Equities

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Admittedly, it's very tempting to simply reuse last quarter's article for this column. Not because it was particularly brilliant (even if we thought as much, it still wouldn't be right to mention it), but because investors today should be asking themselves precisely the same questions they did in March. That may come as a surprise given the recent political events, particularly in the United States and Europe. But the stock markets reacted to the political developments with such nonchalance and climbed to new records with such ease, that some investors actually started to get nervous. In the first half-year, the S&P 500 Index had moves of more than 1% on only four occasions, and the Stoxx Europe 600 Index on just seven occasions. At such low volatility, isn't it time that even risk-averse investors – for example, the average German retail investor – start warming up to this asset class? Every equity fund manager would welcome such a change in investors' mindset. A newfound love for equities, however, could quickly lose its bloom and see a return to the usual skepticism. We fear that equity indices, particularly those in the United States, have raced somewhat ahead of the facts; that is to say they are behaving in more of a pre-truth rather than a post-truth manner. Therefore, we see a certain risk that U.S. equities may suffer a setback during the summer or fall. Experience tells us that the other indices could also be affected, particularly if a setback turns out to be a stronger correction. The spring of 2016 was the last time we saw how quickly market corrections can develop a negative dynamic all of their own. Especially when you have too many overconfident investors.

There's no arguing that there are several factors right now that speak in favor of equities: global economic growth, in our view, should accelerate this year with central banks remaining in an accommodative mood overall. Furthermore, there are signs that the first quarter's positive reporting season may continue into the second quarter. German companies, in particular, sound pretty euphoric when it comes to their business outlook. Naturally, in such an environment, no one wants to be the first to call the end of the rally, and potentially get it wrong. And what investor would want to exit the market prematurely and leave returns on the table? This is why investors are staying invested, comforting themselves with the notion that, this time, they will surely be able to recognize a deterioration in the indicators and react in time.

Most investors, of course, are well aware that surprises, positive momentum and even economic cycles can't go on forever. Yet, the

Andre Koettner
Global Co-Head of Equities

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In a nutshell

- We're expecting further upside, especially for equities in Europe and the emerging markets.
- However, high valuations and a correction-free first half-year are cause for caution.

latter don't die of old age alone. Even though seasoned market players still stare in wonder, the current cycle, as flat as it is, keeps going and going.

Sectors – we prefer growth stocks

The character of this unusual, gracefully aging cycle leads to a composition of preferred sectors that is not typical for any given stage of the cycle: information technology (IT), financials and materials. We believe IT can deliver sales growth even in the absence of strong cyclical tailwinds. Financials on the other hand should benefit from increasing interest rates while still trading at historically low valuations. The latter also applies to the materials sector, especially the sub sector metals and mining, which also profits from stabilizing commodity prices and ongoing stable industrial activity in China. We are less enthusiastic about the other sub sector, chemicals, even though it could benefit from further M&A activity.

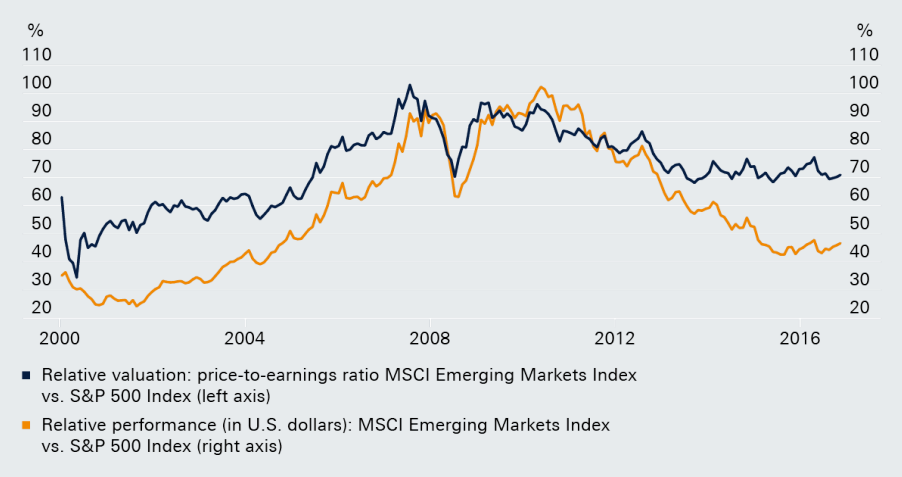
In contrast to the health-care sector, the values of the large players in the IT sector have reached such dimensions that M&A activity in this area, amongst the top players, is now unimaginable. The five companies with the highest market capitalization in the world come from this sector, four of which are focused on the internet. The digitization of industrial sectors is in full swing, IT security budgets are growing, and an end to the short product and innovation cycles in consumer IT is nowhere in sight. Compared to the tech bubble of 2000, this sector earns more than adequate margins and is trading at entirely different valuations.

Among value stocks – a term that takes some time getting used to in this context – we have preferred financials for some time. This sector profits from each and every hike in interest rates. At the same time, there are enough banks that have lately strengthened their balance sheets to the extent that we can now look forward to increasing payouts to shareholders. The wave of regulation, which has been a drag on the sector for some time, seems to have peaked.

While we have left our rating unchanged for the three sectors above, we have reduced our rating for the energy sector. We have now returned to a neutral rating after the extended production cuts by OPEC failed to bring about a stabilization in the oil price. We are underweight in the three defensive, interest-rate-sensitive sectors: utilities, telecommunications and real estate.

A trend reversal in the emerging markets (EM)?

EM equities ended their multi-year underperformance versus the S&P 500 Index more than a year ago. We are now expecting a period of outperformance.



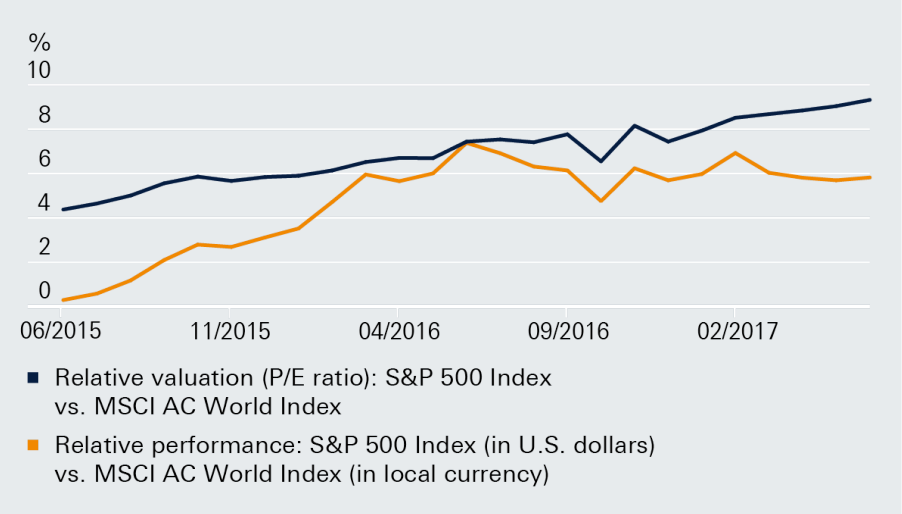
Sources: FactSet Research Systems Inc., Deutsche Asset Management Investment GmbH; as of 6/26/17

Valuations

Valuations overview

U.S. equities

We expect solid 2017 EPS growth for the S&P 500 Index as U.S. business and consumer sentiment are solid and first-quarter earnings have been strong. Demanding valuations, lowered expectations on U.S. policy and the market's sensitivity to lower oil prices make us move tactically to "underweight" whilst staying "neutral" strategically.



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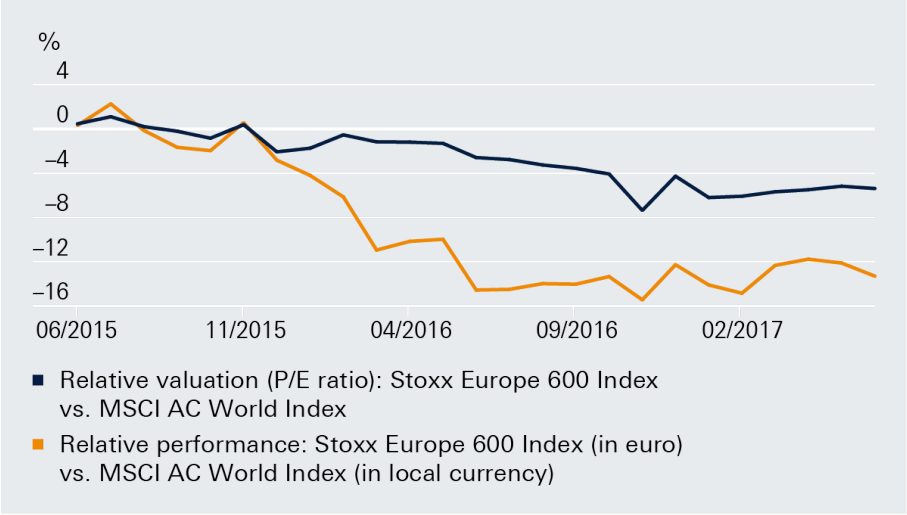
European equities

Negative news regarding EU disintegration are off the table after Macron won the elections in France. Macro factors are supportive, as is the ECB. Both EPS and top-line growth surprised positively so far this year. We like Germany in particular as business-sentiment indicators are at record highs and stay "overweight."



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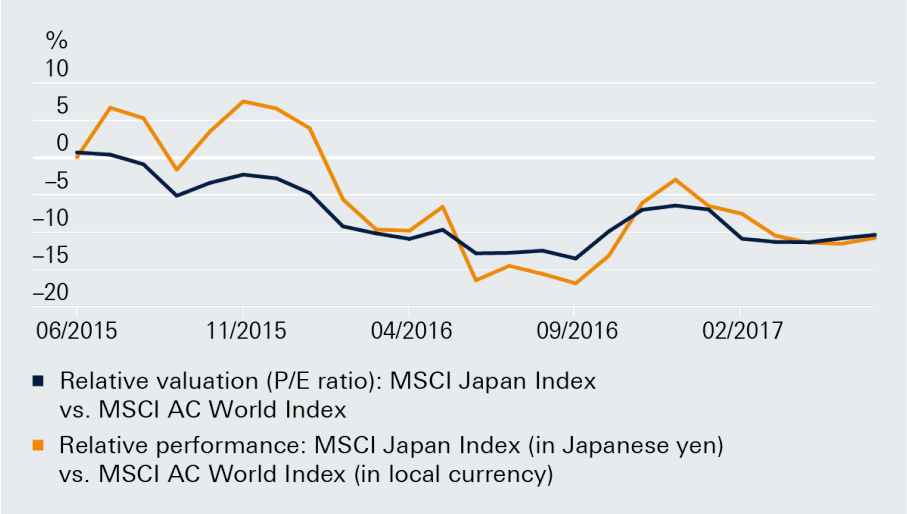
Japanese equities

In the reporting season, firms have issued more benign outlooks than we thought, leading us to upgrade Japan back to neutral. Structural reforms are slowly unfolding and balance sheets look solid. BOJ policy remains a question mark. Political tensions in Korea and the risk of yen appreciation keep us from becoming even more positive.



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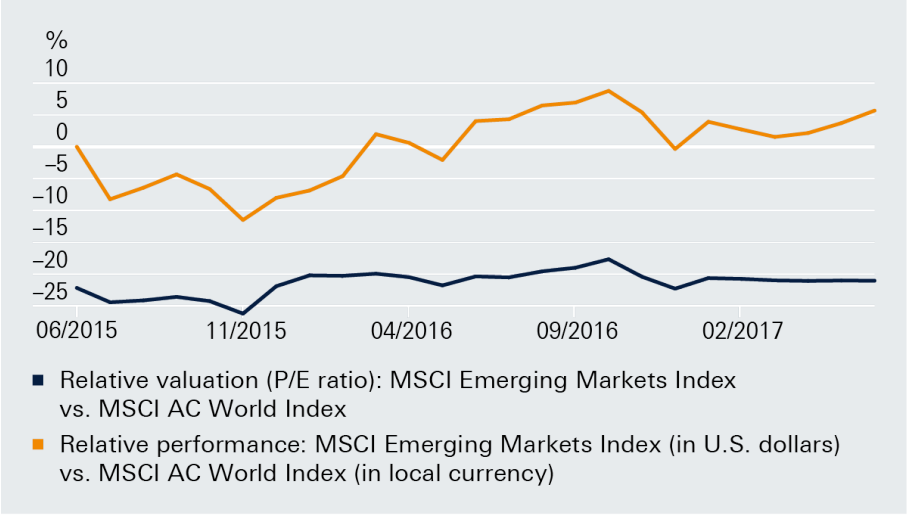
Emerging-market equities

Stabilizing macro fundamentals, increasing intra-EM trade, less fear about the Fed and U.S. trade policy and solid EPS recovery – all of these trends are still valid. Reform processes, low inflation figures, particularly in Asia, and expectations for a weaker U.S. dollar confirm our overall "overweight" rating, while we stay cautious on Latam.



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Glossary

Accomodative

The aim of an **accommodative** monetary policy is to support the economy by means of monetary expansion.

Bank of Japan (BOJ)

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

Earnings per share (EPS)

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

Emerging markets (EM)

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.

European Union (EU)

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

Mergers and acquisitions (M&A)

Mergers and acquisitions (M&A) are the two key methods of corporate consolidation. A merger is a combination of two companies to form a new company, while an acquisition is the purchase of one company by another in which no new company is formed.

Organization of the Petroleum Exporting Countries (OPEC)

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

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.

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Stoxx Europe 600 Index

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

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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.

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