DWS

March 2, 2020 Marketing Material

# VIRAL FEARS

## The severe market reaction is understandable enough. In the longer term, though, we remain cautiously optimistic.

- As the virus has spread widely outside of China, most assumptions concerning economic growth and company earnings are being revised
- Markets suffered a historic sell-off during the past ten days, with oil and equities being hit hardest and 10-year U.S. Treasuries reaching new lows below 1.2%
- We believe that markets will remain volatile in the days to come but stick to our constructive strategic view (based on our expectations that new virus infections outside China are likely to peak before the end of Q2)

What a difference ten days make. It looked almost like the worst fears of the novel coronavirus (Covid 19) were already behind us. Since then, we have seen a spike in cases, notably in South Korea and in northern Italy, the country's industrial heartland. Epidemiologically even more worrying, the number of cases has also been growing in Africa and the Middle East, with new clusters of cases in Iran and the first confirmed case (in Nigeria) of Subsaharan Africa. The virus already having hit the United States has likely contributed to the market sell-off.

Despite the number of new cases in China itself falling, all this has taken a heavy toll on global financial markets, with the S&P 500 and the German Dax declining by close to 15% from their recent peaks. That partly reflects markets having been priced for perfection heading into the crisis. In terms of the speed of the declines, though, technical factors have also played a role, making this one of the harshest corrections in history. The drumbeat of companies warning on profits, economists cutting their forecasts, schools closing and politicians looking helpless, seem unlikely to conclude for at least several days yet.

Nevertheless, we think that the market panic – if not necessarily the rate of infections – is likely to peak relatively soon. Standard epidemiological models have actually worked reasonably well so far for the novel coronavirus, both in China and elsewhere. They suggest that this second wave in Western Europe will probably crest as well in the coming weeks. None of which is to deny the seriousness of the situation. It appears increasingly likely that Covid 19 will spread in countries where local health systems risk being overwhelmed.

With the situation having clearly developed in a less benign way than we had hoped for only in mid-February, it seems that we have to reconsider some of our estimates.

In terms of global growth, it has become all but clear that the damage will not be confined to China's economy and not only to the first quarter. It becomes ever more likely that global growth will take a hit in the first half of this year, and likely pushing full year 2020 growth rates down as well. Nonetheless, we believe that a recovery to at least pre-crisis activity levels may occur in the second half. We will monitor carefully if corporate confidence in the service sector, so far the supporting pillar of global growth, continues to hold up.

Many Asian central banks have already reacted and cut interest rates. The U.S. Federal Reserve (Fed) and especially the European Central Bank (ECB), we believe, will take their time to react in a similar way, as they have set a somewhat higher bar for looser monetary conditions as noted in previous statements. Reacting too soon might actually add to market nervousness. We would however rather expect support to come in before the middle of this year. So far we have pencilled in one rate cut by the Fed this year and none for the ECB. The market expects three rate cuts from the Fed this year.

Ten-year U.S. Treasury yields have reached new record lows, trading below 1.2% on Friday. This, we believe, is not only a reflection of lowered growth expectations but also the result of Treasury purchases as a means to hedge portfolios. Nonetheless, we will reconsider if our strategic U.S. yield forecasts need downward revisions, just as with the targeted spread levels for emerging-market, corporate and peripheral bonds. While the corporate bond market lacks liquidity at this point in time, we are not inclined to be sellers any more at these levels. We are not expecting German Bund yields to reach new lows, as we believe the ECB will be less inclined than the Fed to act.

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Concerning equities, our base-case assumptions so far have called for 5% earnings growth in 2020, which is now under review. Certain sectors are likely to show profit declines. While this would weigh on markets, we expect in our base scenario that lower earnings should be met with higher price-earnings (P/E) multiples as investors may deem the dent to be temporary. While we feel comfortable with our positive sector views on healthcare and technology, we might have to reconsider our positive stance on financials. Investors' focus on quality stocks that deliver steady income is likely to increase further. We expect volatility to remain for some more days, as portfolio de-risking continues and as stock markets may be used to reduce risks where bond markets lack liquidity.

For currencies we believe that any further risk-off mode should support the euro, which has served as a funding currency in past months.

Summing up, while the development of the virus has taken an unexpected turn, likely with a negative impact for the global economy for the full year, we believe that markets after their historic sell-off are reflecting the new situation adequately. Should the spreading of the virus abroad follow the pattern in China, the situation might look better in the course of the second quarter. In the short term, we do not rule out further downside and market volatility. But eventually, economies too should recover. Long before then, fiscal and monetary stimulus are likely to prove supportive to markets. In the meantime, positive news on the containment of the virus might do so as well.

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## GLOSSARY

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

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

The euro (EUR) is the common currency of states participating in the Economic and Monetary Union and is the second most held reserve currency in the world after the dollar.

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

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.

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

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

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

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.

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.

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