DWS

Americas CIO View

What to do with small caps and higher beta after this rally?

U.S. equities have priced in a patient Fed and a path to an eventual trade deal

The S&P 500 is up 11.5% year-to-date and 18.9% since the Christmas-Eve trough. In late December, we advised investors not to panic because the blatant market protest of dissent in the last days of 2018 would force the U.S. Federal Reserve (Fed) to realize that they should bluntly signal a much more cautious stance on future hikes as the federal funds rate enters its arguable neutral range and the economy slows. We acknowledged then and now, that the U.S.-China trade deal and Brexit risks remain, but we expect time to be provided to find solutions that avoid severely adverse outcomes to the economies of the negotiating parties. While full resolutions are still unlikely in the near-term, we believe that it becomes more likely as time evolves.

Small caps significantly outperformed large caps across all sectors in this rally

The Russell 2000 is up 17.8% year-to-date and 25.4% since its Christmas trough, significantly outperforming its large-cap counterparts as the outperformance is across all sectors. It is typical for small caps to outperform when exiting recessions or bear markets. But now that both the S&P 500 and Russell 2000 are within shouting distance from their previous peaks, an examination of the macroeconomic backdrop, earnings-growth outlook, balance sheets and valuations causes us to return to our small underweight we had before late 2018's sell off.

Five reasons why large Growth stocks and Banks have a better risk-reward

First, on a rolling 5-year basis, the relative performance of small vs. large is near the high end again for this cycle. Second, in case of a continuing slowdown in U.S. gross domestic product (GDP) at least through 2020 it should continue to make it hard for the Russell 2000 to deliver superior earnings growth than the S&P 500. The S&P 500 is more exposed to global GDP, but its higher quality businesses should grow more if global growth is decent. Third, if the market continues to rally from here, good news from the trade talks and Brexit should be important drivers and large caps should benefit more; yet if the market pulls back on bad news small caps likely suffer more, especially if levered. Fourth, despite a higher tax-cut benefit, the Russell 2000 failed to deliver stronger earnings-per-share (EPS) growth than the S&P 500 in 2018. The fourth quarter of 2018 was another disappointing quarter with Russell-2000-EPS growth at 10.4% ex. companies with negative earnings, which compares to 15% at the S&P 500. Fifth, while the valuation premium of the Russell 2000 vs. the S&P 500 is off its prior highs (the relative price-to-earnings ratio (P/E) of the Russell 2000

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In a nutshell

- U.S. equities have priced in a patient Fed and a path to an eventual trade deal
- Small caps significantly outperformed large caps across all sectors in this rally
- Five reasons why large growth stocks and banks have a better risk-reward
- DWS strategic views: Global equities near fairly priced and overweight emerging markets

vs. the S&P 500 is back to average of this cycle) the relative P/E is still above average since 1976 if excluding companies with negative earnings. These levels of valuation would not be concerning if the Russell 2000 was delivering EPS growth at least on par with the S&P 500, but because the Russell 2000 did not in 2018 it seems unlikely for the rest of cycle. Besides the Russell 2000 leverage is higher.

DWS strategic views: Global equities near fairly priced and overweight EM

For the next 12 months through March 2020, we expect global equities to deliver better returns (4-9%) than fixed income. Our 12-month total return estimates by equity regions are: Emerging Markets (EM) (9%), EM Asia (7%), United States (5%), Europe (4%) and Japan (4%). Our CIO View is overweight EM and neutral on the relative preferences among the other regional equity markets. Our EM overweight is based on the view that several headwinds should be fading: 1) no sharp U.S. Dollar (USD) gains are likely now that the Fed plans to move more slowly; 2) the negative impact of semi-conductor profit reductions, severely impacting 2019 Taiwanese and South-Korean EPS, should soon lapse; 3) new structural reforms or stimulus programs in Brazil and China are in progress; 4) low inflation rates should allow monetary easing in several EM countries; 5) while relative P/Es of EM to developed market (DM) are not depressed, we expect EM to show the best EPS momentum over the coming years. Sector-wise, our CIO view is overweight Financials, particularly big U.S. Banks. In the United States, we have a preference for growth-stock sectors as they tend to outperform in the latter years of long-lasting expansions. We point to the United States and EM Asia as having high growth-stock compositions. Our CIO view is that 10-year U.S. Treasury yields will climb gradually to 3.0%, and U.S. investment-grade (IG) credit spread will remain tight, but the high-yield (HY) spreads widen slightly. Euro is expected to be stable at 1.15 and USD/CNY (Chinese yuan) to weaken to 7.0. West Texas Intermediate (WTI) oil is expected to rise to 60 USD per barrel.

Performance over the past 5 years (12-month periods)

	01/14 - 01/15	01/15 - 01/16	01/16 - 01/17	01/17 - 01/18	01/18 - 01/19
S&P 500	11.9%	-2.7%	17.5%	23.9%	-4.2%
Russell 2000	3.1%	-11.2%	31.5%	15.7%	-4.8%
10-year U.S. Treasuries	10.2%	0.6%	-2.0%	0.2%	3.9%

Glossary

Balance sheet

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

Barrel (bbl)

A **barrel (bbl)** is the commonly used unit to measure crude oil. One barrel is about 159 liters.

Bear market

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

Brexit

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

Chinese yuan (CNY)

The **Chinese yuan (CNY)** is legal tender on the Chinese mainland and the unit of account of the currency, Renminbi (RMB).

Developed Markets (DM)

A **developed market (DM)** is a country fully developed in terms of its economy and capital markets.

Earnings per share (EPS)

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

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.

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.

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.

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.

Leverage

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

Monetary easing

includes measures such as lowering interest rates, implemented by Central Banks with the aim of facilitating GDP growth or inflation.

Price-to-earnings (P/E) ratio or multiple

The **price-to-earnings (P/E) ratio** compares a company's current share price to its earnings per share.

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.

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.

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)

The **U.S. dollar (USD)** is the official currency of the United States and its overseas territories.

U.S. Federal Reserve (Fed)

The **U.S. Federal Reserve**, often referred to as "**the Fed**", is the central bank of the United States.

Valuation

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm's stock price in relation to its earnings.

Valuation premium

A **valuation premium** is the excess a buyer is willing to pay for one asset relative to other assets.

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.

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