A few opportunities left

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Joern Wasmund
Head of Fixed Income/Cash

In a nutshell

- U.S. Treasuries and liquid MBS look interesting, especially at the short end of the U.S. yield curve.
- We are more cautious on European government bonds, especially of the countries at the core of the Eurozone.
- Positive absolute return potential exists for corporate credit across regions. Selective opportunities remain in emerging markets.

Call it a tug of war between fears and fundamentals. While President Trump keeps markets in suspense, the U.S. economy looks robust to us and, more importantly, to the Fed. Until December 2019, we expect two more 25-basis-point (bp) interest-rate hikes, driving 2-year interest rates gradually up to 2.75%. This makes 2-year U.S. Treasuries quite an attractive investment on a risk-adjusted basis. Whereas the short end of the yield curve seems well contained, macroeconomic uncertainties make longer-term Treasury rates more susceptible to occasional yield spikes. Overall, we expect 10-year U.S. Treasury rates to grind slightly higher to 3%. In contrast to some of our peers, we do not expect a sell-off in long-dated Treasuries nor a full inversion of the yield curve over the coming 12 months. We also stay constructive for liquid dollar-denominated mortgage-backed securities (MBS) as the Fed comes closer to the end of its balance-sheet unwinding. Nevertheless, supply of MBS assets could remain a drag for some time. Collateralized loan obligations (CLO) and shorter U.S. municipal bonds also look appealing.

For most Eurozone government bonds, we see negative expected total returns, due to the prolongation of accommodative monetary policies by the European Central Bank (ECB). We expect deposit rates to increase by only 15bps and no hike of the refinancing rate in 2019. This looks set to keep 2-year Bund yields in negative territory. From a strategic perspective, we turned cautious on Italy. Political uncertainty, the implied tail risks and concerns over Italian banks continue to weigh on sovereign spreads. However, we expect political uncertainty and the resulting volatility to create a number of trading opportunities in sovereign bonds across the Eurozone. We expect no key-rate change in Japan over the next 12 months. We expect yields on 2-year government bonds to stay at around or maybe just slightly below 0%. In the UK, we see the Bank of England (BoE) decreasing policy accommodation further. Brexit uncertainties are likely to generate some volatility in Gilts ahead of the deadline of March 29, 2019, when the UK is scheduled to leave the European Union (EU).

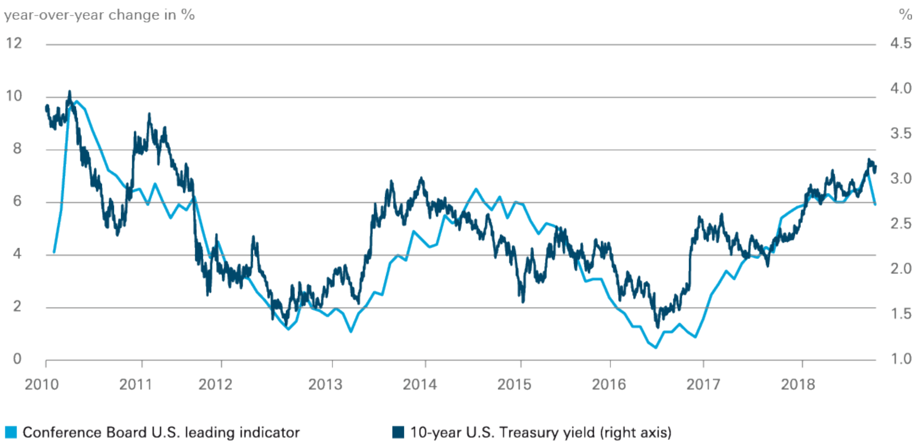
For corporate credit, we continue to expect positive absolute returns across all regions, but the environment is getting more challenging. The re-emergence of cash as an attractive asset class in the United States will have some crowding-out effect on corporate credit. We expect U.S. investment-grade spreads to only widen slightly. Higher leverage in various BBB credits, a rising downgrade-to-upgrade ratio (currently 2:1), high currency-hedge costs and the attractive yield on cash will weigh on the asset class. But let's not turn too negative. While we see various individual deteriorating credit stories, we do not expect a wave of BBB-rated companies to move into high yield (HY). Opportunities exist in U.S. high yield. After the recent spread widening, the asset class looks attractive again. It should benefit from low default rates, fairly high yields and stable corporate fundamentals. Equity-market volatility, Fed uncertainty and recession concerns are likely to keep a lid on spread tightening potential.

European investment grade has suffered in 2018, not just from concerns over financials and Italy's protracted budget negotiations but also from the announced end of QE by the ECB. The extent of recent market moves looks unjustified to us. We think that spreads will tighten again. In European high yield, we see attractive entry opportunities. Low default expectations and attractive relative value support the asset class.

Finally, let's look at EM. We continue to see selective opportunities. Markets may have overreacted to negative news flow on countries such as Mexico, Turkey and Argentina. We particularly like shorter-dated bonds. On the sovereign side, we like Central and Eastern Europe (including Turkey and Russia) and Africa but underweight Latin America. In general, we favor hard-currency over local-currency emerging-market sovereign bonds. For Asian credit, we expect spreads to stay around current levels. We see selective opportunities in China. However, this segment is highly dependent on ongoing trade negotiations between China and the United States. A strong U.S. dollar and higher Treasury yields also remain risk factors.

How 10-year Treasury yields got where they are

U.S. Treasury yields have moved in line with an improving economy. They are unlikely to move much further, until the economic outlook becomes clearer.



Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 11/1/18

U.S. real rates from a historical perspective

Real U.S. interest rates remain very low. The rate at which monetary policy is neutral appears lower, too, reflecting various structural changes.

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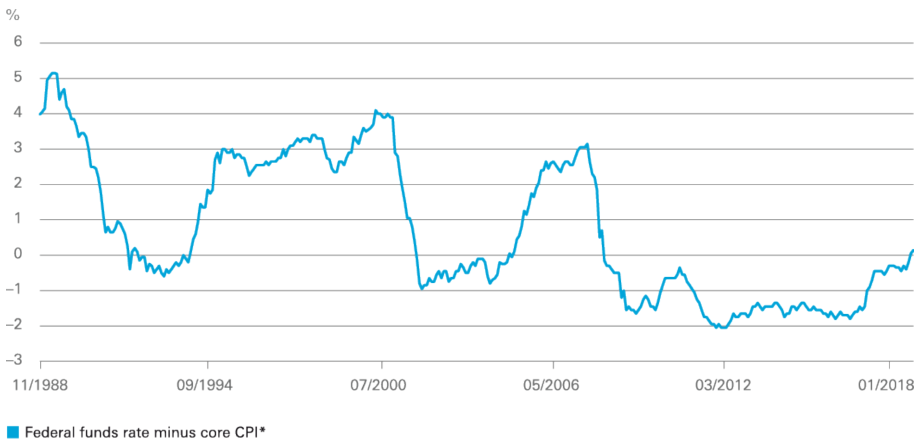


Source: Thomson Reuters Datastream as of 12/6/18
*core CPI: year-over-year change

Currencies

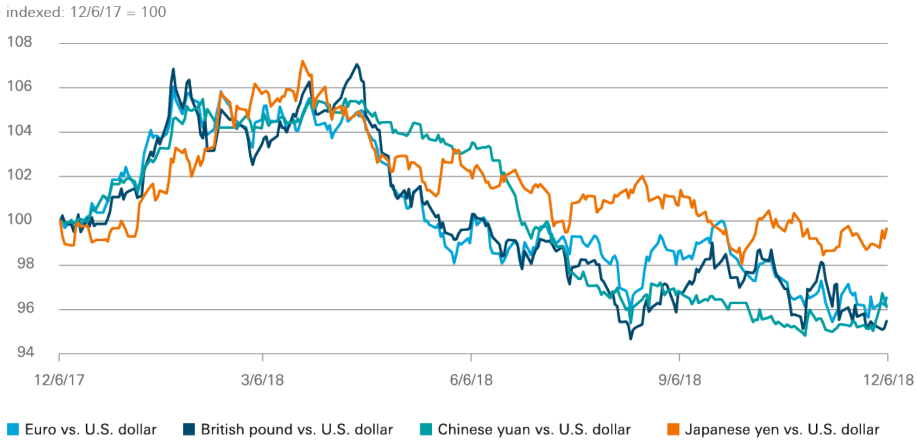
A relatively quiet place

After many currency pairs have left 2018 at about the same level as they entered it, we expect the same in 2019

As the year ends, most markets have been turbulent, but the foreign-exchange markets have remained rather calm. And this is despite the fact that currencies are said to have a good nose for political changes, of which there have been plenty in the past year. In fact, the last few years have been very stable for exchange rates by historical standards. Against the euro, the U.S. dollar has moved in a corridor of 1.05-1.25 for almost four years, in contrast to 2014 when it slipped from 1.40 to 1.05 within one year. Nor do we expect any leaps now and see the dollar at the end of 2019 at 1.15 against the euro. This apparent standstill, however, hides the many underlying forces pulling at the exchange rate. At present, however, they are largely neutralize each other. What these forces are is well known: the U.S. twin deficit, the transatlantic interest-rate differential and the growth-rate gap between the United States and Europe. Interesting, however, is not the absolute levels of these differences but the changed expectations regarding their development. In 2018, the positive element of surprise on the last two factors was clearly in the United States' favor. 2019 could be a tighter call. Although it is unlikely that the ECB will tighten the monetary reins faster than previously announced, it is increasingly likely that the Fed will pause on hikes earlier than expected. Expectations on Fed rate hikes are already declining anyway – just one hike is priced in for 2019. But this expectation could shift in either direction. As far as growth is concerned, revisions on both continents are more likely to be down than up.

Main currency pairs are relatively stable

Measured against other asset classes and its own history, the currency market has been rather quiet.



Sources: Thomson Reuters Datastream as of 12/6/18

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Glossary

Accommodative

The aim of an **accommodative** monetary policy is to support the economy by means of monetary expansion.

Balance sheet

A **balance sheet** summarizes a company's assets, liabilities and shareholder equity.

Bank of England (BoE)

The **Bank of England (BoE)** is the central bank of the United Kingdom.

Basis point

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

Brexit

Brexit is a combination of the words "Britain" and "Exit" and describes the exit of the United Kingdom of the European Union.

Bunds

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

Collateralized loan obligations (CLOs)

Collateralized loan obligations (CLOs) are securities backed by a pool of debt, such as low-rated corporate loans.

Credit market

The **credit market** is the market for corporate bonds

Default rate

The **default rate** refers to the proportion of borrowers who cannot service their loans.

Deposit rate

The **deposit rate** is the rate banks receive when they make overnight deposits with the ECB.

Emerging markets (EM)

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

Euro (EUR)

The **euro (EUR)** is the common currency of states participating in the Economic and Monetary Union and is the second most held reserve currency in the world after the dollar.

European Central Bank (ECB)

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European Union (EU)

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

Eurozone

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

Exchange rate

The **exchange rate** is the rate at which two currencies are traded.

Foreign exchange

FX or foreign exchange is the currency — literally foreign money — used in the settlement of international trade between countries.

Fundamentals

Fundamentals are data giving information about the general well-being of companies, securities or currencies and serving for the subsequent valuation of these as an investment opportunity.

Gilts

Gilts are bonds that are issued by the British Government.

Government (sovereign) debt/bonds

Government (sovereign) debts/bonds are debt/bonds issued and owed by a central government

Hard currency

A **hard currency** is any globally traded currency that is considered as historically stable and can be exchanged easily.

Hedge

A **hedge** is an investment to reduce the risk of adverse price movements in an asset.

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.

Key interest rates

Key interest rates stated by central banks to determine the most important rates of borrowing.

Leverage

Leverage attempts to boost gains when investing through the use of borrowing to purchase assets.

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).

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Mortgage-backed security (MBS)

A **mortgage-backed security (MBS)** is a special type of asset-backed security where the holder receives interest and redemption payments from pooled mortgage debtors, secured by the underlying mortgages.

Municipal bonds (Munis)

Municipal bonds (Munis) are debt securities issued by a state, municipality or country.

Quantitative easing (QE)

Quantitative easing (QE) is an unconventional monetary-policy tool, in which a central bank conducts broad-based asset purchases.

Rating

A **rating** is a standardized assessment of the creditworthiness of the issuer and its debt instruments by specialized agencies. The main three rating agencies are the Moody's (Aaa over Baa1 to C, best to worst) , S&P (AAA over BBB+ to D, best to worst) and Fitch (AAA over BBB+ to D, best to worst).

Recession

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

Risk-adjusted

Risk-adjusted implies that the risk involved is taken into consideration. For example, risk-adjusted return is how much return your investment has made relative to the amount of risk the investment has taken.

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.

Tail risk

Tail risk is the risk that a very unlikely event actually happens.

Total Return

The **total return** is a performance measure of an investment. It measures the earned income of an investment over a specific time period.

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).

Twin deficit

A **twin deficit** is a simultaneous fiscal and current-account deficit

U.S. dollar (USD)

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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.

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.

Yield-curve inversion

A **yield-curve inversion** is when the yields on bonds with shorter duration are higher than the yields on bonds that have a longer duration.

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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