September 18, 2019

Marketing Material

Low for longer, but not lower

Yields are likely to remain low but not fall further. We believe a severe economic downturn would be needed to push them lower still.

- Yields are likely to remain low for longer. Central banks have guided the way. Accordingly, we see only a little potential upside for most bonds.
- Should recession fears increase again, yields could fall even further.
- That makes the hunt for yield even more difficult. Corporate and emerging-market bonds remain among our favorites.

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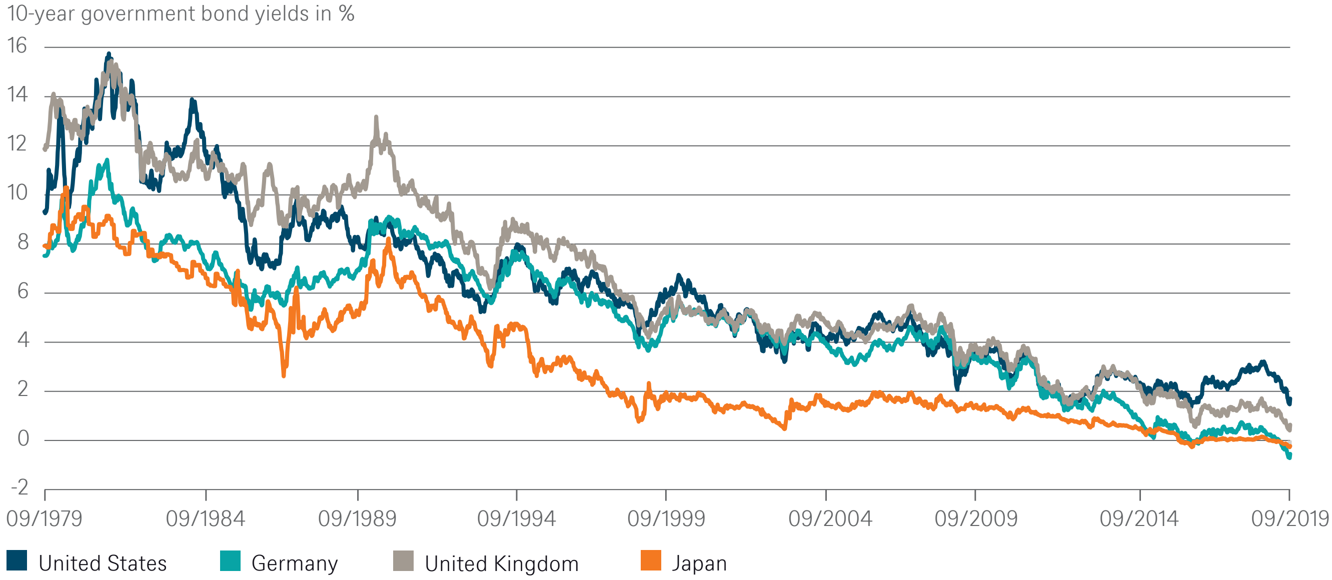
Last year saw the beginning of something many people had started to think would never happen: a turnaround in interest rates. What this meant was an end to the decade-long downward path for industrialized countries' rates. A big factor was certainly the U.S. Federal Reserve (the Fed). The Fed raised the key interest rate four times in the course of 2018, so that the effective federal funds rate (EFFR) rose from 1.4% to 2.4%. 10-year Treasury yields climbed to 3.26% in October, a level not seen for seven years. Meanwhile, 2-year yields reached a 10-year high. All this was against the backdrop of a U.S. economy that was humming along nicely and a distinctly robust labor market, with very low unemployment. Investors ought perhaps to have been pleased at these encouraging signs of returning normality. Instead they were nonplussed. The S&P 500 plunged by almost a fifth. "Sure, ok, let's have an interest-rate turnaround" seemed to be most investors' reaction, "but please let's not overdo it!" Their worries were understandable. The orders component of the U.S. purchasing managers' index fell below the dreaded 50 mark, which has happened in every cycle of interest-rate hikes by the Fed since the Second World War.

And the end of the decade-long tailwind from ever falling interest rates was, after all, a very big deal, implying a major change in all global financial markets. A year later, however, it all looks like the turnaround was what some might call fake news. The 10- and 30-year Treasury yields have tracked back down. Yields are once again in their long-term downward channel. We are in fact back right where we started. But where are we heading now? If things were to continue along this route Treasury yields would have to plunge into negative territory. Quite a few commentators are now predicting exactly that.

MAKING A BOTTOM OR CONTINUING THE TREND?

10-year yields of various countries bonds are surprisingly closely aligned. The long-term downward trend seems intact. Only in the U.S. does a bottom seem to be forming.



Sources: Refinitiv, DWS Investment GmbH as of 9/11/19

How likely is it that U.S. rates will go negative? Let's look at some pointers. 2-year U.S. yields came very close to the zero line in autumn 2011, at 0.14%. 30-year government bonds are yielding below 2% percent for the first time in history and the U.S. yield curve (spread between 2- and 10-year government bonds) has inverted for the first time since 2007. Meanwhile real, inflation-adjusted yields in the U.S. are falling again and have been negative for almost seven years.

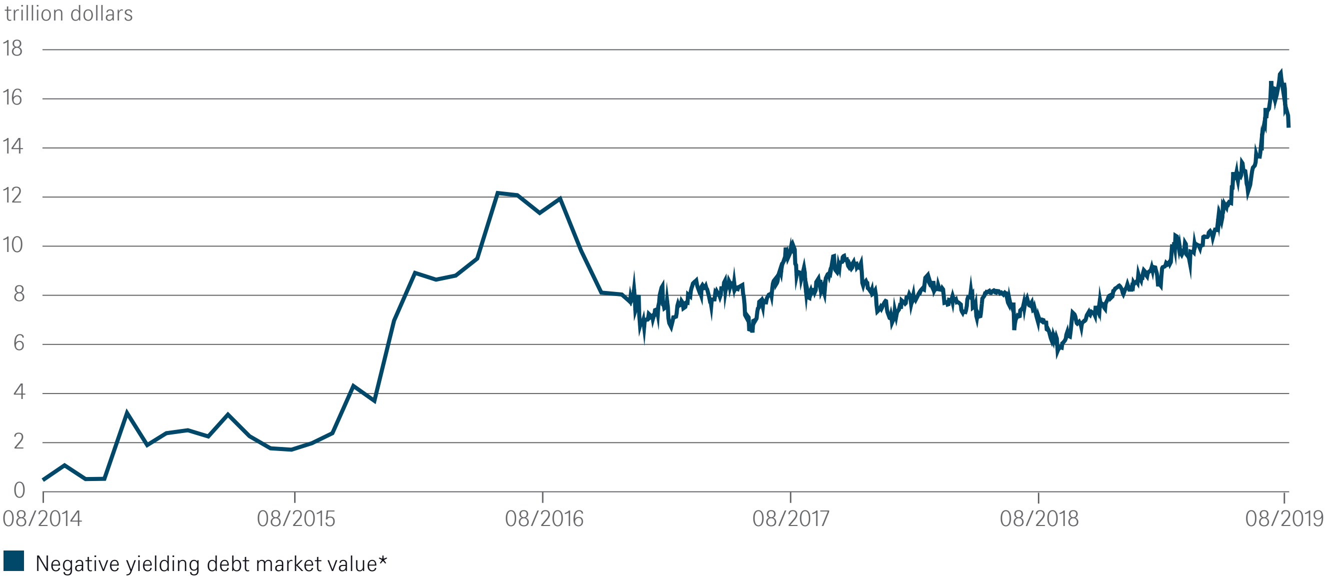
This summer, however, the real historical landmarks of the bond market were found outside the U.S. The yield on 30-year Italian government bonds also fell below 2%, and 10-year bonds yielded less than 1% for the first time ever. In Germany, 10-year government bonds closed at -0.71%, the lowest ever, and 30-year bonds plunged into negative territory for the first time in their history. Thus, for a few weeks, it was impossible to buy any German government bonds with a positive yield. By late summer, global bonds worth 17 trillion dollars had negative yields.

The idea that the decade-long trend will continue and that 10-year U.S. Treasuries, too, slide into negative territory should therefore not be ruled out too quickly. All the more so given lingering fears of recession.

And yet we do not expect the downward trend in yields to continue, at least in the next 12 months. On the contrary, we expect most yields to track sideways, with a slight upward trend. That would not necessarily be a disaster for bonds in normal times. But in today's times, with so many bonds that currently yield nothing, it would imply that many bonds provide investors with negative returns over a 12-month period.

MORE AND MORE BONDS GO NEGATIVE

For ever more bond yields, zero is no longer a natural lower limit. More than a quarter of bonds worldwide now have negative yields. Most of them are in Japan.



*Bloomberg Barclays Global Agg Neg Yielding Debt Market Value
Sources: Bloomberg Finance L.P. as of 9/11/19

In autumn 2019, it seems that all major central banks will continue to relax their monetary policy. We expect the Fed to cut interest rates twice in the next twelve months, with the first cut in September. As expected, the European Central Bank (ECB) opened up its big toolbox on September 12 and even gave investors a bit more than they had been expecting: a reduction in the deposit rate from -0.4% to -0.5%, the resumption of the bond-purchase program, at a rate of 20 billion euros per month, and the introduction of a tiering system for excess cash in order to give some at least partial relief to the banks. That the package has been left open-ended was its most dovish surprise: ECB President Mario Draghi may be leaving, but his legacy will remain. Other central banks, such as in China, Japan and the UK, are also moving towards easing. Bond markets see that and their reaction is clearly visible in the striking decline in yields in recent months.

What does all this mean for our fixed-income strategy? We expect yields to stay low for longer. In their search for positive yields, European investors might want to look outside the government bonds of core Europe. Our preferences are for euro corporate bonds – investment grade and some high yield. For the latter, we prefer issuers with a "B" rating. Those who want to stay in government bonds might want to consider moving to the periphery. We have lowered our forecast for 10-year German government bonds to -0.5%, due to additional purchases of government bonds by the ECB and continued demand from institutional investors. Expected purchases by the ECB (from the new bond-purchase program and from reinvestments of maturing securities) will also continue to support Spanish and Portuguese bonds. In Italy, the political situation has improved a bit but bonds had already amply priced this in – as the halving of the yield premium over German government bonds shows. Our view is that after so much anticipation the risk is of disappointment: that is, rising yields of Italian bonds.

Institutional investors who want to invest in euros could consider looking at another asset class that offers the potential for positive returns: illiquid securities for example. They currently offer a premium over government securities for those who have longer investment horizons and don't require continuous tradability. Collateralized loans, in our view, deserve a special look as their market in Europe is now quite large.

Outside the Eurozone – with the exception of Japan – returns are still generally positive. In the U.S., we expect 2-year Treasuries to yield 1.6% and 10-year government bonds to yield 1.75% in twelve months' time – not far at all from today's level. And so we see the decline in yields as being arrested. Nor do we expect the yield curve to remain inverted. We like emerging-market hard-currency bonds.

Trade-dispute-related risks, however, have increased. The intensification of the global trade conflict and the potential impact of slower growth in export-oriented countries is worrying us. But their reasonable valuations are appealing and lower U.S. interest rates, a stable U.S. dollar and comparatively low government debt are supportive. Attractive investment-grade-rated countries and select high-yield opportunities are among our favorites in this environment. We are modestly positive on Turkish government bonds given the relatively low level of debt. For both EM- and U.S.-bonds, however, European investors are bearing the currency risk.

Despite the euro's weakness against the dollar for more than a year now, we are sticking to our 12-month forecast, with the euro at 1.15 dollars. The strengths and weaknesses of the two currencies in relation to one another look largely balanced. Following the decisions of the Fed and the ECB in September, we expect the market to see further Fed easing as more likely than anything fresh from the ECB under Draghi's successor, Christine Lagarde. We continue to regard the yen, particularly vis-à-vis the euro, as a currency that investors might want to consider moving into in times of higher risk aversion.

GLOSSARY

The Bloomberg Barclays Global Agg Neg Yielding Debt Market Value Index calculates on a daily basis the value of all outstanding bonds worldwide with a negative yield.

Collateralized loan obligations (CLOs) are securities backed by a pool of debt, such as low-rated corporate loans.

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 European Central Bank (ECB) is the central bank for the Eurozone.

The Eurozone is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

The federal funds rate is the interest rate, set by the Fed, at which banks lend money to each other, usually on an overnight basis.

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

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 (IG) refers to a credit rating from a rating agency that indicates that a bond has a relatively low risk of default.

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

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).

Periphery countries are less developed than the core countries of a specific region. In the Eurozone, the euro periphery consists of the economically weaker countries such as Greece, Portugal, Italy, Spain and Ireland.

The Purchasing Managers Index (PMI) is an indicator of the economic health of the manufacturing sector in a specific country or region.

A rating is a standardized assessment of the creditworthiness of the issuer and its debt instruments by specialized agencies. The main three rating agencies are the Moody's (Aaa over Baa1 to C, best to worst) , S&P (AAA over BBB+ to D, best to worst) and Fitch (AAA over BBB+ to D, best to worst).

In economics, a real value is adjusted for inflation

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 S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

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

A tiering system would set different interest rates for banks' deposits at the central bank, depending on the amount.

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

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

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.

A yield-curve inversion is when the yields on bonds with shorter duration are higher than the yields on bonds that have a longer duration.

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