Investment traffic lights

Our tactical and strategic view

General Market Overview

"What was that?" those with tender souls might say, as they look back on the month of February. "That's it?" sturdier market participants might reply. After all, it turned out to be a surprisingly mild market correction, in the end. Of course, both perspectives have some merit. After a strong start into the year, markets surprisingly slumped at the beginning of the month. The S&P 500 lost 10% in nine days, technically went into correction territory and ended a record-breaking run without declines of five percent or more. February also marked the end of 15 record breaking months that saw not a single negative total return at the end of the month (the same is true of the MSCI AC World). That sounds dramatic. However, that decline only set back the S&P 500 by 3 months. Moreover, it pretty much corresponds to the average drawdown you have tended to see at least once each year over the past 40 years, as we showed in our Chart of the Week of February 9th. On top of that, equity markets recovered quite quickly. Most are already at higher levels than at the beginning of 2018. One reason for this is that technical factors played key roles in this correction. Amongst other issues, this included forced selling by some market participants bound by risk parameters (see CIO Flash - Back to normality). Volatility rose far more quickly on a single day in certain equity markets than ever before. The VIX is still well above its average level of recent months. And yet, we would describe higher volatility as a sign of a return of slightly more normal times. This new normalcy is also what caused investors to fret throughout the month of February, in terms of what it might mean for interest rates and the dollar. To be sure, yields on 10-year U.S. Treasuries only rose by 15 basis points, after an increase of 30 basis points in January. But that was enough to cause the yield differential between German and U.S. sovereign bonds to widen to multi-year peaks. Despite this, the dollar merely stabilized at a fairly weak level.

Outlook and changes

After the market correction, we confirmed most of our year-end forecasts in an extraordinary CIO review. This was mainly due to the continuing strong macro-economic prospects world-wide. While technical factors probably reinforced the correction, another source has probably been growing inflation concerns. After all, we saw several surprisingly strong readings on the robustness of U.S. economic momentum at the end of January. Despite this, we would consider inflation fears to be overdone, at this stage and do not expect an overshooting any time soon (see also our report "Low and slow" does not equal "Never, ever"). By the end of 2019, we expect the U.S. Federal Reserve to have hiked interest rates six times. We see three rate hikes in the current year. The rise in U.S. Treasury yields has not solely been driven by high inflation expectations. Instead, the key driver was higher

real interest rates, as we showed in our Chart of the Week of February 16th. This shouldn't be seen as a negative for equity markets in our view, because it suggests that bond investors are seeing improvements in the underlying economic outlook. So, what would make us more cautious? An increase of (nominal) yields on 10-year U.S. Treasuries above 3.5% or an inverted U.S. yield curve. The purchasing managers indices suggest a similar conclusion: they remain very strong, but have lately been losing some steam. Earnings estimates reinforce this picture: after upwards revisions in January, they stabilized in February. That is still an unusually strong earnings picture around this time of the calendar year and should prove supportive for equity markets. However, it is also likely to limit the upside. From a sector and regional perspective, we decided to retain our tactical allocations. Our decision to maintain our exposure to technology shares paid off, given their strong recovery.

For fixed income and currencies, by contrast, we have made some tactical and strategic changes in February. We continue to think that we have already seen the bulk of the rise in U.S. yields, just as we did at the beginning of last month. Nevertheless, we have raised our year end forecast from 2.6% to 3% for 10-year and from 2.1% to 2.5% for 2-year U.S. Treasuries. For 10-year German Bunds, we raised our yield forecast from 0.8% to 1%. We also cut our spread expectations for sovereign bonds from the Eurozone periphery which allowed us to raise Italian sovereigns (10-year) to overweight. Our base case remains that political developments in Europe will not spoil the market mood. However, we are well aware of the risks surrounding Italy's parliamentary elections, which we have described in detail in our asset-class perspective An Italian muddle. Other risks include the coalition formation in Germany and ongoing Brexit talks. All in all, we are tactically positioned neutral for sovereign bonds (coming from underweight for Bunds), with a slight negative bias. We have also cut our assessment on U.S. municipals back to neutral.

For corporate bonds, we remain positive on investment grade in Europe and raised our assessment to positive for U.S. investment grade. The same is true in high yield, where we are now positive on both Europe and the United States. The recent correction brought more interesting valuations, while we believe fundamentals remain solid. In emerging markets, we cut corporate bonds back to neutral and remain positive on sovereigns. While we have been neutral on all major currency pairs last month, we now expect the dollar to strengthen against the euro and the Japanese yen.

Equities*

	1 to 3 months	until December 2018
Regions		
United States	🔴	→
Europe	🟢	↗
Eurozone	🟢	↗
Germany	🟡	↗
Switzerland	🟡	↗
United Kingdom (UK)	🟡	↗
Emerging Markets	🟢	→

Asia ex Japan	🟢	↗
Japan	🟢	↗
Latin America	🟡	→
Sectors		
Consumer staples	🟡	
Healthcare	🟡	
Telecommunications	🔴	
Utilities	🔴	
Consumer discretionary	🟡	
Energy	🟡	
Financials	🟢	
Industrials	🟡	
Information technology	🟢	
Materials	🟢	
Real Estate	🔴	
Style		
Small and mid cap	🟢	

Fixed Income*

	1 to 3 months	until December 2018
Rates		
U.S. Treasuries (2-year)	🟡	↗
U.S. Treasuries (10-year)	🟡	↗
U.S. Treasuries (30-year)	🟡	→
UK Gilts (10-year)	🟡	→
Italy (10-year)[1]	🟢	↘
Spain (10-year)[1]	🟢	→
German Bunds (2-year)	🔴	↗
German Bunds (10-year)	🟡	↗
German Bunds (30-year)	🟡	↗
Japanese government bonds (2-year)	🟡	→
Japanese government bonds (10-year)	🟡	→
Corporates		
U.S. investment grade	🟢	↘
U.S. high yield	🟢	→
Euro investment grade[1]	🟢	↘
Euro high yield[1]	🟢	↘
Asia credit	🟡	→
Emerging-market credit	🟡	→
Securitized / specialties		
Covered bonds[1]	🔴	↗
U.S. municipal bonds	🟡	→
U.S. mortgage-backed securities	🔴	↗
Currencies		
EUR vs. USD	🔴	↘
USD vs. JPY	🟡	↗
EUR vs. GBP	🟡	→
GBP vs. USD	🟡	↘
USD vs. CNY	🟡	↗
Emerging markets		
Emerging-market sovereigns	🟢	→

Alternatives*

	1 to 3 months	until December 2018
Infrastructure	●	↗
Commodities	●	↗
Real estate (listed)	●	↗
Real estate (non-listed) APAC	●	↗
Real estate (non-listed) Europe	●	↗
Real estate (non-listed) United States	●	→
Hedge funds	●	↗
Private Equity[2]	●	→

Comments regarding our tactical and strategic view

Tactical view:

- The focus of our tactical view for fixed income is on trends in bond prices, not yields.

Strategic view:

- The focus of our strategic view for sovereign bonds is on yields, not trends in bond prices.
- For corporates and securitized/specialties bonds, the arrows depict the respective option-adjusted spread.
- For bonds not denominated in euros, the illustration depicts the spread in comparison with U.S. Treasuries. For bonds denominated in euros, the illustration depicts the spread in comparison with German Bunds.
- For emerging-market sovereign bonds, the illustration depicts the spread in comparison with U.S. Treasuries.
- Both spread and yield trends influence the bond value. Investors who aim to profit only from spread trends should hedge against changing interest rates.

Key

The tactical view (one to three months):

- ●
  Positive view
- ●
  Neutral view
- ●
  Negative view
- ◉
  A **circled traffic light** indicates that there is a commentary on the topic.
- The traffic lights' history is shown in the small graphs.

The strategic view up to December 2018

Equity indices, exchange rates and alternative investments:

The arrows signal whether we expect to see an upward trend ↗ , a sideways trend → or a downward trend ↘ .

The **arrows' colors** illustrate the return opportunities for long-only investors.

- ↗ Positive return potential for long-only investors
- → Limited return opportunity as well as downside risk
- ↘ Negative return potential for long-only investors

Fixed Income:

For sovereign bonds, ↗ denotes rising yields, → unchanged yields and ↘ falling yields.For corporates, securitized/ specialties and emerging-market bonds, the arrows depict the option-adjusted spread over U.S. Treasuries: ↗ depicts a rising spread, → a sideways trend and ↘ a falling spread.

The **arrows' colors** illustrate the return opportunities for long-only investors.

- ↘ Positive return potential for long-only investors
- → Limited return opportunity as well as downside risk
- ↗ Negative return potential for long-only investors

Footnotes:

* as of 2/28/18

[1] Spread over German Bunds in basis points

[2] These traffic-light indicators are only meaningful for existing private-equity portfolios

Glossary

Basis point

One basis point equals 1/100 of a percentage point.

Bunds

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

CBOE Volatility Index (Vix)

The **CBOE Volatility Index (Vix)** is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index. It is a popular measure of the volatility of the S&P 500 as implied in the short term option prices on the index.

Emerging markets (EM)

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

Eurozone

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

High Yield (HY)

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

Investment grade (IG)

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

MSCI AC World Index

The **MSCI AC World Index** captures large- and mid-cap companies across 23 developed- and 24 emerging-market countries.

S&P 500

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

Sovereign bonds

Sovereign bonds are bonds issued by governments.

Spread

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

Treasuries

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).

U.S. Federal Reserve Board (the Fed)

The **U.S. Federal Reserve Board**, 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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