DWS

June 24, 2020 Marketing Material

# Time for a bit of patience

## During the swift rebound since the March lows, equity markets may have gotten a little ahead of themselves.

_ We are leaving all of our 12-month index targets unchanged from the last review meeting, suggesting limited upside.
_ We feel that we have sufficiently stretched our fundamental valuation models in deriving our index targets.
_ Despite recent signs of a recovery, risks remain. Given these underlying uncertainties, there is scope for short-term disappointments but also selective opportunities.

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Unlike our equity index targets, markets have been on a rollercoaster ride in the year-to-date. The recovery in share prices since March has certainly been faster than we expected. We would attribute this to a combination of a health crisis unprecedented in recent economic history that has been accompanied by equally unprecedented monetary and fiscal stimulus measures. In such an environment, it is naturally difficult to assess the current value of highly uncertain future earnings streams that, in theory, underpin market valuations.

Against this backdrop, we are leaving all of our 12-month index targets unchanged from our last review meeting. Those were 3,100 for the S&P 500 and Dax 12,000, to cite two prominent examples. We will leave it to you to calculate the likely price returns until June 2021 by the time you read this. At the time we made our decision, our targets translated to mid-single-digit total returns over the coming 12 months – or roughly what markets have been gaining or losing on a weekly and sometimes daily basis in recent months.

In such an uncertain environment, we believe a disciplined approach is crucial. We feel that we have sufficiently stretched our fundamental valuation models in deriving our index targets. Driven by falling interest rates we have increased the warranted price-to-earnings multiples for the global lead index – the S&P 500 – from 16 times earnings in 2013 to about 20 times expected earnings. Lately, the Covid-19 pandemic has compelled us to extend the time horizon for our earnings per share (EPS) forecasts as well, from 2 to 3 years. This was necessary in order to capture the pandemic and lockdown-related EPS collapse in 2020 and subsequent expected sharp profit recovery until 2022. It is worth noting, however, that most companies have suspended their guidance during the past few months, making all EPS forecasts highly uncertain. As we apply a very generous discount rate to highly unpredictable earnings streams, we feel that equity markets may have gotten ahead of their fundamental prospects.

This need not necessarily translate into quick and dramatic setbacks of the sort markets experienced in March. Nor does it rule out markets overshooting further on the way up. After all, monetary and fiscal policy remain ultra-loose. Leading indicators should turn positive shortly and many workers who recently became unemployed are likely to find their way back to the labor market during the coming months. However, the downside risks for the economy and earnings remain considerable. To name only a few: a renewed surge of Covid-19 cases might require a second wave of lockdowns; the timing and effectiveness of the various fiscal stimulus programs are uncertain; lower interest rates will continue to pressure bank

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earnings; U.S.-Chinese tensions remain a burden; and, last but not least, the upcoming U.S. election introduces plenty of uncertainty in terms of U.S. economic policymaking.

Among these risk factors, our most crucial assumption is that a second wave of lockdowns can be avoided in most industrialized countries. Partly, this reflects our growing confidence that populations and policymakers are rapidly learning how to deal with the pandemic in less economically damaging ways. To again list just a few examples, testing capabilities are much improved. In most countries, wearing masks is becoming increasingly common. Hospital capacities have been expanded and will probably be upgraded further ahead of this year's flu season in the Northern hemisphere. All this should help alleviate the need for a second round of broad-based lockdowns in the face of renewed outbreaks. While the above describes the situation in the European Union and parts of Asia quite well, however, we are less confident that the first wave has already been contained in the United States. There, it is quite possible that we could see further lockdowns at the municipal or state level, or alternatively, consumers might themselves decide to stay at home. Moreover, the pandemic continues to spread in many emerging markets. So for the world as a whole, it is still premature to talk about second waves – for now, the first one has not even crested yet!

Partly as a result of all these uncertainties, we do not express a strong regional preference. Instead, we favor a well-diversified global portfolio with a meaningful share invested in emerging-market equities and a bias towards "quality" (i.e. with little debt and resilient cash flows) companies. We believe this should offer the best balance of risks and reward prospects for long-term equity investors, especially when combined with selectively buying high-quality names during periods of market turbulence.

Regarding sectors, we have long favored growth stocks compared to value stocks. We continue to like segments with solid long-term prospects, including in the technology and health-care areas. During the current crisis digitalization trends have accelerated further. In particular, office workers and their employers have gained plenty of firsthand practice in working from home. This is likely to lead to change in how they work much more quickly than might otherwise have been the case. Contactless payments and efficiency initiatives may also provide additional support to the IT sector. Health care should continue to benefit from its structural defensive-growth characteristics and may get additional support from more investments in health systems.

That said, we do believe that the expected economic recovery will eventually favor some attractive "value" and "cyclical" stocks to temporarily outperform. As a result, we have already started to weaken our growth bias somewhat. Notably, we have recently raised the materials sector to neutral. Mining companies, in particular, should benefit from rational pricing, stable Chinese demand for iron ore and copper and resulting attractive free-cash-flow yields. This is in striking contrast with oil markets, where OPEC producers continue to jockey for market share with each other and producers from other countries. It also highlights the need for a selective approach, combined with an in-depth understanding of relevant sector dynamics. Similarly, we expect some of the stocks in the highly cyclical machinery industry to outperform as leading indicators are improving. We remain underweight in utilities, due to subdued growth prospects, and are downgrading real estate to underweight, with shopping malls being challenged by e-commerce and office real-estate investment trusts (REITs) suffering from "working from home." In our view, selection and active management will be key in coming months – whether at the country, sector, or company level.

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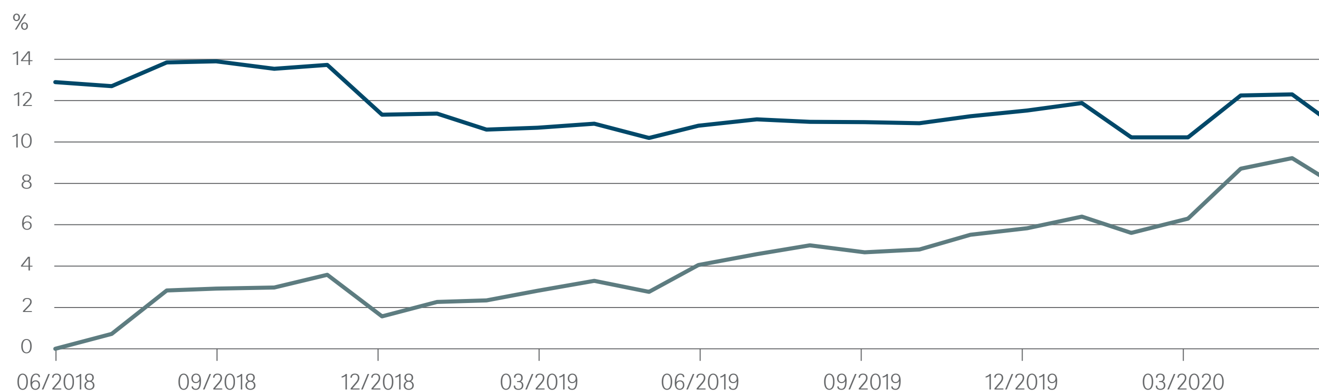
# Valuations overview

**UNITED STATES: NEUTRAL (NEUTRAL)***

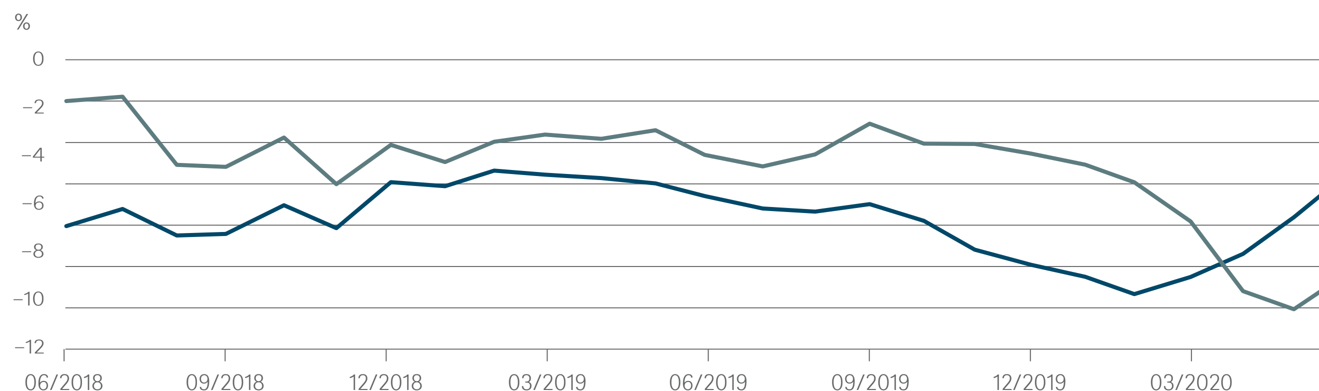
Compared to most industrialized countries, the U.S. has been less successful in containing the pandemic thus far. In the recovery phase, U.S. equities may nevertheless benefit from a more flexible and dynamic jobs market, a large number of technology mega caps, and outsized U.S. fiscal and monetary stimulus, easily outpacing European economic emergency-relief measures. Given recent stock-market strength, a lot of hope is already priced in, leaving scope for short-term disappointments.




Relative valuation (P/E ratio): S&P 500 vs. MSCI AC World Index
Relative performance: S&P 500 (in dollars) vs. MSCI AC World Index (in local currency)

**EUROPE: NEUTRAL (NEUTRAL)***

Investor positioning in European equity markets remains quite low. This suggests scope for further upside in companies able to deliver solid second-quarter earnings, or at least reassuring guidance on the likely slope of their earnings recovery. Meanwhile, the new EU recovery fund marks the first sizeable mutualized-debt-issuance program, which may make the common currency less prone to future crises. Risks abound, however, including no trade deal between the UK and the EU being reached.




Relative valuation (P/E ratio): Stoxx Europe 600 vs. MSCI AC World Index
Relative performance: Stoxx Europe 600 (in euros) vs. MSCI AC World Index (in local currency)

* Our assessment is relative to the MSCI AC World Index, the last quarter's view is shown in parentheses.
Sources: FactSet Research Systems Inc., DWS Investment GmbH as of 6/17/20

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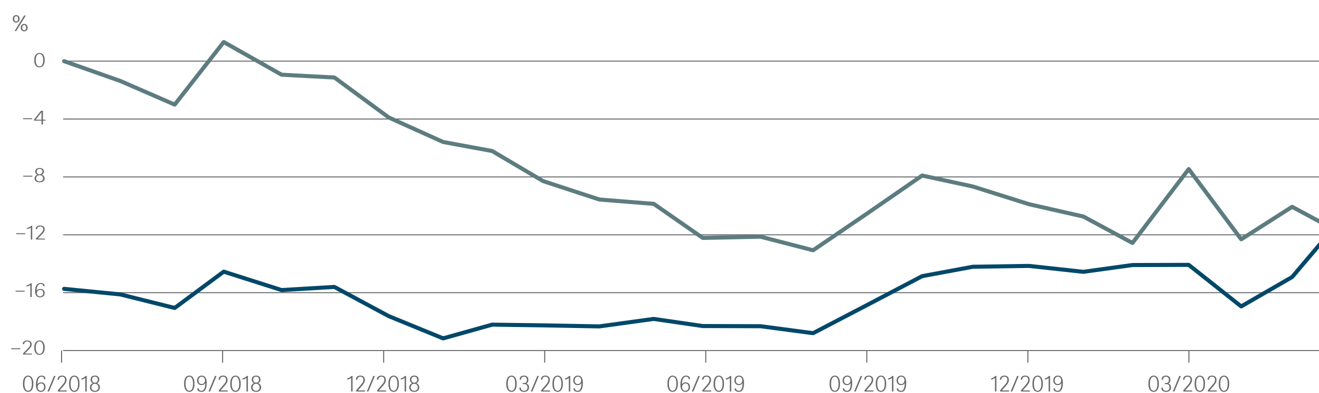
### JAPAN: NEUTRAL (NEUTRAL)*

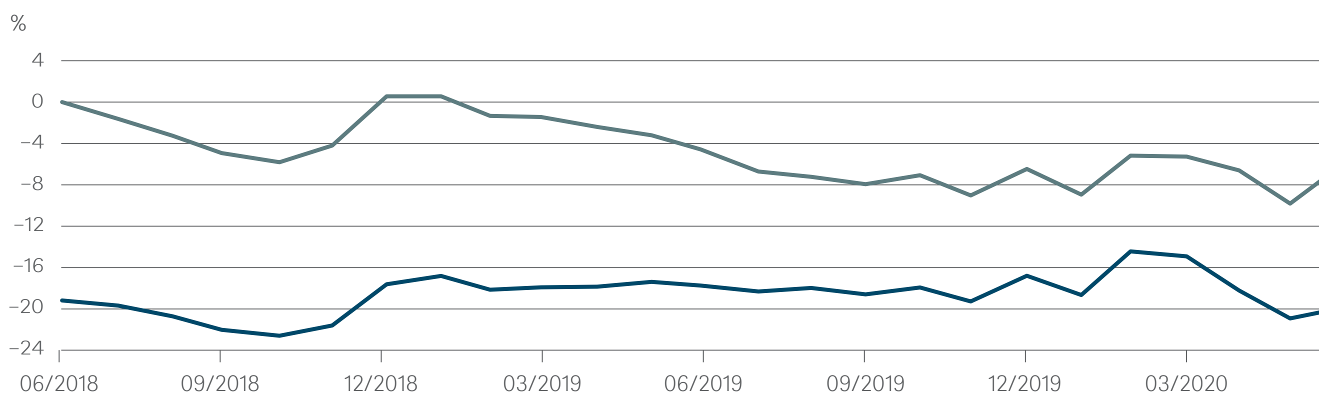
In the current crisis, earnings and dividends of Japanese companies have been much more resilient than in most countries. Partly, that reflects the success of public-health authorities in containing the pandemic, albeit after a slow start. Solid balance sheets have helped and many companies would be well positioned to benefit from a world-wide economic rebound. The reverse, alas, is also true, if global trade stalls or geopolitical risks rise, for example due to rising tensions with China.




Relative valuation (P/E ratio): MSCI Japan Index vs. MSCI AC World Index
Relative performance: MSCI Japan Index (in yen) vs. MSCI AC World Index (in local currency)

### EMERGING MARKETS: NEUTRAL (NEUTRAL)*

Many emerging markets have been badly hit by Covid-19, with Brazil, India, Russia, Mexico and Peru among the most prominent examples. Moreover, it remains too early to say when and at what cost the pandemic can be contained. Even in China, the discovery of new clusters of cases at a Beijing wholesale food market has brought back the specter of further disease waves. Renewed tensions with the U.S. over Hong Kong, as well as China's border conflict with India, have not helped matters either.




Relative valuation (P/E ratio): MSCI Emerging Markets Index vs. MSCI AC World Index
Relative performance: MSCI Emerging Markets Index (in dollars) vs. MSCI AC World Index (in local currency)

* Our assessment is relative to the MSCI AC World Index, the last quarter's view is shown in parentheses.
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## GLOSSARY

Cyclical is something that moves with the cycle.

The Dax is a blue-chip stock-market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange.

The discount rate is the interest rate charged to commercial banks and other depository institutions for loans received from the country's central bank's discount window.

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

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

The European Union (EU) is a political and economic union of 28 member states located primarily in Europe.

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

Free Cash Flow (FCF) is a measure of financial performance calculated as operating cash flow minus capital expenditures. It shows how much cash a company is able to generate after deducting the money required to maintain or expand its asset base.

Growth stocks are stocks from companies that are expected to grow significantly above market average for a certain period of time.

Market capitalization (caps), in the context of an individual firms, is the number of shares issued multiplied by the value of the shares.

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

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

The MSCI Japan Index is designed to measure the performance of the large- and mid-cap segments of the Japanese market.

The Organization of the Petroleum Exporting Countries (OPEC) is an international organization with the mandate to "coordinate and unify the petroleum policies" of its meanwhile 12 members.

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

A Real Estate Investment Trust (REIT) is a company that owns and, in most cases, operates income-producing real estate. REITs sell like a stock on the major exchanges and invest in real estate directly, either through properties or mortgages.

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 Stoxx Europe 600 is an index representing the performance of 600 listed companies across 18 European countries.

Value stocks are stocks from companies that are trading at prices close to their book value and that are therefore cheaper than the market average on that metric.

## 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 |
|---|---|---|---|---|---|
| Dax | –10.1% | 22.9% | –0.1% | –7.0% | –1.2% |
| MSCI AC World Index | –7.4% | 15.2% | 9.7% | –3.3% | 3.5% |
| MSCI Emerging Market Index | –17.6% | 27.4% | 14.0% | –8.7% | –4.4% |
| MSCI Japan Index | –8.2% | 15.0% | 14.6% | –10.0% | 7.0% |
| S&P 500 | 1.7% | 17.5% | 14.4% | 3.8% | 12.8% |
| Stoxx Europe 600 | –10.0% | 16.1% | 1.5% | 0.0% | –2.4% |

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