

ADJUSTING OUR TARGETS FOR 2019

Markets are repricing risks and feel neglected by the Fed.
This could create some downward momentum.

How should a hedge fund have positioned itself if it had known the U.S. Federal Reserve's (Fed's) decisions and press release a day ahead of the market? Until lunchtime on Wednesday noon its staff might have reasonably concluded that the material contained precious little actionable information. On paper, it would have all looked exactly as expected, leaving limited scope for any meaningful market reaction.

This is not, of course, how things actually turned out. Equity markets continued their downward slide, which in turn illustrates two things. First, there are often large gaps between the market consensus, aggregated and communicated in whatever way in the media and by financial-services providers, and what active market participants actually expect and hope for in their heart of hearts. Second, the Fed moves the markets and not the other way around, which seems to be a cause of real anger to the latter.

This steadfastness on the part of the Fed has its merits, as the tweets of the U.S. President that preceded this meeting made it all the more important to demonstrate the central bank's independence, and not only to the financial world. Moreover, a capitulation the Fed in the face of political pressure would only have stored up trouble for the future. Over the medium term, a sudden change in monetary policy would only have increased uncertainty and restricted its room for maneuver at its next but one meeting in March. Should the data situation require it, the Fed could then skip the next interest-rate hike, without risking damage to its credibility.

Even though we share the Fed's economic optimism in principle, on Thursday we decided to adjust our market targets for the end of 2019. Not least, this reflects our view that we can no longer rule out negative feedback from the financial markets to the real economy. Be it solely through the mood component, or also through the worsening financial conditions, there is likely to be some impact on the spending behavior of households and businesses from recent market turbu-

lence. Moreover, market participants often take on more risks in good times than is apparent from the outside – or even to themselves. Sometimes, these risks only become clearly visible with the benefit of hindsight, after market turmoil starts causing damage in unexpected places.

In our opinion, all these channels should not be underestimated. Capital markets played an outsized role in given direction to the U.S. economy, compared to other advanced countries. Given the sharp increase in risk premia for corporate loans, the weaker capitalized U.S. companies, for example, are likely to significantly reduce their share-buyback programs. We might also see declines in the corporate takeover and merger activity, until the dust settles. However, all this can also be seen as overdue normalization, which does not justify panic. As unusual as this fourth quarter may be – the S&P 500 has lost more than 15% so far – recent market weakness must also be seen in relation to the previous rally. The S&P 500 has "only" relinquished the price gains of the past 18 months. Of course this is painful, but by the low point in March 2009 the bear market had set the index back by more than 20 years. And the situation on the bond markets was, as is well known, much worse than it is today – with a corresponding effect on the situation of companies.

Our view of the world did not change fundamentally last month. We continue to see 2019 as a positive year, but at the same time note that there are a handful of developments that are already discernible at present and that could still significantly worsen our picture in the course of the year, or slightly improve it if the situation eases. The market is currently pricing in the risks somewhat higher than we are doing. The minor – adjustments to our price targets are shown in the table below. We now expect two instead of three federal funds rate hikes in the coming year, with corresponding effects on interest rates, which we have also reduced somewhat for Europe. Our preferences regarding asset classes have not changed.

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	Current level Dec 20, 18	Forecast December 2019
Capital market yields (sovereign bonds)		
United States (2-year)	2.67%	2.75%
United States (10-year)	2.81%	3.00%
United States (30-year)	3.05%	3.20%
Municipals*	83.75%	85.00%
Securitized / MBS**	90.7 bp	110 bp
Germany (2-year)	-0.60%	-0.30%
Germany (10-year)	0.23%	0.60%
Germany (30-year)	0.83%	1.20%
Italy (10-year)	250.7 bp	350 bp
Spain (10-year)	114.4 bp	100 bp
United Kingdom (10-year)	1.27%	1.75%
Japan (2-year)	-0.15%	-0.05%
Japan (10-year)	0.03%	0.20%
Currencies		
EUR vs USD	1.14	1.15
USD vs JPY	111	115
EUR vs JPY	127	132
EUR vs GBP	0.90	0.90
GBP vs USD	1.27	1.28
USD vs CNY	6.9	7.0
Commodities in U.S. dollars		
Gold	1,260	1,275
Crude Oil (WTI)	46	60

	Current level Dec 20, 18	Forecast December 2019
Equity markets (index value in points)		
United States (S&P 500)	2,467	2,850
Germany (DAX)***	10,611	11,800
Eurozone (Eurostoxx 50)	3,000	3,150
Europe (Stoxx600)	337	360
Japan (MSCI Japan)	911	990
Switzerland (SMI)	8,414	9,000
United Kingdom (FTSE 100)	6,712	7,080
Emerging Markets (MSCI EM)	960	1,050
Asia ex Japan (MSCI AC Asia ex Japan)	594	650
Benchmark rates in percent		
United States (federal funds rate)****	2.25-2.50	2.75-3.00
Eurozone (refi rate)	0.0	0.0
United Kingdom (repo rate)	0.75	1.00
Japan (overnight call rate)	0.0	0.0
Spreads (corporate & EM bonds) in bps		
EUR IG Corp	169	150
EUR HY	501	430
US IG Corp	137	150
US HY	508	480
Asia Credit	287	285
EM Credit	356	390
EM Sovereign	401	420

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GLOSSARY

Bear market

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

Federal funds rate

The federal funds rate is the interest rate, set by the Fed, at which banks lend money to each other, usually on an overnight basis.

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).

Risk premium

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

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.

Share buybacks

A share buyback involves a company buying back its own shares.

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.

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PERFORMANCE OVER THE PAST 5 YEARS (12-MONTH PERIODS)

	11/13 - 11/14	11/14 - 11/15	11/15 - 11/16	11/16 - 11/17	11/17 - 11/18
UST 30yr	19.2%	1.8%	1.2%	6.3%	-5.3%
UST 10yr	6.7%	2.0%	0.6%	2.2%	-1.6%
UK 10yr	8.9%	2.9%	5.2%	2.2%	2.0%
UST 2yr	0.8%	0.4%	0.7%	0.4%	0.8%
GER 10yr	10.1%	3.2%	2.5%	0.4%	1.6%
GER 2yr	0.4%	0.4%	0.1%	-0.8%	-0.5%
GER 30yr	20.1%	5.8%	6.6%	-1.3%	3.8%
Japan 2yr	0.4%	0.1%	0.1%	-0.1%	-0.1%
Japan 10yr	2.8%	1.8%	2.1%	0.3%	0.1%
EM Sovereign	10.5%	0.2%	7.2%	10.9%	-4.8%
EM Credit	7.1%	-0.2%	8.6%	8.6%	-2.4%
US HY	4.5%	-3.4%	12.1%	9.2%	0.4%
US IG Corp	7.2%	0.0%	4.2%	6.0%	-2.8%
EUR HY	6.5%	2.4%	5.8%	8.1%	-3.0%
Asia Credit	8.6%	2.7%	5.7%	5.4%	-1.9%
EUR IG Corp	7.3%	0.6%	3.2%	3.3%	-1.7%
Spain 10yr	22.1%	4.7%	2.2%	4.2%	1.5%
Italy 10yr	18.3%	6.7%	-1.6%	5.0%	-7.3%

	11/13 - 11/14	11/14 - 11/15	11/15 - 11/16	11/16 - 11/17	11/17 - 11/18
MSCI Asia xJ	3.4%	-12.7%	4.6%	32.2%	-11.7%
MSCI EM	-1.3%	-19.0%	6.0%	29.9%	-11.2%
MSCI Latam	-8.6%	-36.2%	21.4%	16.7%	-4.4%
S&P 500	14.5%	0.6%	5.7%	20.4%	4.3%
MSCI Japan	11.9%	10.0%	-7.7%	19.9%	-6.4%
SMI	10.7%	-1.7%	-12.4%	18.3%	-3.0%
DAX	6.1%	14.0%	-6.5%	22.4%	-13.6%
FTSE 100	1.1%	-5.5%	6.7%	8.0%	-4.7%
Stoxx600	6.8%	11.0%	-11.3%	13.1%	-7.6%
Eurostoxx 50	5.3%	7.9%	-13.0%	17.0%	-11.1%
U.S. mortgage- backed securiti- es	5.4%	1.7%	1.6%	2.1%	-0.5%
CSI 300	15.2%	27.0%	-0.8%	13.2%	-20.8%

Past performance is not indicative of future returns.

Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 12/21/18

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