Media Information

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DWS Market Outlook 2023: Return on risk assets should be above inflation

- Geopolitical tensions will influence markets for a long time to come
- Asian emerging markets with catch-up potential
- Interest rate investments partly more attractive than equities - promising infrastructure investments

"The questions of to what extent and how quickly inflation can be pushed back and how much central banks still need to raise interest rates to do so will be the dominant theme for capital markets in the coming year," said Björn Jesch, Global CIO at DWS, at the DWS Market Outlook 2023 on 28 November 2022. "We think central banks will keep interest rates high for longer than markets currently expect," Jesch said. For the US Federal Reserve, Jesch expects it to raise key interest rates to between 5 and 5.25 per cent next year, while in the eurozone the key rate is likely to rise to 3.0 per cent. "We do not currently see a rate cut next year," Jesch said. "Inflation rates are expected to fall in 2023 but will still remain at a high level – 6.0 per cent in the eurozone and 4.1 per cent in the US."

Geopolitical tensions will continue

Global tensions between the US, China, Russia and Europe will dominate political and economic events in the coming years. "The world will be a different place than it has been in the last five to ten years," Jesch said. The population in developed countries is shrinking, combating climate change will require huge investments and Europe will have to break new ground in energy supply.

The trend to make supply chains more resilient and to reduce the high dependence on individual countries is understandable and also necessary in view of the crises, but it reduces efficiency and thus leads to higher production costs and ultimately weakens the supply side of the economy.

The biggest geopolitical risk factor is currently Russia. The eurozone economy is suffering particularly badly from the consequences of the Russian war of aggression on Ukraine. However, it has held up surprisingly well so far with growth of 3.2 per cent despite the sanctions.

Only a mild recession, but also only a weak upswing

The looming mild recession in the US and the eurozone will be very different from previous downturns. "Thanks to the demographically driven labour market, which is robust even in a downturn, workers will keep their jobs – for the most part – household incomes will remain stable and consumers will continue to consume," Jesch said. However, the recovery after the downturn will also be very modest. Jesch forecasts growth rates of 0.3 per cent (2023) and 1.2 per cent (2024) for the Eurozone, and 0.4 and 1.3 per cent for the US.

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On the corporate side, profits are likely to come under pressure, but much less so than in past recessions. Jesch's conclusion: "In view of the higher interest rate level, bonds are significantly more attractive than in the past, as a yield generator and as a diversification instrument.” In general, however, the return prospects of risk assets are limited, but high enough to be able to beat inflation.

Emerging markets favourably valued - India and Indonesia promising

"Once Covid Zero Policy restrictions are significantly rolled back in China, Chinese equities should get a significant boost, said Sean Taylor, CIO APAC. "It's not going to happen overnight, but I think we can expect to see some upside over the next year." In the medium-term, he said, there are still some risk factors. For example, the further development of wealth equilibrium levels, the real estate sector and geopolitical risks. In general, emerging markets are now quite favourably valued. The price-earnings ratio is currently at 10.5, well below the average of the last ten years (14.2). India and Indonesia are particularly promising. Both countries should benefit from the reopening of the economy and the prospects for strong, structural growth. Taylor is also positive about South Korea. The stock market there had corrected significantly in September and October and is now favourably valued again. Particularly interesting here: Companies from the semiconductor and battery sectors. In general, the expected somewhat weaker dollar and easing inflation should have a positive effect on the emerging markets in the short-term. "In the medium-term, however, global export weakness needs to be overcome and the Chinese economy needs to regain momentum before we overweight emerging markets in our portfolios," says Taylor.

Japan, a traditionally defensive equity market, remains a good vehicle for diversification, he said. Companies could score with healthy balance sheets and robust earnings. An opening of the Chinese economy could have a positive effect on Japan next year, as about 45 per cent of the Japanese stock market's profits are generated in Chinese business. However, the Japanese stock market is not likely to develop as dynamically in 2023 as other Asian countries that have a higher catch-up potential. On the other hand, the risk of a worse development in Japan is significantly lower than in the Asian emerging markets.

New attractiveness of interest-bearing investments – Euro corporate bonds look promising

"We are currently seeing the comeback of an asset class. "Euro corporate bonds with good credit ratings (investment grade) are currently offering yields of just under four per cent, a level we last saw more than ten years ago," said Thomas Höfer, Head Investment Grade Credit. This means that the yields of solid corporate bonds are even higher than the corresponding dividend yields". The outlook for this asset class – with a view to the next twelve months – is extremely positive, the risks manageable. The imminent recession is already priced into the interest rate premiums. The balance sheets of most companies are much more solid than they used to be in times of an economic downturn. On the credit side, there are currently no excessively high risks in sight. According to Höfer, senior bank bonds and hybrid corporate bonds with yields of six to seven percent are particularly promising. Also interesting are the riskier euro high-yield bonds, which currently have yields of 7.3 per cent. At 0.7 per cent, default rates are at a historically very low level. They are likely

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to rise, but much less than in previous phases of an economic downturn. Nevertheless, a careful selection of stocks is mandatory.

Equities – slight advantage for Europe and value stocks

"The equity markets face another test. After the rise in interest rates put pressure on valuations this year, the development of corporate earnings will play a decisive role next year," said Marcus Poppe, Portfolio Manager Global Equities. In general, however, companies are much better positioned for the expected mild recession than they were during the 2008 financial crisis, for example, he said. "Tactically, we are quite bullish on European equities." The valuation discount to US stocks of 31 per cent is more than double the average of the past 20 years (14 per cent). The outlook for value stocks, which have a higher weighting in European indices than in US indices, remains positive, he said. "The days of buying growth stocks at any price are over for now," Poppe said. In general, the following applies to equity investments in the coming year: "Price opportunities are moderate, prices are likely to fluctuate strongly. We do not expect a pronounced upswing across the board. The selection of the right sectors and, within these, the most promising individual stocks is decisive. Particularly promising are selected stocks from the health care sector as well as companies from the industry sector whose business models are based on advancing energy efficiency.

Trend reversal expected for real estate – promising infrastructure investments

The rise in interest rates has also made itself felt in the real estate sector. "The yield advantage of real estate investments over ten-year government bonds has shrunk significantly this year; real estate valuations have come under pressure," said Jessica Hardman, Head of European Real Estate Portfolio Management. But this trend is likely to reverse next year. The yield gap to government bonds will rise and real estate investments will become more attractive for investors again. The residential real estate segment remains promising. There is still a high demand from European residents for very limited supply.

Hardman also shifted the focus to infrastructure investments. Especially in the environment of an economic transformation with a high demand for infrastructure investments, investments in this field are promising. "The major tasks of decarbonisation and digitalisation in the areas of public transport, energy and circular economy open up interesting, defensive investment opportunities for investors in the infrastructure sector, which furthermore offers contractual inflation indexation and reliable, long term income streams," Hardman said.

“Lower volatility compared to other asset classes, less correlation to the performance of equities and fixed income, and improved pricing resulting in a good risk-return profile in the near term continue to speak in favour of the alternative investment asset class,” she added.

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DWS Group (DWS) with EUR 833bn of assets under management (as of 30 September 2022) aspires to be one of the world's leading asset managers. Building on more than 60 years of experience, it has a reputation for excellence in Germany, Europe, the Americas and Asia. DWS is recognized by clients globally as a trusted source for integrated investment solutions, stability and innovation across a full spectrum of investment disciplines.

We offer individuals and institutions access to our strong investment capabilities across all major liquid and illiquid asset classes as well as solutions aligned to growth trends. Our diverse expertise in Active, Passive and Alternatives asset management – as well as our deep environmental, social and governance focus – complement each other when creating targeted solutions for our clients. Our expertise and on-the-ground knowledge of our economists, research analysts and investment professionals are brought together in one consistent global CIO View, giving strategic guidance to our investment approach.

DWS wants to innovate and shape the future of investing. We understand that, both as a corporate as well as a trusted advisor to our clients, we have a crucial role in helping navigate the transition to a more sustainable future. With approximately 3,900 employees in offices all over the world, we are local while being one global team. We are committed to acting on behalf of our clients and investing with their best interests at heart so that they can reach their financial goals, no matter what the future holds. With our entrepreneurial, collaborative spirit, we work every day to deliver outstanding investment results, in both good and challenging times to build the best foundation for our clients' financial future.

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