Investment Traffic Lights

Our tactical and strategic view

General market overview

After a burst of volatility in the first quarter of 2018, financial markets settled down in April, despite a flurry of breaking news stories from and about the White House, including news on trade policies. If fully implemented, new U.S. tariffs and related measures might well have a negative impact on share prices, but investors seemed to take the news in stride, believing that a full-blown trade war would be avoided. At the same time, markets also had to contend with the corporate reporting season. Although many companies managed to surpass earnings expectations, their stocks were still punished. That was true across a wide variety of sectors. Among the victims was one of the leading U.S. construction-equipment manufacturers, whose quarterly figures were at first applauded by the market but whose stocks slipped sharply when its top management told analysts during a teleconference that the first quarter could have marked the peak of the current year. Some investors swiftly extended this notion to the overall market, fearing that this might be as good as things are likely to get and that the cyclical peak has already been reached. Looking at the usual pattern of missing and beating consensus forecasts, the U.S. reporting season was very positive – roughly 80% of all companies beat the forecasts (the best result since 2010), and have done so by an average of 8.9% (twice the historic average)[1], whereas the reporting season in Europe was rather neutral. Partly, this reflected currency effects, i.e. the strong euro in the first quarter, which dragged down earnings of many European exporters. In Japan as well, a strong currency (in this case the strong yen) was blamed for the very conservative corporate outlooks in the first quarter. However, annual consensus forecasts were not really corrected downwards in the wake of the reporting season, which is somewhat unusual. But there were no upwards corrections either.

This divergence in reported earnings might have been expected to give the U.S. stock market a renewed boost compared to those of other developed markets. Instead, European and Japanese stocks performed so well in April that they almost managed to catch up with the U.S. stock market. This means that all major stock markets have more or less returned to their levels seen at the beginning of 2018.

Investors in currencies, fixed income and commodities definitely experienced a more exciting April. Although sharp rises were rather sporadic, even smaller increases enabled some asset classes to break long-term records. The 10-year U.S. Treasury yield thus managed to surpass the 3% mark for the first time since the turn from 2013 to 2014. As the 2-year yield has simultaneously risen to 2.5% for the first time since 2008, the yield curve (10-year minus 2-

[1]Data as of April 27, 2018 when about roughly half of the S&P 500 corporations had reported their figures

year) flattened to 43 basis points , its lowest level since 2007. You have to go even further back in history to find a match of another indicator: The yield spread of 10-year U.S. Treasuries and Bunds, which rose to almost 2.4%, a level last seen in 1989. Even the dollar could no longer withstand these movements. Although it had traded in a very tight range vs. the euro since February, the dollar broke out to the upside of this band in the last week of April.

Finally, it is worth mentioning the path of oil prices. OPEC has managed to restrict supply so that today, oil prices are almost three times as high as at their low in early 2016.

Outlook and changes

How do these April developments impact our outlook? In particular, how will the confluence of political developments, corporate profitability, and economic activity affect the markets? Let's start with the economy. We assume that growth was only temporarily constrained in the first quarter and will soon gain steam, starting with a strong second quarter. First-quarter performance should be considered an even less reliable guide for 2018 economic growth than usual, because of, guess what, the weather. In 2018, we saw unusual weather patterns in both the United States and Europe, including heavy snow hitting London. Whether the weather was good or bad is in the eye of the beholder – this justification should no longer concern all that many investors anyway. Two reasons which without any doubt weakened performance in Europe were fewer working days than in the previous year and an extraordinarily severe wave of influenza.

We continue to hold a positive view on equities. The reporting season has been overall encouraging so that we feel quite comfortable with our forecasts: Earnings growth of roughly 10% in Europe and between 15% and 20% in the United States and in emerging markets. In our view, equities in the United States and in Europe are more likely to move up rather than down by 5% in the near term. We have downgraded Japan to neutral for the time being, since corporates tended to communicate very cautiously during the reporting season and the political situation of Prime Minister Abe remains opaque. Europe and the emerging markets appear to be more attractively valued than the United States. However, trade disputes remain the elephant in the room, and decisions will be taken in May that could decide whether the elephant makes itself more comfortable or starts withdrawing again.

We have made no changes at a sector level but do acknowledge that the picture has brightened for several defensive segments, such as utilities, where we nevertheless keep an underweight. Although energy continues to appear particularly suited as a hedge against geopolitical tensions, the current cash-flow generation is not really convincing. Our downgrade of the materials sector last month has been proven right – particularly metals and mining are burdened by weaker demand from China. This sector risks being additionally impaired if a strengthening dollar starts to put further downward pressure on prices. Consumer demand has remained rather strong in the first four months, however with

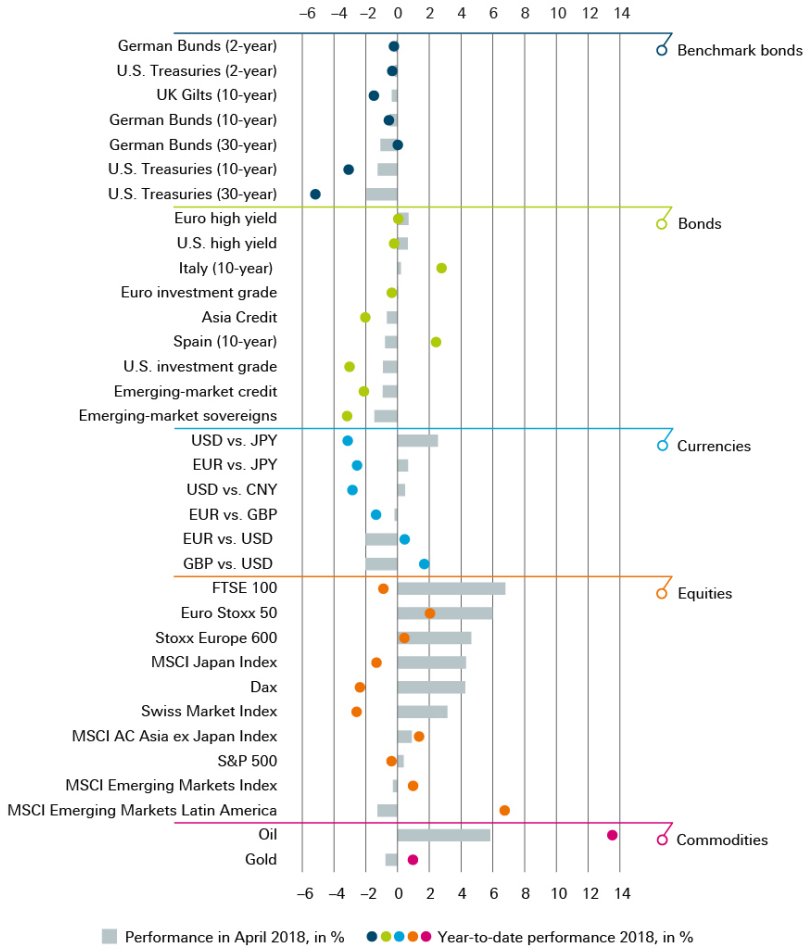
sharply diverging trends. Although non-cyclical consumer stocks underlined their defensive qualities on weaker market days again, they are still struggling. For this reason, we favor cyclical consumer stocks.

One of our most important changes is upgrading the dollar vs. the euro to positive. Apart from fundamental reasons for strategically favoring the dollar – especially the record level of the yield spread between U.S. and German government bonds mentioned above – the picture has also turned more interesting from a tactical viewpoint.

As already mentioned, many rates only made minor moves in April, but nevertheless managed to break some long-term records. While we cannot ignore these moves, we do not feel compelled to change our strategic forecasts. We still believe in a moderate rate cycle that will peak at levels way below those seen in previous cycle peaks. We therefore stay neutral on U.S. Treasury yields. We upgrade 10-year UK and 30-year German government bonds to neutral, after their yields rallied during April. We turn more positive on emerging-market bonds, as in our view the repricing has gone far enough to compensate for trade-related risks.

Past performance of major financial assets

Total return of major financial assets year-to-date and past month



Sources: Bloomberg Finance L.P., Deutsche Asset Management Investment GmbH as of 5/2/18

DWS

Tactical and strategic signals

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 4/30/18

[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.

Cash Flow

A company's cash flow is comprised of its inflows and outflows which arise from financing, operational or investing activities.

Emerging markets (EM)

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

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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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.

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).

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

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

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Investment in private equity funds is speculative and involves significant risks including illiquidity, heightened potential for loss and lack of transparency. The environment for private equity investments is increasingly volatile and competitive, and an investor should only invest in the fund if the investor can withstand a total loss. In light of the fact that there are restrictions on withdrawals, transfers and redemptions, and the Funds are not registered under the securities laws of any jurisdictions, an investment in the funds will be illiquid. Investors should be prepared to bear the financial risks of their investments for an indefinite period of time.

Investment in real estate may be or become nonperforming after acquisition for a wide variety of reasons. Nonperforming real estate investment may require substantial workout negotiations and/ or restructuring.

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