June 19, 2020 Marketing Material

# Almost back to normal

## We do not expect much from government bonds for the time being. Our focus remains on corporate and emerging-market bonds.

_ New debt on the one hand, and central-bank purchases on the other, should result in sideways movement in government-bond yields.

_ Corporate bonds have recovered significantly, but we still see good opportunities here, not least because of central-bank support.

_ We also continue to like emerging-market bonds, especially those from Asia.

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The world is going through its most severe recession since the Second World War. Unemployment and short-time working[1] are at record levels in many countries, rating agencies are lowering their ratings at record speed and global Covid-19 new infections continue to rise and are stubbornly high in the U.S. At the same time, however, the recession may prove to be one of the shortest in history, individual regions in Asia and, especially, continental Europe have new infections largely under control, and governments and central banks have put together rescue packages that, both in quantity and in scope, far outweigh the 2008/09 interventions.

In general, this is a crisis in a hurry. Not only the stock markets, but also swathes of the bond market, were at record heights just before their spring dive. U.S. investment-grade corporate bonds, for example, generated a total return of over 21% from the beginning of 2019 until their peak on March 6 this year, from which 19 percentage points were erased within the subsequent two weeks. Yet today, less than three months from the low, they are trading close to their pre-Covid-19 record level[2] again. And this in an environment where the consensus is that the U.S. economy will not return to its pre-crisis level until 2022.[3]

Bond investors don't lack questions about what's going on. Have the markets recovered too quickly? Are they foolishly ignoring the damage that many economies have suffered as a result of the slump or underestimating the dangers of a virus that remains uncontrolled? Will the expected credit defaults wipe out all corporate-bond yields? And will the immense hunger for capital caused by rescue packages and tax deficits drive government-bond yields higher? More generally, what about the inflationary or potentially deflationary forces in the economies during and after the crisis? In addition, have emerging-market bonds seen their best times given low commodity prices, increasing de-globalization and a strong dollar?

Our answer to the risk that interest rates may rise can be summed up in one word: low. The reason, again in one word, is central banks. Of course, they cannot by themselves ensure that bond yields do not rise significantly in the near future. For that to happen, the environment – that is, a gradual economic recovery and the prospect of controlling the virus in the course of next year – must also be right. But support from the central banks for the bond markets could hardly be higher. The key interest rates of the four major central banks (U.S., Eurozone, Japan and UK) are close to or below zero.

[1] Government scheme in a lot of European countries that companies can use to have the government pay their employees (part of their salary) temporarily when they don't have enough work for them (as to avoid laying them off)
[2] Bloomberg Barclays US Credit total return value unhedged, as of 6/14/20.
[3] Bloomberg Finance L.P. as of 6/14/20.

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None of these banks has even hinted at wanting to raise rates in the foreseeable future. (As U.S. Federal Reserve (Fed) Chairman Powell put it, "We're not even thinking about thinking about raising rates yet.")[4] On the contrary, the members of central-bank monetary-policy committees are increasingly being quoted as saying that the interest-rate environment is unlikely to change in 2021. In the case of the Fed, which has repeatedly spoken out against negative interest rates, direct steering of the yield curve (yield curve control, as currently pursued by the Bank of Japan) should also help to ensure that investors do not need to worry too much about rising interest rates. For our strategic planning horizon of twelve months we therefore believe that fears of interest-rate hikes will not play a major role in the markets.

Nevertheless, there are many medium-term uncertainties. The Fed's balance sheet has already almost doubled within a few months to over 7 trillion dollars. The U.S. budget deficit is set to widen to almost 20% of gross domestic product (GDP) and government debt is rising to 99% of GDP, up from 78% last year. Japan shows that still higher debt levels than that do not necessarily force a country to its knees. But we have highlighted the negative consequences of ever higher debt levels and the increase in government intervention on countries' potential growth in a recent study (CIO Special: Fiscal packages – necessary short term, dangerous long term). So far, we assume that the Covid-19 recession could have stronger inflationary effects in the medium term than previous recessions, as demand is likely to recover faster than supply.

For the time being, however, these risks are playing only a secondary role and, given supportive fiscal and monetary policy, we continue to focus primarily on corporate and emerging-market bonds. After the rapid recovery in these bond segments since the beginning of April, much of the potential gain has certainly already been captured, but we believe there is still some meat on the bone. However, the much higher dispersion of yields within bond segments compared with the beginning of the year means that bond selection is more important than before the crisis.

With government bonds what is critical is that we do not expect any significant change in interest rates, in Europe or the U.S. The increased capital needs of governments and increased bond purchases by central banks should balance one another out for the time being. Given the historically low current yield and the poor prospects for bond-price increases, we do not expect much from this segment. In the portfolio context, however, longer-dated securities can serve as protection against renewed market distortions.

We see more potential in government bonds from the emerging markets. Despite their current challenges (the lower oil price, firm dollar and de-globalization), we believe there are a number of points in their favor, in Asia in particular. Asian countries have solid public finances, benefit from low commodity prices and are disproportionately active in the technology segment, which has remained relatively stable during the crisis.

In the case of corporate bonds, two players – central banks in Europe and the U.S. – are (again) on the buyer side, which should provide price support. We see good opportunities in both investment grade and high yield. High yield is currently enjoying special, never before received support in the U.S.: one element of the big Fed bailout package is the purchase of high-yield bonds via ETFs, which has been effective. In this segment, we are also looking at more cyclical stocks, for example from the chemicals, logistics, cable and telecommunications segments, provided the balance-sheet quality is appropriate. In the investment-grade segment, our focus in the U.S. is on more defensive sectors and maturities below five years.

Although we do not fear a rise in inflation in the near future, we believe that inflation-indexed bonds (linkers) are currently well priced to hedge against these risks. For our main scenario, however, these linkers remain merely an addition to a portfolio that continues to focus primarily on corporate and emerging-market bonds.

The currency market, meanwhile, looks more difficult than ever to forecast in the midst of a pandemic, billions of dollars in fiscal and central-bank interventions, and protectionist measures in many countries. At present, investors seem to be attaching most importance to short-term impulses from rescue packages or presumed further developments towards a European debt and liability union, rather than thinking about the possible long-term consequences of these measures.

For now, however, the dollar appears to be continuing to benefit from its reputation as a crisis currency. But in the medium term we believe both the swelling U.S. budget deficit and further protectionist measures by the U.S. could drive the dollar out of fashion again. Aside from the greenback, we expect pressure on the British pound because of Brexit and on the renminbi as a result of the trade disputes with the U.S.

[4] https://www.dailytelegraph.com.au/business/powell-were-not-even-thinking-about-thinking-about-raising-rates/video/7430c3f4b18b5ce663b8bf75ca795cd7

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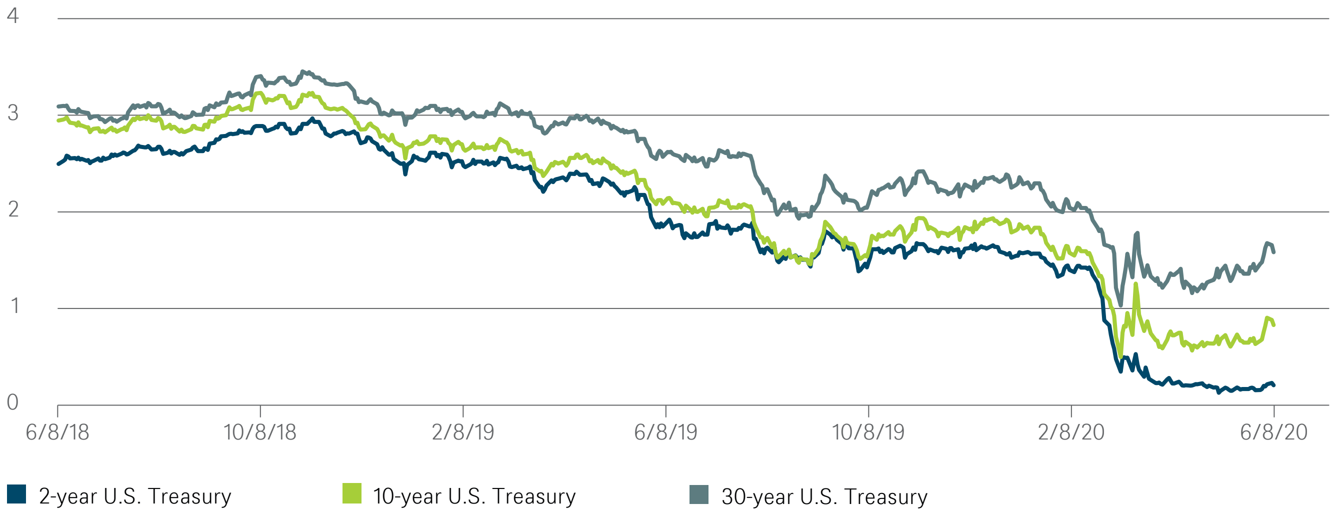
**MINIMAL UPSWING ON THE LONG END**

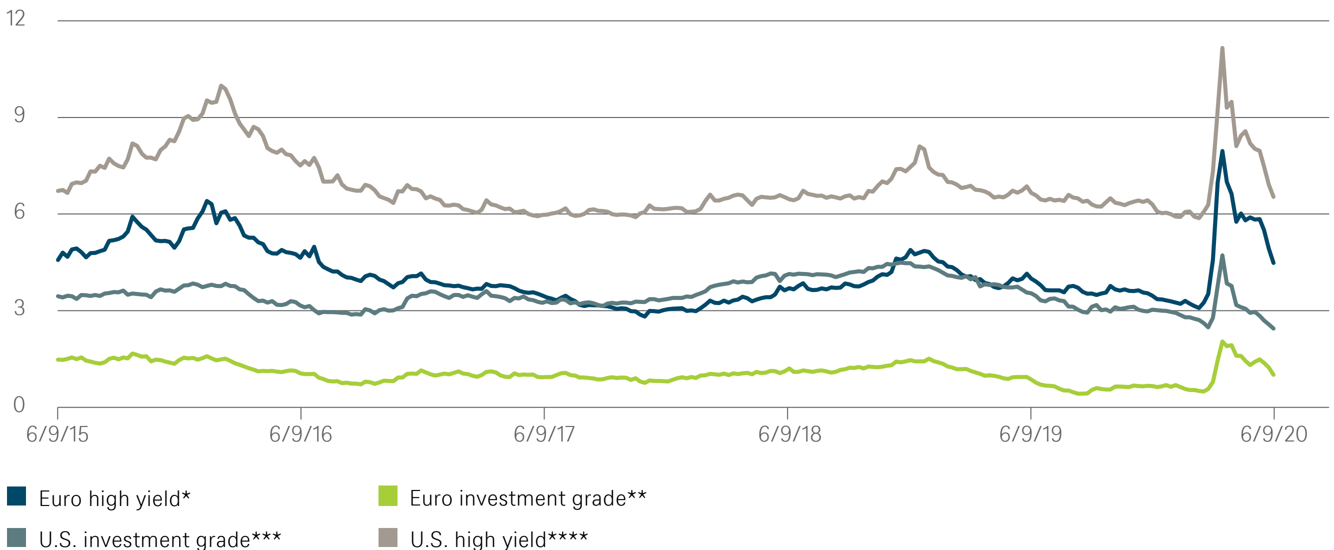
While yields of U.S. Treasuries with shorter maturities remain on record-low levels, they are slightly increasing again on the longer end. This leads to a steepening yield curve.




Sources: Refinitiv, DWS Investment GmbH as of 6/10/20

**SELECTION BECOMES MORE IMPORTANT FOR CORPORATE BONDS**

Corporate bonds have recovered so quickly from their slump that many are back to pre-crisis levels. With the central banks behind them, however, things could go a little further.




* ICE BofA Merrill Lynch Euro High Yield Index; ** ICE BofA Merrill Lynch A-BBB Euro Corporate Index: *** ICE BofA Merrill Lynch A-BBB US Corporate Index; **** ICE BofA Merrill Lynch US High Yield Index; Sources: Refinitiv, DWS Investment GmbH as of 6/10/20

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## GLOSSARY

The Bank of Japan (BOJ) is the central bank of Japan.

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

A corporate bond is a bond issued by a corporation in order finance their business.

Deflation is a sustained decrease in the general price level of goods and services.

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.

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.

An exchange-traded fund (ETF) is a security that tracks an index or asset like an index fund, but trades like a stock on an exchange.

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.

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 hedge is an investment to reduce the risk of adverse price movements in an asset.

High-yield bonds are issued by below-investment-grade-rated issuers and usually offer a relatively high yield.

The ICE BofA Merrill Lynch A-BBB Euro Corporate Index tracks the performance of euro-denominated corporate debt rated A to BBB and publicly issued in the Eurobond or Euro member domestic markets.

The ICE BofA Merrill Lynch A-BBB US Corporate Index tracks the performance of dollar-denominated corporate debt rated A to BBB and publicly issued in the U.S. domestic market.

The ICE BofA Merrill Lynch Euro High-Yield Bond Index tracks the performance of euro-denominated below investment-grade corporate debt by issuers around the world.

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.

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

An inflation-indexed bond is a bond where the principal and/or coupon is indexed to the consumer price index.

Investment grade bonds are all bonds with a good to very good credit rating

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 pound sterling (GBP), or simply the pound, is the official currency of the United Kingdom and its territories.

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

Renminbi (RMB) is the currency of the People's Republic of China.

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.

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CRC 076626 (06/2020)