Christian Hille
Head of Multi Asset

Ready for anything

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If you want to know what is driving the markets and thus multi-asset managers at the moment, you only need to look at the first week of December, which was marked by sharp price fluctuations and both customary and unusual correlations between different asset classes. Monday, December 3, began with cautious optimism that a truce had been reached in the trae conflict between China and the United States after the G20 meeting. But the ink under President Trump's farewell tweet from Buenos Aires was barely dry when details of the "deal" tempered the initial joy. Meanwhile, oil prices continued to fall, with conciliatory noises from Italy and less conciliatory ones from France, where the yellow vests[1] took to the streets, and also from London, where Theresa May suffered a serious defeat in Parliament. With the arrest of a Chinese top manager by U.S. officials, a U.S.-Chinese relaxation seemed to move further into the distance and markets fell to their knees. European stocks lost more than 3% on Saint Nicholas Day, and U.S. stocks were already following when rumors began to spread that the Fed would soon be more "market-friendly," which caused the market to turn around. And what else? Around 90% of a broad selection of asset classes posted a negative annual return at the end of the first week in December – an all-time record.[2] The U.S. yield curve inverted in some areas for the first time in more than ten years, and while government-bond yields declined, risk premiums for corporate bonds in Europe and the United States continued to rise. The FTSE 100 fell back to its 1999 level, and the Dax dropped into a bear market. Despite the oil-price weakness, emerging markets held up surprisingly well, and gold did what it has not always done in recent years during market turbulence: it rose.

Why this detailed recap of the first week of December? Because, in our opinion, it contains many themes that will accompany us in 2019: investors who, despite record employment and lush corporate profits, will fear every interest-rate move in the United States; political activism that causes plans to unravel; continuing concern about the end of the cycle; and, last but not least, automated trading systems that can instantly trigger major market turbulence.

Our overall view nevertheless remains optimistic despite all the problems. We continue to assume that we are in the late phase of the (U.S.) cycle and that market corrections are not unusual in

In a nutshell

- The turbulent end of the year reflects many concerns that will not go away in 2019.
- Our outlook remains positive, but our portfolio allocation takes account of negative sentiment and downside risks.
- We enter 2019 well diversified, hedging various instruments and looking selectively for opportunities.

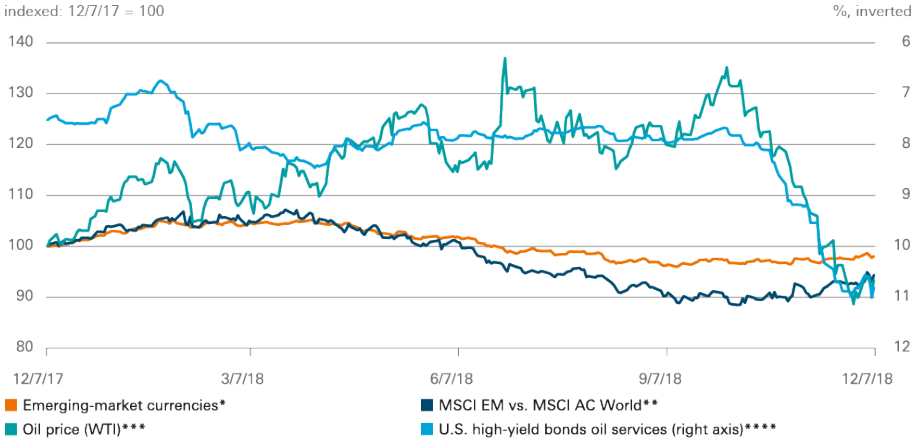
[1] https://www.euronews.com/2018/12/03/gilets-jaunes-who-are-they-and-what-do-they-want-euronews-answers
[2] Data from Jim Reid, Deutsche Bank; as of 12/3/18

this phase. Admittedly, the recent swings are no longer typical of bull-market corrections. Some indices have already entered bear-market territory. But while the market appears to be pricing in a sharp drop in GDP growth or profits, we continue to expect only a slight slowdown. Of course, some regional Purchasing Managers Indices have recently faded, but most are still showing growth. At the same time, however, numerous developments in the capital markets reflect investors' uncertainty. While former drivers, such as technology stocks, are being punished, defensive equities and more defensive investment strategies are enjoying greater popularity. Surveys of asset managers also show growing pessimism. The consensus has begun to revise U.S. corporate earnings downwards for 2019 and 2020 – but in our view not yet enough to warrant pessimism.

For our 2019 investment strategy this means the following: our expectations are not overly high; our investments and risks are diversified across different regions, sectors and instruments (this is one of the reasons why we continue to hold dollars, for example), we are hedged through various instruments (such as gold, and German and U.S. government bonds with longer maturities), and we are looking for specific, potentially higher-yielding investments, such as emerging-market equities and bonds. However, we also like 2-year U.S. government bonds, which look especially appealing on a risk-adjusted basis.

Expectable and less expectable synchronous runs

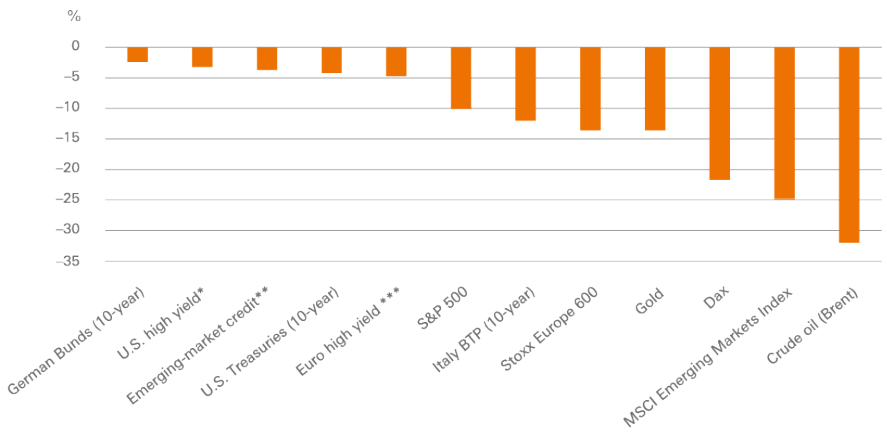
Not surprisingly, bonds from U.S. oil-industry issuers are suffering, while, more surprisingly, emerging-market currencies and equities are trending stronger.



Sources: Thomson Reuters Datastream as of 12/7/18
*MSCI Emerging Markets Currency Index
**MSCI Emerging Markets Index vs. MSCI AC World Index
***West Texas Intermediate
****Bloomberg Barclays US High Yield Oil Field Services Index

Maximum drawdowns back in focus in 2018

In 2018 already, each investment strategy had to take special account of the maximum possible loss over the course of the year. The differences are large.



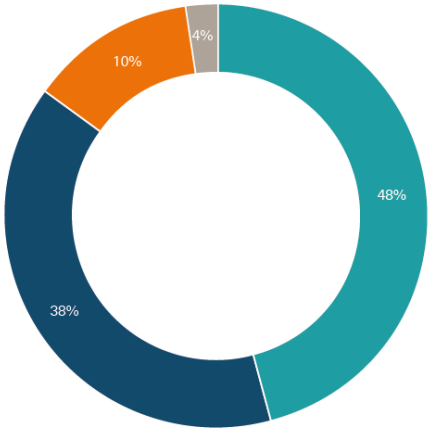
Sources: Thomson Reuters Datastream as of 12/7/18
*Bloomberg Barclays U.S. Corporate High Yield Index
**J.P. Morgan Corporate Emerging Markets Bond Index (CEMBI)
***ICE BofA Merrill Lynch Euro Non-Financial High Yield Constrained Index

Allocation

Cautiously dynamic

Market ruptures are proof of investor's worries but offer opportunities

We are approaching the New Year with a higher equity ratio compared to the previous quarter, preferring the United States and emerging markets over Europe and Japan. However, we will take advantage of rallies by lowering the ratio again. For bonds, we have a preference for 2-year U.S. Treasuries, which yield a handsome risk-adjusted return. At the same time, with the expected slowdown in interest-rate hikes, longer-dated Treasuries are becoming more interesting for hedging reasons. We also like emerging-market hard-currency bonds. We currently see the euro-dollar exchange rate as quite balanced but are still using the dollar for diversification reasons, also with further European turbulence in mind.



Equity	**48%**
Equities United States	22%
Equities Europe	8%
Equities emerging markets	8%
Equities Japan	5%
Equities Global Style	5%
Fixed Income	**38%**
Euro investment grade	13%
Emerging-market (hard-currency) bonds	9%
U.S. Treasuries	6%
Eurozone sovereigns	5%
Euro high yield	3%
U.S. high yield	2%
Alternatives	**10%**
Commodities	5%
Convertibles (euro-hedged)	3%
Alternatives strategies	2%
Cash	**4%**

Source: Multi Asset Group, DWS Investment GmbH as of 12/6/18

The chart shows how we would currently design a balanced, euro-denominated portfolio for a European investor taking global exposure. This allocation may not be suitable for all investors and can be changed at any time without notice. Alternative investments involve various risks and are not necessarily suitable for all clients or for every portfolio.

Indicators

Cold and wet!

Indicators are signaling wet, cold stock weather

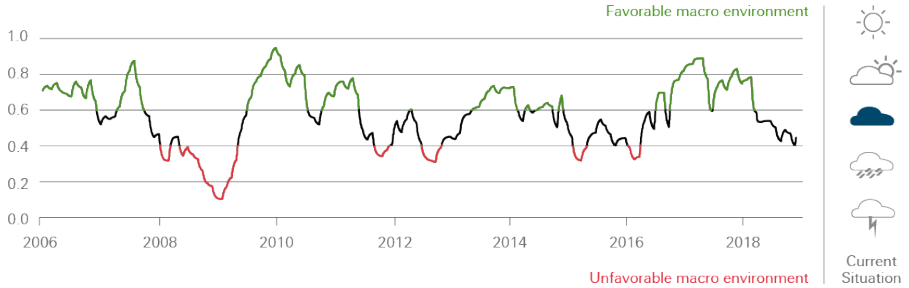
The three DWS indicators have shown a clearly negative market environment since the beginning of the fourth quarter. Looking back over the year, our indicators show that both, the economic environment and investor sentiment, have steadily deteriorated. All three have moved from extremely market-friendly to negative territory during the course of the year.

After stabilizing at the end of the third quarter, the risk indicator slipped back into the clearly risk-averse range in the two months that followed. While the emerging-market subcomponents remained fairly stable to positive over the period, the increased volatility in equity markets and U.S. dollar liquidity in particular weighed on the indicator. The macro indicator was negatively impacted by consumer confidence and global purchasing-manager indices. It currently signals quite weak economic growth. In addition, the surprise indicator has recorded predominantly negative surprises in recent months. Analysts' expectations were largely missed, especially in the United States. The subindicator for the region has fallen from clearly positive to clearly negative.

All in all, our three indicators signal rather wet and cold equity-market weather.

Macro indicator

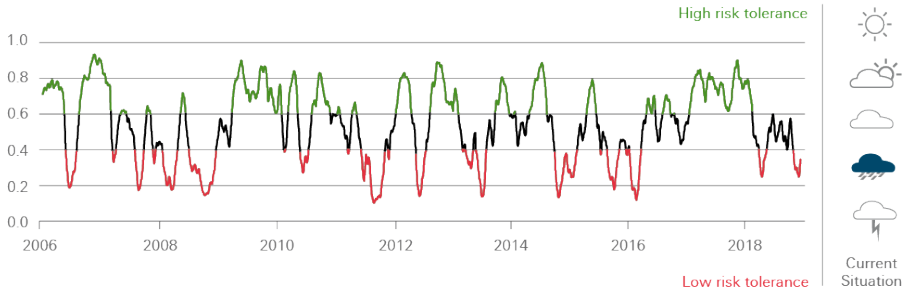
Condenses a wide range of economic data



Source: DWS Investment GmbH as of 12/5/18

Risik indicator

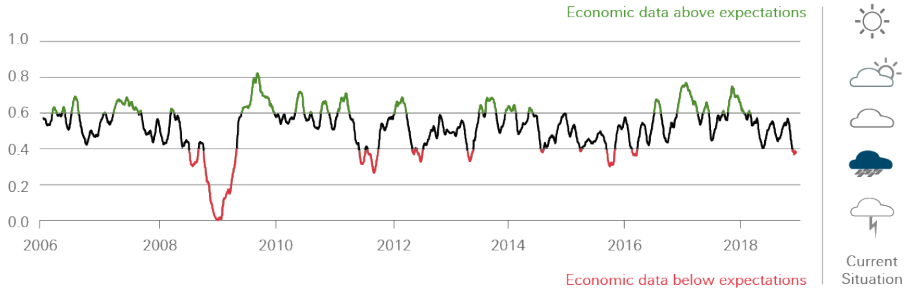
Reflects investors' current level of risk tolerance in the financial markets



Source: DWS Investment GmbH as of 12/5/18

Surprise indicator

Tracks economic data relative to consensus expectations



Source: DWS Investment GmbH as of 12/5/18

Glossary

Bear market

Technically, a **bear market** refers to a situation where the index's value falls at least 20% from a recent high.

Bloomberg Barclays U.S. Corporate High Yield Index

The **Bloomberg Barclays U.S. Corporate High Yield Index** measures the dollar-denominated, high yield, fixed-rate corporate bond market.

Bloomberg Barclays US High Yield Oil Field Services

The **Bloomberg Barclays US High Yield Oil Field Services index** tracks the performance of dollar-denominated below investment grade corporate debt from oil field services companies publicly issued in the US domestic market.

Bull market

A **bull market** is a financial market where prices are rising - usually used in the context of equities markets.

Corporate bond

A corporate bond is a bond issued by a corporation in order finance their business.

Correction

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

Correlation

Correlation is a measure of how closely two variables move together over time.

Dax

The **Dax** is a blue-chip stock-market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange.

Defensive investment strategy

A **defensive investment strategy** is a conservative method of portfolio allocation and management. It aims at choosing and managing assets in a way that generates stable returns and tries to minimize the risk of losing capital.

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.

Diversification

Diversification refers to the dispersal of investments across asset types, geographies and so on with the aim of reducing risk or boosting risk-adjusted returns.

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Emerging markets (EM)

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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.

FTSE 100

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

G20

The **Group of 20** are the largest industrialized and emerging economies in the world.

Government (sovereign) debt/bonds

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

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.

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.

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ICE BofA Merrill Lynch Euro Non-Financial High Yield Constrained Index

The **ICE BofA Merrill Lynch Euro Non-Financial High Yield Constrained Index** tracks the performance of euro-denominated below investment-grade corporate debt publicly issued in the eurobond or euro-domestic markets by non-financial issuers, capping issuer exposure at 3%.

J.P. Morgan Corporate Emerging Markets Bond Index (CEMBI)

The **J. P. Morgan Corporate Emerging Markets Bond Index (CEMBI)** is an index tracking dollar-denominated bonds issued by emerging-market corporates.

Maturity

The final payment date of a financial instrument is its **maturity**.

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.

Multi asset

Multi asset determines investing in more than one asset class, thus creating a group or portfolio of assets with varying weights and types of classes. The diversification of an overall portfolio is thus increased, and risk (volatility) reduced.

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.

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Risk premium

The **risk premium** is the expected return on an investment minus the return that would be earned on a risk-free investment.

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.

Title

Text

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. dollar (USD)

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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.

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.

West Texas Intermediate (WTI)

West Texas Intermediate (WTI) is a grade of crude oil used as a benchmark in oil pricing.

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 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.

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.

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