Investment traffic lights

Our tactical and strategic view

General market overview

In March, investors showed signs of being unnerved, and almost ungrateful. This was despite the rather unspectacular March meeting of the U.S. Federal Reserve (the Fed). The outlook of the world's most influential central bank was closely in line with what investors have gotten used to in recent years. The kind of Goldilocks scenario that, for much of this cycle, has consistently delivered returns of the sort investors can usually only dream of. According to the Fed, the economy should continue to grow, but not overheat. Growth might even accelerate a little further, but without inflationary pressures picking up significantly.

In line with this scenario, the Fed increased its economic-growth projections from 2.5% to 2.7% in 2018 and from 2.1% to 2.4% in 2019. It left its inflation forecast at 1.9% for 2018, but raised it to 2.1% for 2019. For investors, this all looks rather reassuring. After all, U.S. economic growth has averaged 2.5% over the past 25 years. So, it seems plausible enough that growth might peak at 2.7% this year, without triggering overheating.

If you were expecting grateful market applause, you were in for a disappointment, though. Instead, markets resumed their slump. Why? In our view, a number of factors are responsible for recent market nervousness. First, the rise in equity markets last year and at the beginning of this year had left equity valuations rather stretched. In such an environment, even the odd disappointing data point can be quite damaging. Such as, secondly, the Purchasing Manager indices (PMIs). In the first quarter, PMIs either stopped advancing further from their elevated levels, or declined, as they did in Japan and much of Europe. A third factor relates to the protectionist plans of U.S. President Donald Trump. March brought the first clear signs that this threat was getting serious. And fifth, all of this happened against the backdrop of rising U.S. yields.

However, yields are mostly only rising at the very short end and only in the U.S. In itself, this is also a sign of market nervousness. At the long end, there were actually slight yield declines in March. As a result, the U.S. yield curve flattened. The gap between yields on 2-year vs. 10-year U.S. Treasuries reached multi-year lows of 0.49%. The last time it was that low was in 2007. Moreover, some of the strongest performers in U.S. equities have lately been among the weaker ones. For the first time since 2016, the Nasdaq actually performed worse than the S&P 500.

Outlook and changes

Our quarterly CIO Day took place at the end of March. As a result, we have adjusted not just our tactical signals, but also our strategic forecasts. We remain positive, mainly based on our solid economic

outlook. For the world economy as a whole, we expect 3.9% growth both this year and next year. We only expect moderate interest-rate increases. As a result, we continue to view equities and bonds offering a yield premium positively.

Specifically, our positioning in equities remains largely pro-cyclical, with a few minor adjustments. For example, we have downgraded the materials sector and upgraded the real-estate sector, both now at neutral. The reason behind upgrading the real-estate sector is its long underperformance and the discount compared to the rest of the market based on historic average valuation measures, now looks larger than justified. Of course, all sectors where dividend yields make up a large part of total performance tend to struggle at times of rising interest rates. However, we view the likely increases in yields as too small to cause dividend stocks to decline in value on a 12-month basis. During recent periods of market turbulence, dividend stocks once again demonstrated their defensive characteristics. With a volatile year ahead, they may offer a safety buffer for investors wanting only limited risk exposure.

In the materials sector, our concerns mainly center around high levels of steel inventory and rising oil production. We continue to view the technology sector positively. For the first quarter as a whole, it has once again outperformed the broader market. Admittedly, this has also increased its valuation premium. However, this is underpinned by strong underlying performance data. While the technology sector may face some regulatory headwinds, we think it should remain among the better performers.

On a regional basis, we have slightly increased our equity index targets for the United States and emerging markets. These were last formulated at the end of February for the year-end 2018; the current ones are for the next 12 months, i.e. March 2019. For Europe, Germany and Japan, we have slightly cut our equity index targets. However, we continue to favor Europe, emerging markets and Japan on valuation grounds and have also overweighted Germany.

For bonds and currencies, we have slightly increased our strategic yield forecast. In particular, we see yields on 10-year U.S. Treasuries at 3.25% on a 12-month basis, compared to 3% previously. However, the increase is slightly larger for 2-year U.S. Treasuries, suggesting a further minor flatting of the yield curve. We do not expect to see a selloff in sovereign bonds such as U.S. Treasuries. Our favorites remain the Eurozone periphery, corporate bonds and emerging-market bonds.

As for currencies, we are expecting the dollar to strengthen in our strategic outlook. However, we are tactically neutral on all major currencies for the time being. This is because we are expecting important tactical signals in coming weeks, and want to be able to react in a timely fashion.

Also tactically, we have gone to underweight in UK sovereign bonds, because we might see some further upward pressure in yield. For corporate bonds from Asia, we are becoming more cautious, because there could be outflows due to U.S. protectionist rhetoric and the recent strengthening in the dollar.

Equities*

	1 to 3 months (relative to the MSCI AC World)	until March 2019
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 March 2019
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 March 2019
Infrastructure	🟡	↗
Commodities	🟢	↗
Real estate (listed)	🟡	↗
Real estate (non-listed) APAC	🟢	↗
Real estate (non-listed) Europe	🟢	↗
Real estate (non-listed) United States	🟡	→
Hedge funds	🟢	↗

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.
- The tactical view for equities is based on our relative view of the region/sector vs. the MSCI AC World Index. A red signal therefore doesn't mean that we expect a negative total return but rather that we expect other regions/sectors to perform better.

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 March 2019

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 3/29/18

[1] Spread over German Bunds in basis points

Glossary

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.

Goldilocks economy

The term **Goldilocks economy** refers to a state of the economy, where there is neither a threat of inflation due to an overheating economy, nor a threat of a recession.

Inflation

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

MSCI AC World Index

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

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Nasdaq Composite Index

The **Nasdaq Composite Index** is an equity index which contains all common stocks listed on the NASDAQ exchange.

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.

Purchasing Managers Index (PMI)

The Purchasing Managers Index (PMI) is an indicator of the economic health of the manufacturing sector in a specific country or region.

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.

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.

Valuation

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm's stock price in relation to its earnings.

Yield

Yield is the income return on an investment referring to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

Yield curve

A **yield curve** shows the annualized yields of fixed-income securities across different contract periods as a curve. When it is inverted, bonds with longer maturities have lower yields than those with shorter maturities.

Risk warning

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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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