Deutsche
Asset Management

CIO VIEW

Quarterly April 2017

Globalization

The impact on wages and wealth

Marketing Material

How much of a "Trump effect" is in the markets?

Why do markets merely shrug when the new U.S. president fails prominently with his first major bill in Congress? Why doesn't Trump's "art of no deal" end the so-called "Trump rally"? Maybe because it isn't a Trump rally after all but rather a market upswing based on the hope of a sustainable rise in both inflation and growth. This hope is probably what has been driving the bond, currency and stock markets on every continent since around mid-2016. So far, this hope has remained largely untarnished, especially in light of the economic data. Sentiment indicators look particularly good at the moment. Companies have started the current year full of optimism and analysts have raised their earnings estimates.

Stefan Kreuzkamp
Chief Investment Officer

„There's little Trump effect left in markets. This should limit any jitters in case of further stumbles from the White House."

But what does optimism have to do with Trump? Well, for one, it's hard to deny the positive boost to the markets provided by the U.S. elections. However, we believe this boost was mainly fueled by the relief investors felt knowing that the White House and Congress were again in the same, and above all, Republican hands. Added to this was the perception that Trump is a president who is not afraid to take action. Since the beginning of December, however, the S&P 500 Index has been merely keeping pace with global stock markets, while the more domestically oriented Russell 2000 Index has underperformed. This may show that the president has not actually created any new optimism since taking office. The indicator that probably best reflects the market's view of Trump's political assertiveness is the Mexican peso to U.S. dollar exchange rate. After the elections, the Mexican peso fell as much as 20 percent versus the U.S. dollar only to make almost a complete recovery by the end of March.

The positive interpretation chosen by today's more relaxed peso buyers suggests that they believe that Trump's protectionist plans will fail in a similar manner to his health-care-reform policy and travel-ban decrees. The negative interpretation would be to call into question the speedy implementation of tax reforms. This may cause some disappointment for U.S. investors as would a likely postponement of infrastructure projects. But global markets are less likely to be affected. The economic tailwinds are too strong. Besides, many international investors may not have been expecting much from Trump in the first place, so they might not be too disappointed. In our opinion, not expecting too much, so as not to be disappointed, would again be the best approach for investors this year. Although valuations are stretched overall, we are still not seeing any signs of overheating or sharper hikes in interest rates. There also doesn't appear to be any risk of a recession. Both of these factors should protect us from bear markets, even though we cannot rule out a setback before the summer.

CIO | VIEW

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FOCUS

Globalization has reduced the prosperity gap between emerging and advanced economies. At the same time, it has contributed to shifts in labor and capital costs.

MACRO

The list of political risks is long. Nevertheless, global economic growth looks solid, not least as it now has an increasingly broad regional basis. That should help stabilize the world economy.

FIXED INCOME

For a change, U.S. markets are more baffled by politics and underlying economic trends than by the central bank. Meanwhile, all eyes in Europe remain fixed on the ECB and a potential exit from QE.

EQUITIES

By most measures, equities are expensive. Still, during likely periods of market weakness, we believe there can be opportunities to add to our positions. The economic backdrop and earnings remain solid. We favor emerging markets.

ALTERNATIVES

Investor interest remains high in both unlisted real estate and infrastructure. We see opportunities, notably in Europe, but also a strong need for a selective approach.

MULTI ASSET

Policy uncertainty has rarely been as high. By contrast, financial-market volatility remains unusually low. This is hardly reassuring. Against this backdrop, we are looking to reduce overall risk.

OUR FORECASTS

We keep our growth forecast for 2017 unchanged. Yields on government bonds look set to slowly rise, alongside global economic growth and inflation.

ABOUT US

Deutsche Asset Management is one of the world's leading investment-management organizations. We provide retail as well as institutional investors with advice to realize their investment goals.

The price of globalization

» Globalization has brought about a convergence of prosperity between emerging and advanced economies but also a shift in labor and capital costs. «

Discussions about globalization often involve the issue of wealth redistribution. Empirical studies conducted on this issue by economist Branko Milanovic[1] show middle-class incomes in advanced economies have stagnated since 1988. The middle class in many Asian economies and the upper class in advanced economies, on the other hand, have enjoyed rising incomes. But globalization has also had another effect: a change in the cost ratio between labor and capital. This becomes more evident when looking at the number of hours a U.S. wage earner needs to work to be able to afford an S&P 500 Index basket of shares.[2] These hours have been rising sharply since 1995.[3] Companies in advanced economies have been among the real winners of globalization. By shifting their production abroad, they have been able to take advantage of the lower wage level in emerging economies. Workers in advanced economies, however, had to learn to be satisfied with low wage increases to keep jobs from wandering abroad.

The flexible labor market is most probably the main reason the United States has been able to avoid any sustained increases in unemployment after periods of crisis or economic downturns. A consequence of this flexibility, however, is that the proportion of non-supervisory employees in the production sector has increased by just under 8 percent since the mid-1960s. It can also be shown that this development is accompanied by a falling wage ratio (ratio of labor income to total income), which in turn means that the growth of labor income (average hourly wages) has not been able to keep pace with the growth of capital income. The moderate development in wages (lower costs) has further led to a significant increase in corporate profits. This again benefited U.S. equities. All of these developments combined have caused a change in the price relationship between labor and capital.

More winners than losers

The study by Branko Milanovic also shows that there have been more winners than losers. However, it suggests the divide between the rich and the poor within countries has widened. At the same time, he concluded that thanks to globalization, the income differential between workers in emerging economies and those in advanced economies has narrowed. Globalization has also brought greater global economic growth, which means a higher standard of living for everyone.

Companies also take a close look at tax rates when deciding where to locate. One result of this has been a decline in tax rates. Whereas the average corporate tax rate on gross earnings in the United States in 1974 was 46%, today it is just above 25%. This decline has also been a boon for the S&P 500 Index.

Since the mid-1990s, the S&P 500 Index has been trading at higher multiples. In the period from 1964 to 1994 – which also marked the beginning of the rise in the hours worked for a basket of shares – the average price-to-earnings (P/E) ratio for the S&P 500 Index[4] hovered around 14.4. Since 1995, the average P/E ratio has risen to 25.5. This rise was fueled by the trend in interest rates, which declined as a result of lower inflation prompted by globalization. The result: shares became more attractive relative to bonds, and their P/E ratios climbed.

Redistribution effects are fading

We do, however, see early signs that the effects outlined above are fading. The wage ratio for private-sector-pro-

duction and non-supervisory employees, which has declined for decades, has been lingering at around 23% since 2010. This is good news for about two thirds of wage earners in the United States. For U.S. shareholders, however, it's nothing to be enthusiastic about. After all, a rise in the long subdued wage ratio could mean that corporate profits as a percentage of domestic income may fail to rise further.

It would be a mistake to deduce from the above that corporate profits are set to stagnate. Over the long term, it's not the redistribution of income that boosts profits but productivity gains. The U.S. administration's deregulation agenda may help speed up productivity increases and further fuel the U.S. stock market. This, combined with a low-interest-rate environment, is one reason in favor of staying invested in the stock market.

[1] Branko Milanovic: Global Inequality. Migration, the one percent and the future of the middle class. October 2016
[2] Shares included in the S&P 500 Index weighted by market capitalization. The total value of these shares equals the S&P 500 Index and reflects its performance.
[3] The price of the S&P 500 Index was compared to the average hourly wage of private-sector production and nonsupervisory employees excluding agriculture. The average hourly wage includes employee social security contributions but not those of the employer.
[4] Robert Shiller: U.S. Stock Markets 1871-Present and CAPE-Ratio. Online Data, Yale University from 3/17/17

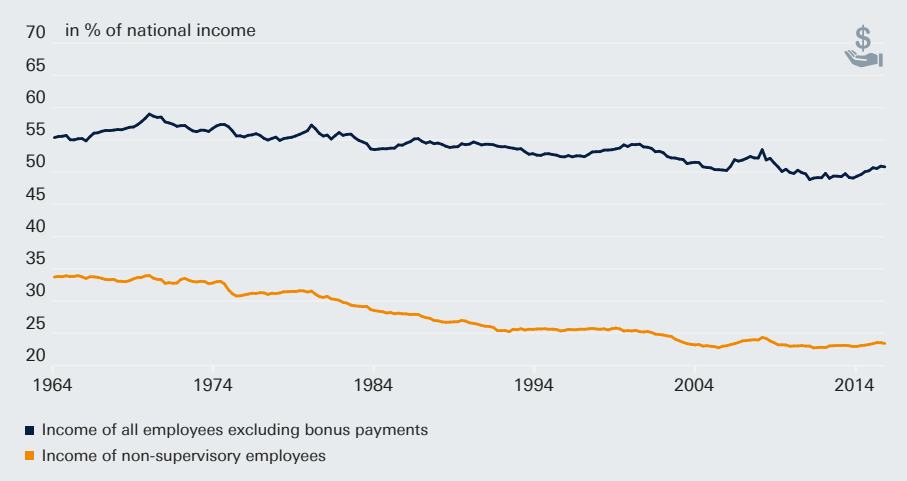
Number of work hours for an S&P 500 basket of shares

Over the past 24 years, the S&P 500 basket of shares has become significantly more expensive relative to wages.

Source: Thomson Reuters Datastream; as of 3/17/17

Income ratio for U.S. workers

Until 2009, the trend in income for non-supervisory employees declined.



Source: Thomson Reuters Datastream; as of 3/17/17

Back on track for growth

» Growth momentum is gaining regional breadth, thereby increasing the stability of the global economy. Politics remain a stress factor. «

Phil Poole
Global Head of Research

The catalog of risks threatening the extended upswing is long indeed. We have U.S. President Trump who in his "America First" campaign raised, among other issues, the prospect of protectionist politics. Then, there are EU opponents and nationalists, especially in the Eurozone, who may gain momentum ahead of the upcoming elections. And high corporate debt in China, which is weighing on the outlook for growth. Despite these risks, the global economy maintains its moderate growth momentum. One indicator of this are the purchasing managers indices, which show that the majority of purchasing managers expect a further improvement in the economy.

Among the advanced economies, the United States is expected to make a major contribution to global growth. In 2017, U.S. real gross-domestic-product (GDP) growth should accelerate by 0.6 percentage points to 2.2 percent. Gross investments are expected to make a larger contribution this year after falling in the prior year and limiting growth. Unemployment is likely to continue to decline to the level of full employment. This should provide a moderate boost to wages and allow the upward trend in consumption to continue. Higher wages and increased demand could drive the core inflation rate to 1.9 percent, which would be just 0.1 percentage points below the target inflation rate set by the U.S. Federal Reserve (Fed). This supports the notion that the Fed may announce another two to three moderate rate hikes before March 2018.

The Eurozone is also continuing its moderate upswing. Sentiment indicators such as consumer confidence and purchasing managers' expectations, as well as hard data such as industrial production and order intake, point to continued steady economic development ahead. The still relatively high aggregate unemployment rate, however, is likely to limit any increase in wages in the Eurozone, despite the trend of falling unemployment. This would indicate a more moderate rise in consumption, which would in turn impede overall growth momentum. Another factor that could potentially limit growth is politics with important elections taking place in the weeks and months to come. This may initially put a damper on investment activities, at least until investors can gain more clarity. Despite these headwinds, the Eurozone's economy is still expected to grow 1.5 percent in 2017 and 1.4 percent in 2018. A rise in inflation should be enough to cause the European Central Bank (ECB) to reconsider its loose monetary policy. In addition, the ECB's self-imposed limit to buy only up to one-third of an issuer's bonds greatly limits the universe of bonds that come into question. This is another argument why the ECB will likely consider ending quantitative easing (QE). On the other hand, the ECB's interest could continue to limit a growth-inhibiting rise in yields and strengthen the banking sector. It is

OUR EXPECTATIONS IN A NUTSHELL

U.S. growth is accelerating, which suggests further step-ups in interest rates by the Federal Reserve

The Eurozone continues to grow moderately. The ECB is likely to maintain its expansive monetary policy at least until the end of 2017

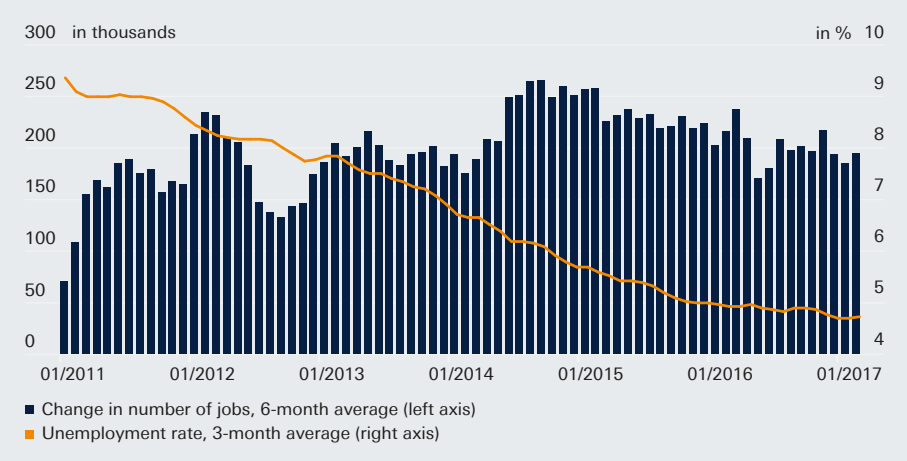
Private consumption is taking center stage in China, creating higher economic stability

conceivable that the first step will be to taper quantitative easing followed by moderately raising interest rates. This would mean that the banking sector would have to continue operating in a low-interest-rate environment. However, if that were the case, the sector could find compensation, if needed, in the form of low-interest, targeted long-term refinancing operations (TLTROs).

The main growth engine for the global economy among the emerging economies is Asia. China plays an important role in this region's growth due to its size. Through gradual change, the Chinese government wants to get a handle on the problems it faces from bad investments, overcapacity and high debt in the state-owned corporate sector. Private consumption as a growth vehicle has been gaining in importance since 2015, which leads us to expect China's economy to grow by 6.3 percent p.a. in both 2017 and 2018. On the whole, it can be said that the picture for the advanced and emerging economies is mixed. A look at the individual countries also shows that the upturn is gaining regional breadth. The peripheral countries in the Eurozone are also likely to continue their recovery in 2017. The U.S. economy is growing stronger again. The economies in Brazil and Russia, which had been suffering from falling commodity prices, are also likely to slowly trend higher in the years ahead.

Strong U.S. labor market

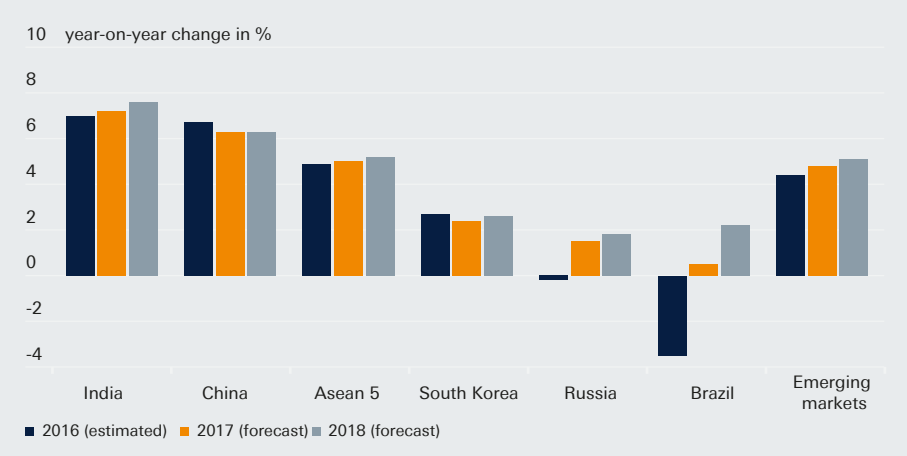
The number of jobs continues to grow, and unemployment is low. Finally, it is starting to look like full employment may be achieved in the United States.



Source: Thomson Reuters Datastream; as of 3/16/17

Emerging economies register real growth

The upswing in the emerging economies is gaining breadth. The economies in Brazil and Russia should resume growth.



Sources: International Monetary Fund, Deutsche Asset Management Investment GmbH; as of 3/23/17

The environment is becoming more confusing for bond investors

» While politics and growth are playing a greater role again for rates in the U.S., markets in Europe are looking at the ECB and its slow exit from quantitative easing. «

Joern Wasmund
Global Head of Fixed Income/Cash

OUR EXPECTATIONS IN A NUTSHELL

The U.S. market is more puzzled by politics than by the central bank

Tapering discussions in Europe may increase; but QE exit set to be different than in the U.S.

We do not expect a strong rise in interest rates or a change in spreads any time soon

Despite the political noise in recent months, central-bank actions have remained important catalysts for bond markets, though with varying effect. The U.S. Federal Reserve (Fed) is following a gradual path of interest-rate hikes, and the European Central Bank's (ECB) quantitative-easing (QE) program is likely coming to an end after two years. The Bank of England, on the other hand, is tending to be more pragmatic in light of Brexit and is temporarily willing to tolerate higher inflation. It is interesting to note that at the end of the quarter the ten-year government-bond yields in the United States were roughly as high as they were when the year began, while yields in Germany rose and in the UK they fell. This leads us to several conclusions:

1. As can be seen by the trend in interest rates and the U.S. dollar, the "Trump trade" has already retreated from an intermediate high. What this means for the future is anyone's guess. It certainly doesn't indicate an end to the U.S. economy's euphoria about the new Republican-led Congress. But the first disappointment must have surely occurred after the administration's bumpy start, which was sealed with the failure of healthcare reform, thereby raising questions about Trump's backing in Congress.

2. Interest-rate developments are driven by several factors that vary for each region. In the United States, there is almost an uncommon consensus regarding the Fed's next steps, while disagreement over the ability of politics to stimulate economic growth is likely to increase. In the UK, the central bank needs to keep an eye on both the potential impact of Brexit and rising inflation. In Europe, on the other hand, the focus is less on actions than on forecasts. For although the ECB continues to buy bonds, rising Bund yields show that...

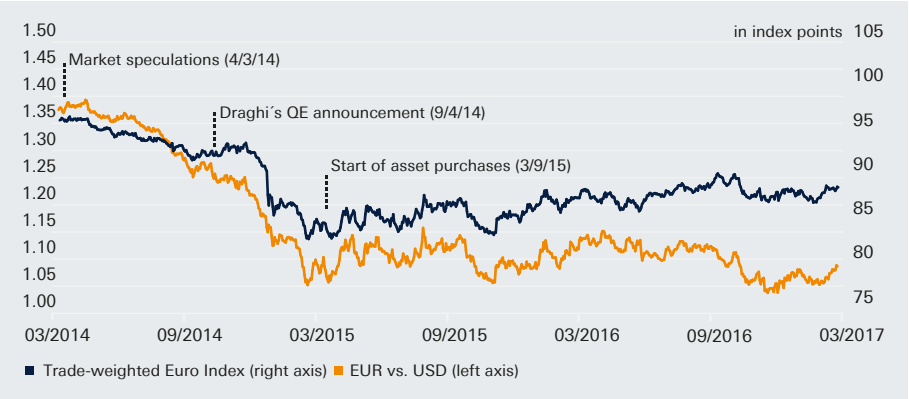
3. ...words are more powerful than actions when it comes to moving markets. This was already clear when the buying program was initiated roughly two years ago. Bund yields, peripheral spreads and the euro had their strongest reaction in the period that started with the first rumors in April 2014 up to the initiation of buying in March 2015. The latter even caused a renewed rise in both yields and the euro.

The ECB's end to QE is likely to be different from the Fed's

This observation will be an important one in 2017 because we expect the tapering discussion to flare up again no later than this summer. We also anticipate ECB buying volumes to decline starting in early 2018. It would be a mistake, however, to make a direct comparison with the Fed. While the Fed's aim is to 'merely' ensure employment and price stability, things are a little more complicated for the ECB. The ECB also needs to keep interest-rate spreads in the periphery low, stimulate lending and keep the euro in check. All this for a heterogeneous monetary union, which, in our view, requires a slower, different kind of exit from QE. For example, bond purchases and key-interest-rate policies could be distinctly decoupled from one another. ECB president Draghi could continue QE until he is no longer worried about peripheral countries. If on the other hand, inflation sees a more sustainable increase, he could then start to adjust interest rates. The market is well aware of this dilemma, which makes it even more difficult to extract any clear meaning from the ECB's words and actions. The problem with interpretation is that it offers no help in reducing the volatility of European bond markets.

The euro faltered long before the ECB's QE

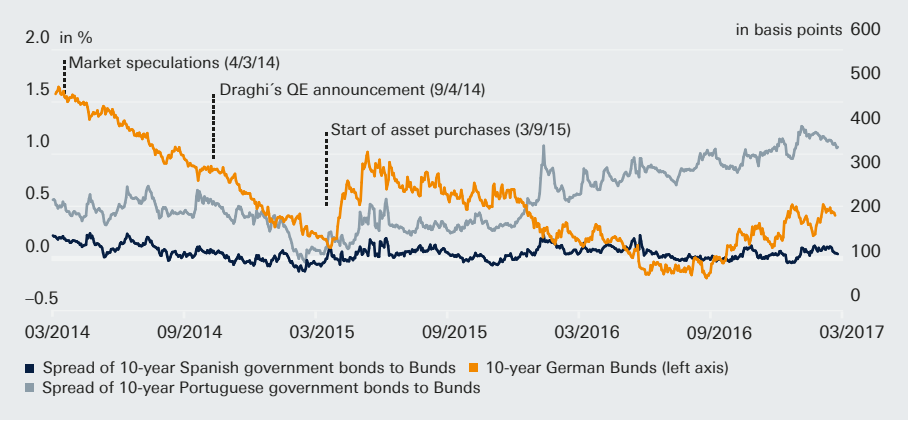
The euro already started to weaken with the first rumors of bond-buying from the ECB. As the buying began, the euro strengthened.



Source: Thomson Reuters Datastream, Deutsche Asset Management Investment GmbH; as of 3/28/17

Bund yields and spreads surprise

Bund yields and premiums on peripheral bonds narrowed before, not after, bond-buying.



Source: Thomson Reuters Datastream, Deutsche Asset Management Investment GmbH; as of 3/28/17

Politics trump macro consensus on currency markets

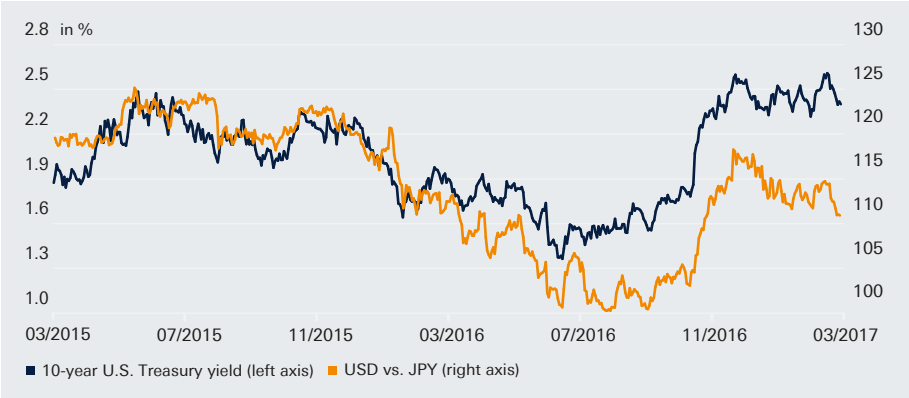
» "Health-care reform is dead, long live tax reform." The speed of Congress approval for a fiscal stimulus package is likely to drive the U.S. dollar. «

Dirk Aufderheide
Chief Currency Strategist

After President Trump failed to unite the Republican Party on the health-care reform, markets will closely watch his ability to push a tax reform through Congress. This is likely to affect U.S. yields, which are a dominant factor for U.S. dollar valuation. Its weakness primarily against the Japanese yen (JPY) came after U.S. yields started sliding in mid-April. We still regard this weakness as a consolidation. Once investors' positioning looks clearer, we expect the dollar to strengthen again. However, this would require the negative Trump-related news flow to abate. Euro strength is based on strong macro data as well as fading worries around the French presidential election. The periphery's yield spreads against Bunds narrowed as did the Bund spread against U.S. Treasuries, supporting the euro. Nonetheless, we view any near-term politically-driven appreciation as a selling opportunity. Concerning the yen, it still remains the most reliable currency if market volatility is rising. However, the Bank of Japan is unlikely to change its monetary course of fixing parts of the yield curve soon. Therefore, any rise in U.S. yields is likely to lead to yen weakness. Hence, we prefer to sell the yen into any further rally.

USD/JPY closely aligned with U.S. rates

Japanese yield stability makes the yen susceptible to U.S. yield changes.



Source: Thomson Reuters Datastream; as of 3/28/17

There is a good reason why markets are expensive

» Equities are expensive by nearly all measures. Still, given the robust economy, we would use any dips in the market as potential buying opportunities. «

Should a woman marry a man just because he is the only one left on the market? Any mother who would pressure her daughter to take such a step would certainly be forgiven for misplaced intentions. But what about an asset manager who recommends stocks simply due to a lack of alternatives? And at a time when stock valuations are historically high, almost reaching the manager's own price target? Needless to say, we wouldn't condemn him right away. Because, despite the S&P 500 Index tripling over the past eight years, an economic upswing that's starting to show its age and profit margins that appear to be peaking, plenty of reasons to buy stocks remain:

The global upswing still may have room to go. Much of the latest economic data surprised to the upside and many corporate executives are more optimistic than last year. So far this year, earnings estimates have been moving higher overall, contrary to the usual seasonality. We too raised our earnings estimates and price targets slightly for almost every region. The upturn is already in its eighth year. If it continues at the 3.5 percent growth rate we expect, the global economy would have grown six consecutive years at rates ranging from 3.1 to 3.5 percent. Some could see this as a negative. After all, the global economy is close to scraping the three-percent recession threshold postulated by the International Monetary Fund (IMF), despite the continued support of central banks. A positive way to look at it, however, is that central banks stand ready to help, whereby, at these growth rates, there's no apparent real threat of a strong turnaround in interest rates. For some investors, the prolonged period of low interest rates might be a reason to accept a lower risk premium.

We are still not seeing any of the broad signs typical for a sustainable market correction or, above all, a recession in the foreseeable future. Historically in the U.S., only one of five bear markets in the past 50 years occurred outside of a recession.

Thomas Schuessler
Global Co-Head of Equities

Andre Koettner
Global Co-Head of Equities

Of course, we are still aware of the potential downside risk inherent in markets with the current valuations and economic-policy risks, despite those arguments. Political and macroeconomic unpredictability is nothing new. The future has always been uncertain. What's remarkable is the accumulation of events that currently define the headlines and have the potential to cause paradigm shifts.

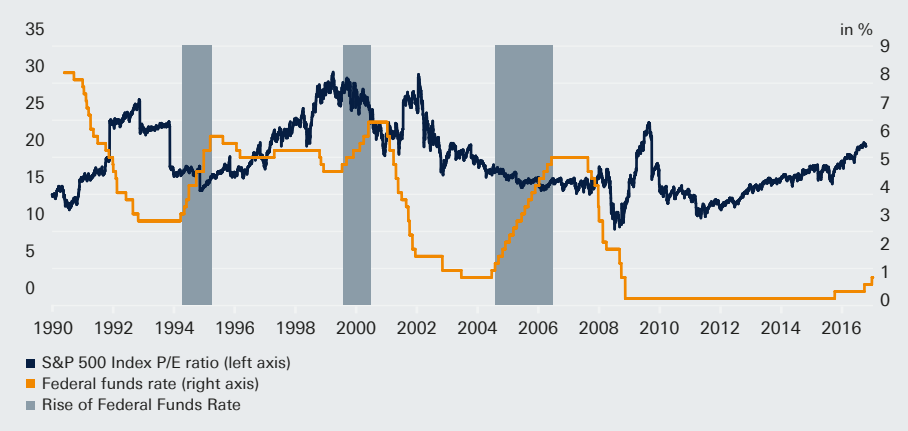
Just as remarkable is the relative serenity of investors. It could be due to the fact that these processes are often subtle and have only a gradual effect on the economy. Similar to Trump's ideas about protectionism and world trade. However, the new U.S. administration could disappoint rather soon if it cannot manage to lower corporate taxes still in the current year. In that case, U.S. companies could only look forward to the prospect of a rollback in regulation to fuel their enthusiasm for the new power constellation in D.C. Ironically, only the earnings estimates for the S&P 500 Index have been cut so far this year. Although we still expect a moderate decline in tax rates to 25 percent, we are no longer sure if this will still have an effect on earnings in 2017.

«The market is close to fair value on a twelve-month view. We would not be surprised to see some interim exaggerations on both the up- and the downside."

Andre Koettner,
Global Co-Head of Equities

Rapid interest-rate increases are unpopular with investors

Rising federal funds rates usually signal a robust economy, but also put pressure on equity valuations. Sharp rises have an even greater effect on P/E multiples.

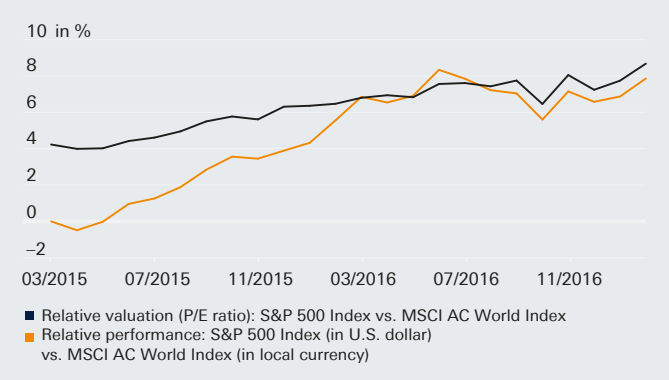


Source: Factset Research Systems Inc., Deutsche Asset Management Investment GmbH; as of 3/26/17

Valuations overview

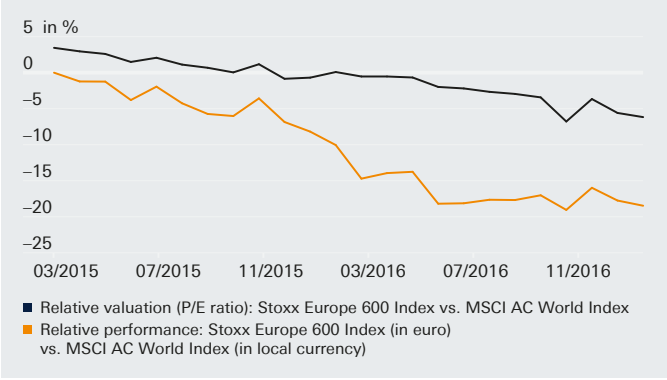
Equities United States

In 2017, we expect the S&P 500 Index to return to double-digit earnings growth for the first time since 2011. Business and consumer sentiment is positive, and there is no break-out in long-term interest rates. Valuations and the potential for disappointment created by the new administration are the reasons we maintain our "neutral" rating.



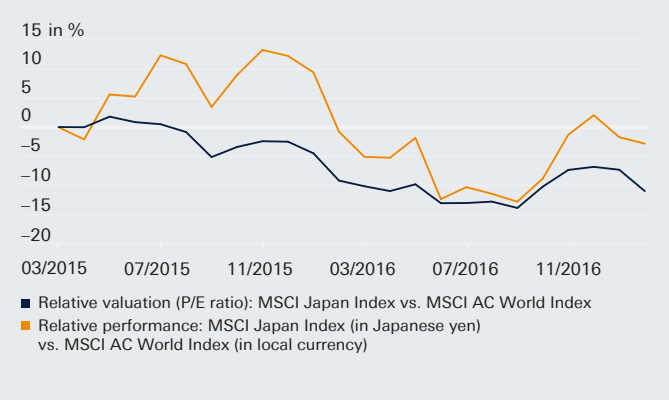
Equities Europe

Many of the economic indicators in Europe are improving. One reason is that companies are benefitting from stabilization in the export markets. The mood is being dampened, however, by the effects of Brexit and the pending elections in the fragile Eurozone. In February, we raised our rating on German equities to "overweight".



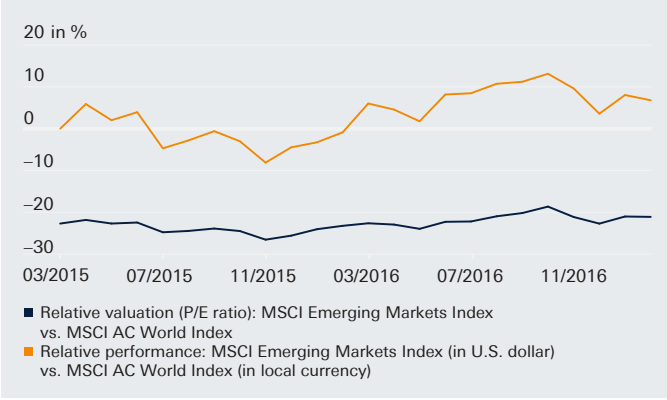
Equities Japan

We believe Japan's fundamentals remain strong, as do companies' balance sheets. The yen has, however, been gaining ground against the dollar since mid-December, which weighs on Japanese equities. Furthermore we fear that companies will guide cautiously and that funds will flow from Japan to EM. We are reducing our rating to "neutral".



Equities emerging markets

The emerging economies trailed global stock markets from 2010 to 2016. We were initially skeptical about their recovery in 2016 because it was largely linked to the oil price. In the meantime, we are seeing political and macroeconomic progress in several of these countries, while central banks continue to have ample room for maneuver. Country selection is still important.



Sources: FactSet Research Systems Inc., Deutsche Asset Management Investment GmbH, as of 3/28/17

Finding the right niches

» Investor interest remains high in both unlisted real estate and infrastructure. We see opportunities, notably in Europe, but also a strong need for a selective approach. «

Mark G. Roberts
Head of Research & Strategy, Alternatives

OUR EXPECTATIONS IN A NUTSHELL

Correlations across real-estate markets continue to decline

Taking selective bets on micro locations and segments with solid prospects is key

In regional terms, Europe looks relatively well positioned

All real estate is local. In recent years, however, this old adage has frequently been overshadowed by loose monetary policies in much of the developed world. Falling return expectations for traditional asset classes have boosted investor interest in alternatives, notably real estate and infrastructure.

Well, monetary policy is already past its inflection point in the U.S. In Europe, too, the beginning of the end of quantitative easing may be getting closer. One upshot of this is that correlations across real-estate markets continue to decline. Going forward, we are likely to see divergences both across and within regions.

Put succinctly, the U.S. real-estate cycle is maturing. Continental Europe looks relatively well positioned, as initial yields remain above the global average. Meanwhile conditions remain mixed in the Asia Pacific region, with trade policies under new U.S. President Trump a key concern. From a sector perspective, logistics continues to benefit from the secular shift towards online retailing.

These broad trends, however, hide as much as they reveal. For example, the scope for internet-driven growth in logistics space naturally depends on how large online sales already are in the market in question. Meanwhile, the impact on traditional retail real estate such as shopping centers varies, with prime locations more than holding their own. Indeed, well-configured retail space in the right locations can actually benefit from more time and money being spent on services that cannot be delivered online, such as dining, health care, fitness and the like.

Looking beyond broad trends

2016 was a strong year for U.S. commercial real estate. For the most part, demand continued to outstrip supply, pushing vacancy rates lower and rents higher. Prices generally ended the year above where they started, delivering total returns to core real estate in line with historical norms.

In more subtle ways, however, the landscape is beginning to shift. While fundamentals remain strong, and risks from new supplies moderate, areas of weakness are emerging, notably in the office sector. With the U.S. close to full employment, the scope for further job creation (requiring new office space) is limited.

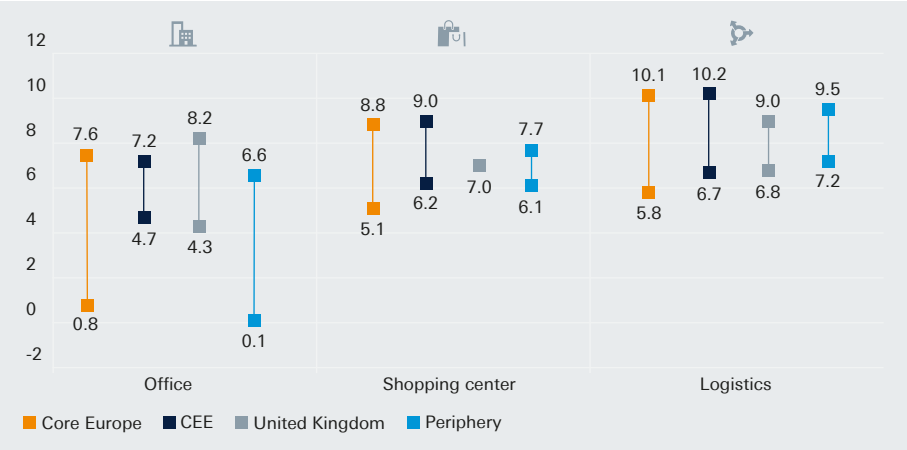
Prospects also appear somewhat subdued for U.S. residential and again it pays to look at local conditions. Among the factors to watch are the shifting life-style preferences of households, particularly millennials entering their 30s. As they start looking for a home to raise a family, this could benefit urban nodes outside central business districts, offering amenities similar to city centers and easy commutes.

European real estate too has provided investors with exceptionally high levels of return over the past few years. However, we are now seeing signs that the market as a whole is starting to moderate. While yields may not yet have reached a trough, and further rental growth is certainly likely, countries such as Germany may now be entering a more mature stage of this cycle.

Real estate in core Europe markets still compares well to other asset classes, but further falls in initial yields during the second half of 2016 are adding to the likelihood of lower absolute returns over the next five years. In the short term, we still see the potential for further real-estate yield compression, driven in part by the current large spread over bonds, as well as the expectation of further rent growth. In the longer term, rising real rates would no doubt be an issue. The key remains taking selective bets on emerging micro locations and niche segments with solid growth prospects, while keeping an eye on political risks. An alternative worth considering could be unlisted European infrastructure, where a reasonable premium over government yields looks achievable and active asset management can create further value.

European prime total returns by sector and region

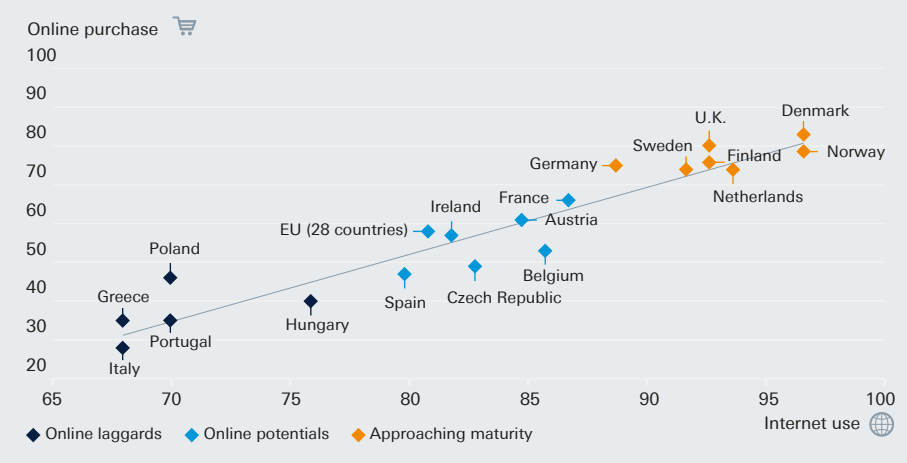
Even within Europe, there is a wide range of expected total returns across different sectors and regions.



Source: RREEF Management LLC, as of 12/2016
Notes: Range shows forecasted top and bottom performing market in each region in % p.a. for 2017-21.

Online leaders vs. online laggards

In assessing the impact of online retailing, attention needs to be paid to how close a country is to maturity.



Source: Eurostat, as of 12/2016
Notes: Horizontal axis shows the proportion of people who have used the internet in the past twelve months; vertical axis shows the proportion of people who have used the internet to make a purchase in the past twelve months.

Getting a tad cloudier

» On both sides of the Atlantic, policy uncertainty has rarely been as high. Not that you would know by looking at financial-market volatility. «

Christian Hille
Head of Multi Asset

Financial markets have been unusually sure-footed, following last year's electoral surprises and ahead of further political risks such as the French elections. This curious fact has not escaped the attention of some of the world's leading central bankers.

As the Bank of England noted in its recent Financial Policy Committee statement, "the high degree of uncertainty in many advanced economies appears not to be fully reflected in asset prices (…) or in measures of market volatility, which remain subdued."

Tactical management remains critical

Measures of implied equity-market volatility indeed remain low, despite occasional, temporary rebounds. Meanwhile, valuations, especially in the U.S., still look stretched and investor positioning not particularly cautious.

Against this background, two questions arise. The simpler one is how to position our multi-asset portfolios. Volatility remains at historically low levels, still offering opportunities for long-dated derivative trades to benefit from tail events being underpriced. Our forecasts reflect an only muted total-return outlook for many asset classes. While macro data have been quite positive lately, economic surprise indicators show early signs of expectations having run too far. On a twelve-month horizon, we only see mid-single-digit gains from current levels for equities, for example. Directionally, we are looking to reduce overall risk over the course of the quarter.

However, this does not imply scaling back risk right away. Instead, we are looking to trade contrarian to make tactical adjustments. Continuing market strength would make some kind of limited correction even more likely. We would react to such a correction by buying into the dips. Europe, in particular, might prove well positioned if and when political risks fade further.

Timing such things is always tricky, of course. This takes us to the second, tougher question, which concerns the longer-term outlook for volatility.

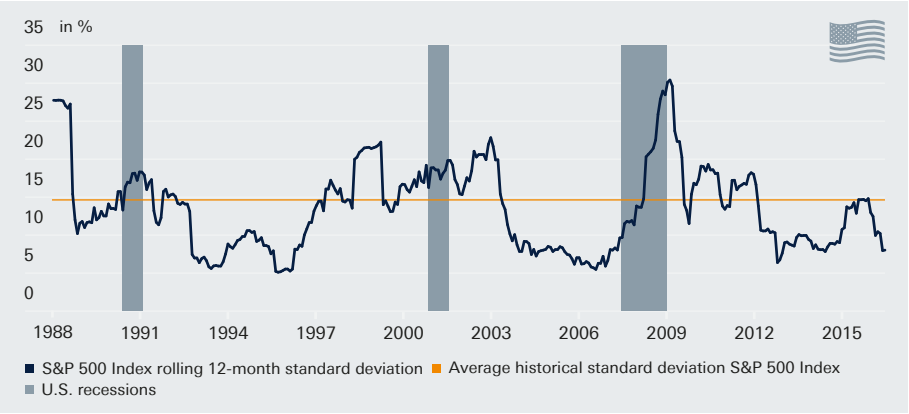
Relatively calm – for now

When you look at actually realized volatility in equity markets and related segments, there has been a clear downward trend in recent years. One plausible explanation for this is monetary policy. Investors have grown used to central-bank activism in the face of market tantrums. This resulted in historically low yields and high equity-market valuations – which necessarily reduces return potential going forward. As the Fed started to increase rates, volatility in fixed-income markets has already rebounded in recent months.

For now, sovereign yields look set to rise but at a moderate pace, with central banks tentatively trying to exit ultra-loose monetary policies. Credit should remain supported, as the hunt for yield continues. Liquidity remains key, which is why we prefer a barbell strategy in fixed income, with increased cash allocation on the one hand and higher yielding assets, such as emerging-market debt, on the other.

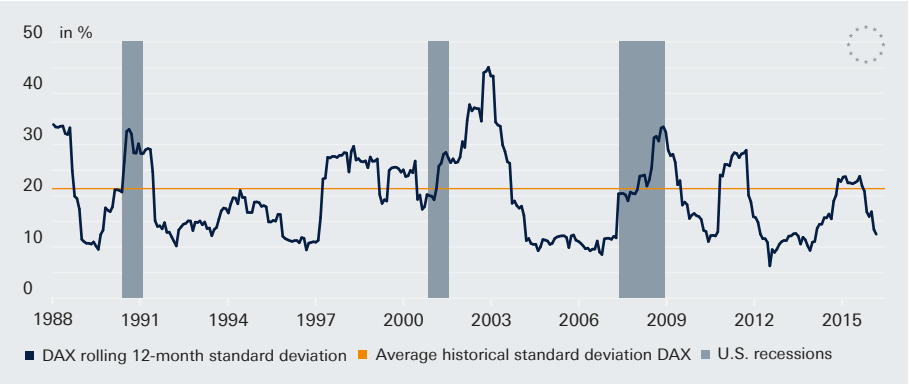
From a longer-term perspective, the fact that central bankers themselves seem puzzled by the low-volatility world they helped originate is hardly reassuring. To be sure, investor demand for income-generating assets should mitigate higher volatility. Moreover, low volatility is not a good timing indicator. It can either lead you to be too early in trading contrarian – or too late, with more severe implications on portfolio risk. Still, it is worth keeping in mind that neither central banks nor other policy makers can eradicate risk forever.

Volatility remains low in U.S. equity markets ...



... but has already rebounded in U.S. Treasuries

In Europe, equity-market volatility remains low



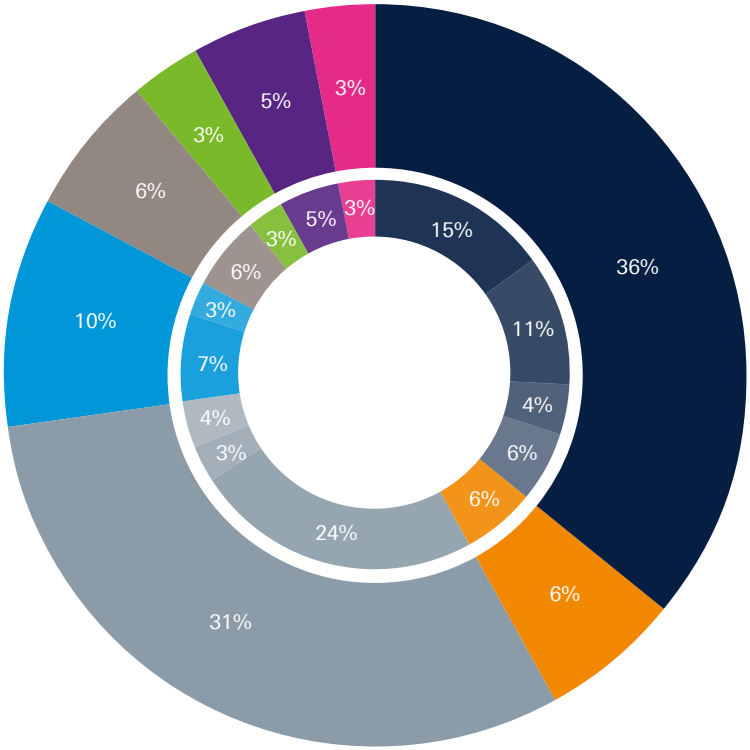
Sources: FactSet Research Systems Inc., Deutsche Asset Management Investment GmbH; as of 02/2017

Getting slightly more cautious

» We are scaling back equity exposure slightly and favor carry assets within fixed income. «

The year has started well, limiting overall total-return expectations going forward. Given stretched valuations, a temporary correction looks likely. Within a slightly reduced equity exposure, we favor Europe and emerging markets. In fixed income, we believe a short-duration stance may be a prudent approach to take. We remain underweight in sovereigns, but slightly less so, as we expect rates to rise only at a gradual pace. Fixed-income credit should remain supported, but the spread environment needs to be monitored closely in the light of central-bank communication.

In this environment, a barbell strategy, consisting of liquid cash-enhanced segments and higher-yielding assets (notably emerging-market debt) may be worth considering. Within commodities, we are positive on cyclical sectors and see gold as a valuable diversifier from a multi-asset perspective.



Developed-market equities	
United States	15%
Europe	11%
Japan	4%
Global Equity Style	6%
Emerging-market equities	
Emerging-market equities	6%
Fixed Income: Credit	
Euro investment grade	24%
U.S. investment grade	0%
Euro high yield	3%
U.S. high yield	4%
Fixed Income: Sovereigns	
Eurozone sovereigns	7%
U.S. Treasuries	3%
Fixed Income: Emerging markets (hard-currency)	
Emerging-markets bonds	6%
Convertibles (euro-hedged)	
Convertibles	3%
Commodities	
Commodities	5%
Alternatives	
Alternatives	3%

The chart shows how we would currently design a balanced, euro-denominated portfolio for a European investor taking global exposure. This allocation may not be suitable for all investors. Alternatives are not suitable for all clients.

Source: Multi Asset Group, Deutsche Asset Management Investment GmbH, as of 3/29/17

As good as it gets?

» Currently, indicators paint a positive picture. Uncertainties remain, however. «

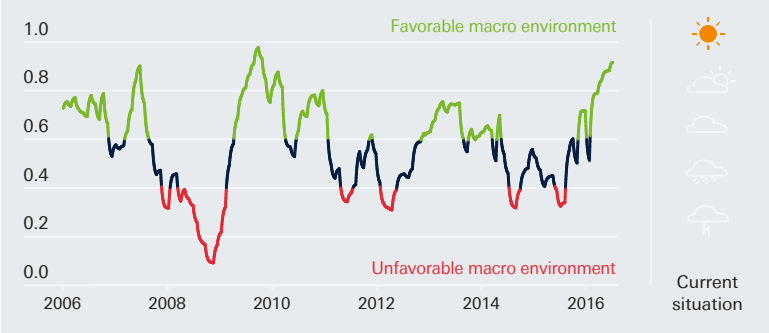
The current financial-market environment is mostly friendly as reflected by our multi-asset indicators. Particularly positive signals are coming from the macroeconomic side. Supported by strong fundamentals, the macro indicator has been rising steadily since the fall of 2016. Its high values continue to show a solid macroeconomic base.

The euphoria seen after the U.S. elections has recently faded slightly as doubts have risen as to the timely implementation of President Donald Trump's policies. This is also reflected in the development of the risk indicator, which recently dipped following a continuous uptrend. However, it remains at a high level.

A look at the surprise indicator shows that the recently published data in Europe have surprised slightly on the negative side when compared with analyst consensus. The data in the United States and Asia, on the other hand, have continued to surprise positively. Overall, the three indicators paint a positive picture, despite some weakness in the risk and surprise indicators.

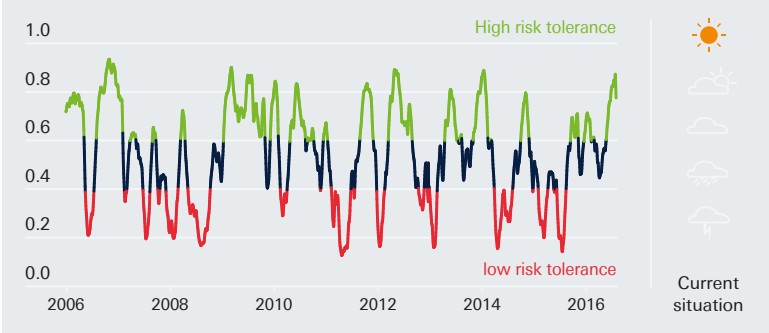
Macro indicator

Consumer confidence, trade figures, unemployment numbers: The macro indicator condenses a wide range of economic data.



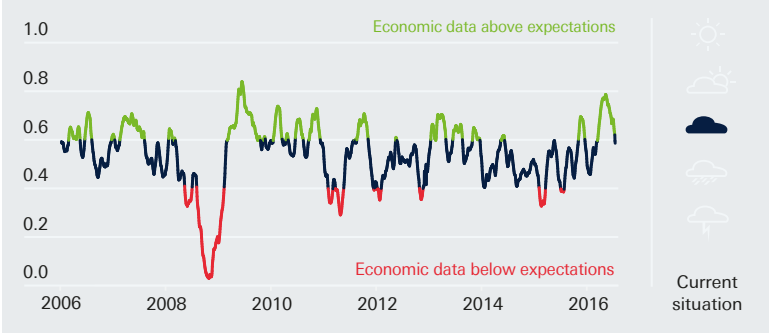
Risk indicator

Our risk indicator reflects investors' current level of risk tolerance in the financial markets.



Surprise indicator

The surprise indicator tracks economic data relative to consensus expectations.



Source: Deutsche Asset Management Investment GmbH; as of 3/24/17

Still on track

Our global growth forecasts are unchanged, with moderate upgrades for the Eurozone and the UK. Monetary policy will probably continue to diverge. The Fed looks set to raise rates two to three times within the next twelve months. Meanwhile, central banks are likely to remain supportive in Japan and the Eurozone, with the ECB unlikely to hint at tapering before the second half of the year. We are keeping a close eye on the political events in Europe and potential protectionist measures in the U.S. Sovereign rates should modestly rise as global growth and inflation accelerate somewhat. Business-friendly policies in the U.S., such as deregulation and potential tax cuts, should benefit U.S. corporates. A lower-default-rates environment

Macro | Solid growth

GDP growth in % (year-on-year)

Region	2017F		2018F
United States	2.2	↗	2.4
Eurozone	1.5	↘	1.4
United Kingdom	1.6	↘	1.3
Japan	1.1	↗	1.6
China	6.3	→	6.3
World	3.5	↗	3.7

Fiscal deficit (in % of GDP)

Region	2017F		2018F
United States	3.3	↗	3.6
Eurozone	1.6	→	1.6
United Kingdom	3.5	↗	3.6
Japan	5.2	↘	5.0
China	3.4	↘	3.2

Consumer price inflation (in %)

Region	2017F		2018F
United States[1]	1.9	↗	2.0
Eurozone	1.7	↘	1.5
United Kingdom	2.5	→	2.5
Japan	0.7	↗	1.0
China	2.4	↗	2.5

Current-account balance (in % of GDP)

Region	2017F		2018F
United States	–2.9	↘	–3.1
Eurozone	2.9	↘	2.7
United Kingdom	–4.5	↗	–3.5
Japan	3.2	→	3.2
China	2.2	↗	2.4

Benchmark rates in %

Region	Current*		Mar 2018F
United States	0.75–1.00	↗	1.50–1.75
Eurozone	0.00	→	0.00
United Kingdom	0.25	→	0.25
Japan	0.00	→	0.00
China	4.35	→	4.35

Commodities

in U.S. dollars	Current*		Mar 2018F
Crude oil (WTI)	51	↗	58
Gold	1,249	↘	1,200
Copper (LME)	5,838	↗	6,200

WTI = West Texas Intermediate
LME = London Metal Exchange
F refers to our forecasts as of 3/23/17.
* Source: Bloomberg Finance L.P.; as of 3/31/17
[1] core rate, personal consumption expenditure Dec/Dec in % (no average as for the other figures)
Source: Deutsche Asset Management Investment GmbH; as of 3/31/17

and the search for yield should support high yield, particularly in the U.S. In Europe, investment-grade credit looks well positioned, given loose monetary policy and limited supply. Meanwhile, emerging-market bonds could benefit from slightly falling spreads. On equities, we remain constructive and would use setbacks as a potenti-al buying opportunity. After the strong start to the year, the upside from cur-rent levels looks limited, however. We favor Europe, which may outperform in the aftermath of the French elections. The U.S. dollar currently looks well sup-ported, given higher U.S. growth and interest rates, as well as current fund flows. We are sticking to our parity forecast of EUR/USD for now, but may have to revisit this, if European political risks recede further.

Fixed Income | Yields to rise

	Current*		Mar 2018F
United States			
U.S. Treasuries (10-year)	2.39%	↗	3.00%
U.S. municipal bonds	95%	→	96%
U.S. investment-grade corporates	112 bp	↘	100 bp
U.S. high-yield corporates	383 bp	→	400 bp
Securitized: mortgage-backed securities[1]	87 bp	↗	105 bp
Europe			
German Bunds (10-year)	0.33%	↗	0.80%
UK Gilts (10-year)	1.14%	↗	1.75%
Euro investment-grade corporates[2]	126 bp	↘	100 bp
Euro high-yield corporates[2]	348 bp	↗	375 bp
Securitized: covered bonds	58 bp	↗	75 bp
Italy (10-year)[2]	198 bp	↘	180 bp
Asia-Pacific			
Japanese government bonds (10-year)	0.07%	→	0.00%
Asia credit	220 bp	↗	235 bp
Global			
Emerging-market sovereigns	306 bp	→	300 bp
Emerging-market credit	306 bp	↘	290 bp

F refers to our forecasts as of 3/23/17; bp = basis points
* Source: Bloomberg Finance L.P.; as of 3/31/17
[1] Current-coupon spread vs. 7-year U.S. Treasuries
[2] Spread over German Bunds
Source: Deutsche Asset Management Investment GmbH; as of 3/31/17

Currencies

	Current*		Mar 2018F
EUR vs. USD	1.07	↘	1.00
USD vs. JPY	111.39	↗	120
EUR vs. GBP	0.85	↘	0.813
GBP vs. USD	1.26	↘	1.23
USD vs. CNY	6.89	↗	7.10

Equities | Expensive for a reason

Equity markets (index value in points)	Current*		Mar 2018F	Total Return (expected)**			
			Forecast	in %	Expected earnings growth	P/E impact	Dividend yield
United States (S&P 500 Index)	2,363	↗	2,400	3.9	12%	–9%	2.3%
Europe (Stoxx Europe 600 Index)	381	→	380	3.3	11%	–10%	3.6%
Eurozone (Euro Stoxx 50 Index)	3,501	↗	3,500	3.6	10%	–9%	3.6%
Germany (Dax)[1]	12,313	→	12,600	2.3	7%	–8%	2.9%
United Kingdom (FTSE 100 Index)	7,323	↗	7,300	3.8	15%	–13%	4.1%
Switzerland (Swiss Market Index)	8,659	→	8,300	–0.8	5%	–8%	3.4%
Japan (MSCI Japan Index)	905	↗	950	7.5	13%	–7%	2.4%
MSCI Emerging Markets Index (USD)	958	↗	1,000	7.0	12%	–8%	2.6%
MSCI AC Asia ex Japan Index (USD)	582	↗	600	5.6	12%	–8%	2.5%
MSCI EM Latin America Index (USD)	2,611	↗	2,650	4.2	19%	–15%	2.7%

F refers to our forecasts as of 3/23/17.
* Source: Bloomberg Finance L.P., FactSet Research Systems Inc.; as of 3/31/17
** Expected total return includes interest, dividends and capital gains where applicable
[1] Total-return index (includes dividends)

The Chief Investment Office …

… is headed by Stefan Kreuzkamp, Global CIO Deutsche Asset Management

… plays a central role in Deutsche Asset Management's investment process

… brings together the expertise of the global investment platform to create a consistent economic and market view

… serves as a point of contact between the portfolio management, the research teams and the distribution teams

… prepares our global investment outlook: the CIO View.

„Our broad geographic and thematic reach allows us to offer sector-leading assessment and analysis across all asset classes."

Stefan Kreuzkamp, Chief Investment Officer

Deutsche Asset Management[1]…

… is one of the world's leading investment management organizations with about EUR 706 billion of assets under management (as of December 31, 2016).

… offers individuals and institutions traditional and alternative investments across all major asset classes.

… provides flexible products and solutions to a wide range of investment opportunities across all asset classes – from pooled funds to highly customized portfolios for a wide range of investors.

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Glossary

» Here we explain central terms from the CIO | VIEW. «

Bank of England (BOE) – The Bank of England (BOE) is the central bank for England.

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

Barbell strategy – In finance, a barbell strategy means avoiding assets with an average risk-reward profile. A common example of this would be to invest in long- and short-duration bonds but not in intermediate-duration bonds.

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

Bunds – Bunds is a commonly used term for bonds issued by the German federal government with a maturity of 10 years.

Correlation – Correlation is a measure of how closely two variables move together over time.

Duration – Duration is a measure expressed in years that adds and weights the time periods in which a bond returns cash to its holder. It is used to calculate a bond's sensitivity towards interest-rate changes.

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

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

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

Federal funds rate – 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.

Gross domestic product (GDP) – 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.

International Monetary Fund (IMF) – The International Monetary Fund (IMF), created in 1945 and headquartered in Washington, D.C., is an organization of 188 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world.

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

Periphery countries (sometimes referred to as just the periphery) – 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.

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

Quantitative easing (QE) – Quantitative easing (QE) is an unconventional monetary-policy tool, in which a central bank conducts broad-based asset purchases.

Republican Party (Republicans) – The Republican Party, also referred to as Grand Old Party (GOP), is one of the two major political parties in the United States. It is generally to the right of its main rival, the Democratic Party.

Russell 2000 Index – The Russell 2000 Index captures the 2,000 smallest stocks of the Russell 3000 Index, which again comprises 3,000 small- and mid-cap U.S. listed stocks.

S&P 500 Index – The S&P 500 Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

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

Targeted longer-term refinancing operations (TLTROs) – Targeted longer-term refinancing operations (TLTROs) refer to the ECB's providing of financing to Eurozone banks.

Trump trade/rally – The terms "Trump trade" or "Trump rally" describe the strong movements in various asset prices in the weeks and months following the U.S. elections of November 2016.

United States Congress – The United States Congress is the legislature of the federal government. It is comprised of the Senate and the House of Representative, consisting of 435 Representatives and 100 Senators.

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

Volatility – 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.

Risk warning

Investments are subject to investment risk, including market fluctuations, regulatory change, possible delays in repayment and loss of income and principal invested. The value of investments can fall as well as rise and you might not get back the amount originally invested at any point in time.

Investments in Foreign Countries – Such investments may be in countries that prove to be politically or economically unstable. Furthermore, in the case of investments in foreign securities or other assets, any fluctuations in currency exchange rates will affect the value of the investments and any restrictions imposed to prevent capital flight may make it difficult or impossible to exchange or repatriate foreign currency.

Foreign Exchange/Currency – Such transactions involve multiple risks, including currency risk and settlement risk. Economic or financial instability, lack of timely or reliable financial information or unfavorable political or legal developments may substantially and permanently alter the conditions, terms, marketability or price of a foreign currency. Profits and losses in transactions in foreign exchange will also be affected by fluctuations in currency where there is a need to convert the product's denomination(s) to another currency. Time zone differences may cause several hours to elapse between a payment being made in one currency and an offsetting payment in another currency. Relevant movements in currencies during the settlement period may seriously erode potential profits or significantly increase any losses.

High Yield Fixed Income Securities – Investing in high yield bonds, which tend to be more volatile than investment grade fixed income securities, is speculative. These bonds are affected by interest rate changes and the creditworthiness of the issuers, and investing in high yield bonds poses additional credit risk, as well as greater risk of default.

Hedge Funds – An investment in hedge funds is speculative and involves a high degree of risk, and is suitable only for "Qualified Purchasers" as defined by the US Investment Company Act of 1940 and "Accredited Investors" as defined in Regulation D of the 1933 Securities Act. No assurance can be given that a hedge fund's investment objective will be achieved, or that investors will receive a return of all or part of their investment.

Commodities – The risk of loss in trading commodities can be substantial. The price of commodities (e.g., raw industrial materials such as gold, copper and aluminium) may be subject to substantial fluctuations over short periods of time and may be affected by unpredicted international monetary and political policies. Additionally, valuations of commodities may be susceptible to such adverse global economic, political or regulatory developments. Prospective investors must independently assess the appropriateness of an investment in commodities in light of their own financial condition and objectives. Not all affiliates or subsidiaries of Deutsche Bank Group offer commodities or commodities-related products and services.

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