
Equities	US Equities	MSCI USA
Equities	Europe Equities	MSCI Europe
Equities	Germany Equities	MSCI Germany
Equities	UK Equities	MSCI United Kingdom
Equities	Japan Equities	MSCI Japan
Fixed Income	US Treasuries	Bbg Barclays US Treasury
Fixed Income	Euro Agg Treasuries	Bbg Barclays Euro Treasury
Fixed Income	US Corporates	Bbg Barclays US Corporate
Fixed Income	Euro Agg Corporates	Bbg Barclays Euro Corporate
Fixed Income	US High Yield	Bbg Barclays Euro Aggregate Corporate
Fixed Income	Pan-Euro High Yield	Bbg Barclays Pan-European High Yield
Fixed Income	EM Sovereigns	Bbg Barclays Emerging Markets USD Sovereign
Alternatives	Developed REITs	S&P Developed REIT
Alternatives	US REITs	S&P USA REIT
Alternatives	Global Infrastructure	Dow Jones Brookfield Global Infrastructure
Alternatives	Americas Infrastructure	Dow Jones Brookfield Americas Infrastructure
Alternatives	Broad Commodities Futures	Bbg Commodity

Source: Bloomberg Finance L.P., DWS Investments UK Limited. As 30 September 2021.

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