Investment Traffic Lights

Our tactical and strategic view

Market overview

That classic stock-market saying, "sell in May and go away", has stuck around for a reason: it has proven itself empirically. The hot summer months are usually hot in the stock markets too – but negatively. On average, this historically tends to be their weakest period. The fact that financial markets ended July in the black may have relieved many investors. But they could still get burned. July has been a strong month in the past – and has often been preceded and followed by weak months. September, especially, has been weak, whether you look at the FTSE 100 or the S&P 500, and the trend is consistent, going back to 1988, or 1948, or 1928. But in recent decades, at least in the United States, August has been the worst month of all. We do not want to overstretch these historical comparisons; and for the sake of completeness it should be mentioned once again that August has also often been a great month for shareholders. But the current pattern in the markets looks a good fit both with the historical weak summer tendency and our tactical assessment of the current position. Even though all major share indices and many bond indices rose in July, investor nervousness is clear and can be seen below in the headline numbers. Market reactions to quarterly results in July have been the most extreme for more than a decade. Some growth stocks were punished, in some cases quite viciously, and were outperformed by defensive or value stocks. At the same time some cyclical stocks obtained little or no upside from good results and sovereign bond yields barely moved – and the yield curve flattened further. The extent to which some investors had to sweat was best illustrated by Facebook, which lost around 140 billion dollars in market value in three trading days. The reason for this extraordinary bout of investor skepticism is concern about sales growth. As expected, U.S. companies were able to ratchet up their after-tax earnings thanks to the tax reform this quarter. On the operational level, on the other hand, complaints were regularly filed about pressure on margins from the higher cost of materials and wages, or the new punitive trade tariffs. Interestingly, there were numerous examples of U.S. companies pointing out the negative implications of punitive tariffs – while some European companies noted the opportunities the tariffs create for them. In our short study we explain why and how quickly these side effects, unwanted by the U.S. government, can occur.

It is difficult to assess the extent to which trade disputes are already reflected in the economic figures. Overall, the GDP numbers were good, with the United States slightly more positive and the European Union (EU) slightly more negative than expected, and sentiment indicators remained high. In China, too, purchasing managers in the manufacturing sector continue on an expansionary course and yet, at 50.8, the Caixin/Markit PMI Index is at its lowest since November 2017. China is fighting on several fronts. No other

country has been as severely affected by the hostile trade moves from Washington – nor as disrupted by the need to deal with new threats almost every day. Meanwhile Beijing is seeking to help its economy with a loose monetary policy, but without causing bad loans to swell once again – a difficult juggling act.

Outlook and changes

From a tactical point of view, the investment environment might be described as "good for now…but". For now the global economy remains in excellent shape. But at the same time U.S. trade conflict, the future of China's economy and the slow end to loose global monetary policy remain major concerns for investors. For our investment decisions, this also means a largely neutral positioning at the index level, with a greater focus on sub-segments and individual securities. This can be illustrated by the following example: of the ten companies with the highest losses in market value, measured by their respective highs of the past 52 weeks (cumulatively around 900 billion dollars), five are Chinese and four American. And there are four financial and three technology stocks in this list. The fact that we are sticking to these two sectors as our favorites shows how important stock selection remains. Overall, we have not changed anything in our regional or sectoral equity weightings, which means that Asian emerging markets remain our only regional favorite. On an absolute basis, we now also see a 5% correction in the United States as being more likely than a correspondingly strong rally. The trade dispute remains a sword of Damocles over the markets, though we feel increasingly that China wants to de-escalate the conflict.

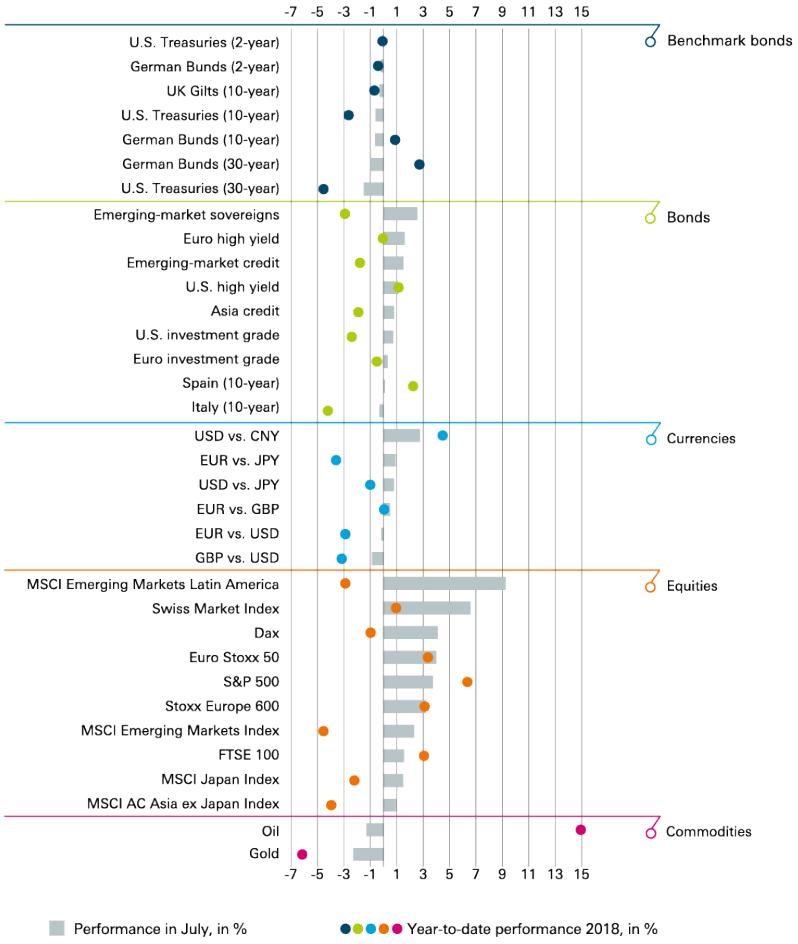
In the case of bonds, we also prefer not to put our heads too far above the parapet in the summer months. Many yields have been trading in a range for weeks, with no clear direction. Even the meetings of three major central banks in the first week of August hardly provided any fresh impetus. Unless, that is, what happened with 10-year Japanese yields is seen as significant. For the first time since the beginning of 2016 they were allowed to trade at above 0.1%, after the central-bank chairman, Haruhiko Kuroda, leaked that the 10-year yield would no longer be nailed to 0.0% and that a margin of 20 basis points up and down would be permitted. You might even call it a market with unregulated prices – if it weren't for the fact that the Bank of Japan (BoJ) already holds the majority of government bonds.

European and American interest rates are slightly less distorted. Here we continue to prefer shorter maturities and European corporate bonds, investment grade as well as high yield, over their American counterparts.

For the time being, we do not see any clear directions for currencies either. After the renminbi weakened against the dollar as we expected, we returned to neutral. Against the euro, the dollar would have to weaken even further before we view it positively again. Most recently, we have also retreated to a neutral position in raw materials. Although the late cycle continues to argue for some sub-segments, the trade dispute continues to weigh on prices.

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 7/31/18

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		
United States small caps **	🔴	
Europe small caps ***	🟢	

** Relative to the Russell 2000 Index

*** Relative to the Stoxx Europe 600

Fixed Income*

	1 to 3 months	until June 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 June 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 7/31/18

[1] Spread over German Bunds in basis points

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

Glossary

Bank of Japan (BOJ)

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

Basis point

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

Correction

A **correction** is a decline in stock market prices.

Defensive stocks

Defensive stocks are stocks from companies whose sales are expected to fluctuate less than the market average as the demand for their products are less tied to business cycles.

European Union (EU)

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

FTSE 100

The **FTSE 100** is an index that tracks the performance of the 100 major companies trading on the London Stock Exchange.

Gross domestic product (GDP)

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Growth stocks

Growth stocks are stocks from companies that are expected to grow significantly above market average for a certain period of time.

Margin

Margin describes borrowed money that is used to purchase securities.

Monetary policy

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

MSCI AC World Index

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

Pro-cyclical sectors

Pro-cyclical sectors are those throught likely to particularly benefit from an upturn in the economic cycle (i.e. stronger growth).

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.

Renminbi (RMB)

Renminbi (RMB) is the currency of the People's Republic of China.

Russell 2000

The **Russell 2000** is an index that captures the 2,000 smallest stocks of the Russell-3000 index, which again comprises 3,000 small- and mid-cap U.S. listed stocks.

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.

Stoxx Europe 600

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

Value stocks

Value stocks are stocks from companies that are trading at prices close to their book value and that are therefore cheaper than the market average on that metric.

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.

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