DWS

Investment Traffic Lights

Our tactical and strategic view

General market overview

Will U.S. President Trump fondly remember the month of May? Hard to say, even if we just look at the impact of his tweets on capital markets. Trump's policy positions continued to make plenty of headlines in the press. However, the time it has taken investors to move on to business as usual, appears to be getting shorter and shorter on most of his tweets.

By contrast, the new Italian government is getting plenty of attention. The birth pangs of the populist coalition in Rome lead to turbulences of the sort rarely seen, especially in the bond markets. This has been most drastically demonstrated with the 2-year Italian government bonds. Their yield shot up by 184 basis points on May 29 to 2.70%. Only two trading days later, at the end of the month, Italy's two-year-olds are back at 0.99%. That's how long it took the coalition parties to turn 180 degrees, deciding they would rather like to govern, after all. How long the new government can last remains anybody's guess. In any case, we would argue that not all that much has changed all that suddenly. Governing Italy was always going to be hard. That said, this may also limit the damage any new government can do in the short term, at least in terms of Italy's economic policies. (For further details, see: "Italy's new coalition".)

On the international political stage, only Trump seems to be able to match the political agility displayed in Italy. Take North Korea. After much back and forth, top-level talks currently appear on track, once again, as of today. Trump's trade policies, on the other hand, have at least followed a fairly straightforward path. Nevertheless, they have caused plenty of consternation among economists and policymakers around the world as it is feared that they may prove counterproductive. Following the steady exodus of free traders from Trump's economic advisory staff, the U.S. negotiating stance has become increasingly rigid. On June 1, punitive tariffs for steel and aluminum imports from the European Union (EU), Canada and Mexico went into force. All of them are close U.S. allies and all of them immediately announced retaliatory measures. In addition, Trump is now investigating to what extent car imports from these trading partners might endanger the U.S. security interests. Ultimately, all the posturing might eventually lead to relatively little change, as Fed member James Bullard recently pointed out.[1] Furthermore, the impact of many of the measures, implemented or under consideration, still looks relatively insignificant in terms of trade volumes. But we would not underestimate the dangers coming from the recent rise in protectionist tendencies. In the longer term, the increasing unpredictability of U.S. trade policy risks

[1] Bloomberg TV interview with James Bullard from June 1.

undermining the rules global trade relies on, as we have explained in a recent CIO View Special: "Free trade under attack".

There has been a lot of politically explosive news for markets to digest in the days leading up to the end of May. June has started on a similar note, with the surprising change of government in Spain. All this caused many asset classes to turn negative once again. The majority of the major indices from the various asset classes are currently showing losses for the year-to-date time frame. Above all, the segments regarded as riskier have lately suffered, as investor became less keen on taking on risks in a politically uncertain world. You can see the impact on many equity indices, European corporate and peripheral bonds as well as the emerging markets. Emerging markets also suffered from the strong dollar and the spike in yields on 10-year U.S. government bonds, which briefly jumped well above 3%.

Outlook and Changes

We do not believe that political headline risks will disappear in June. Depending on developments in Rome and various other European capitals, there certainly remains a risk that the stability of the European Union and the euro could once again be called into question by market participants. On the other side of the pond, it already appears like a safe bet that the White House will continue to generate plenty of surprising headlines throughout the summer.

All this suggests that we could continue to see fairly volatile capital markets in coming months. This could be reinforced by seasonal effects. Summers have historically tended to be weak. And there are plenty of non-political factors to watch, which could trigger wild market swings. These include the strong dollar, the 10-year U.S. yield, which continues to hover at the 3.0% mark, and the high oil price. All of these will continue to impact various other assets in a wide variety of ways. The high oil prices, for example, raised German consumer-price inflation in May to 2.2%. Beyond developed markets, there are also some trouble spots to watch. Turkey, Brazil and Argentina have lately been generating plenty of disconcerting news. However, they are hardly representative for emerging markets as a whole.

So, what does all this mean for our positioning? From a tactical point of view, we are reducing our risk exposure in some asset classes. Strategically we remain optimistic, given that the overall economic outlook continues to look very solid.

In equities, we have downgraded Europe to neutral as a result of political uncertainties, but stay overweight Germany. Otherwise we are not changing any tactical positioning. This partly reflects the very good quarterly reporting season we have just seen, especially in the United States. This has allowed us to raise our earnings estimates for the S&P 500 for 2018 by 3.2%. Mainly for valuation reasons, we keep the United States on underweight, however. In emerging markets, we share the fundamental concerns about individual countries, including their sharp currency devaluations. For the overall MSCI Emerging Markets Index, however, the latter plays a minor role, as some of the most volatile currencies are either

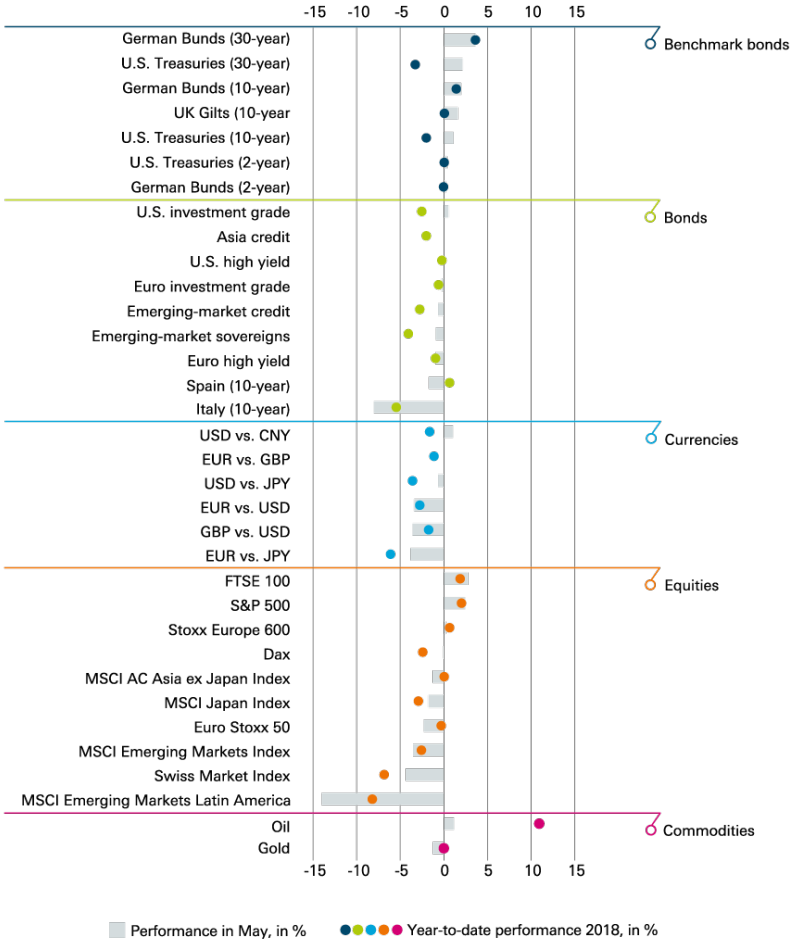
not represented at all (Argentina) or have only with very little weight (Turkey) in the index. In any case, we expect the headwinds that emerging markets might face from rising U.S. interest rates and the strengthening dollar to recede.

For both U.S. interest rates and the dollar, we suspect that the largest movements are already behind us. Nevertheless, we have somewhat reduced our risk exposure in bonds. In the case of government bonds, we have reduced Italy and Spain to Neutral. We believe Spain is fundamentally much better positioned than Italy (see our recent Chart of the Week). However, we assume that Spanish bonds will not be able to escape the turbulence surrounding Italy in the short term. We are reshuffling our tactical positions in German bunds, where we upgrade 2-year Bunds to neutral and go back to negative in 10- and 30-years, as the latter had seen unusually high demand when the Italian situation escalated. Corporate bonds, both from Europe and the United States, have been downgraded to neutral, for U.S. investment grade we even turned negative. Just as for emerging-market bonds, which we also reduced to neutral, we expect risk appetite might remain muted in the coming months.

We remain positive on the dollar, despite its rapid gains in May. We expect the dollar to continue to strengthen against the euro. However, this now appears likely to be driven mainly by the euro weakening.

Past performance of major financial assets

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



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	🟢	

All articles are available on https://go.dws.com/cio-view-articles

Industrials	🟡	
Information technology	🟢	
Materials	🟡	
Real estate	🟡	
Style		
U.S. small cap	🔴	
European small 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.

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 5/31/18

[1] Spread over German Bunds in basis points

Glossary

MSCI AC World Index

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

MSCI Emerging Markets Index

The **MSCI Emerging Markets Index** captures large- and mid-cap representation across 23 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.

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.

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