

# Our monthly market analysis and positioning



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### IN A NUTSHELL

- March saw the first prominent victims of the current interest rate hiking cycle amidst banking sector turmoil.
- It remains hard to tell how much of a slowdown in real economic activity tighter financial conditions might cause. For now, rate hikes look set to continue.
- We continue to see Eurozone credit, in both the HY and IG segment as stand-out picks in terms of their risk/reward profile.

## 1 / Market overview

### 1.1 First prominent victims of this interest rate hiking cycle amidst banking sector turmoil

**Nevertheless, comparisons with the 2008 crises should not be overdone.**

The best thing that can be said about the month of March from an investor's perspective is that it ended relatively calmly. Compare that to the sense of panic in the week of March 10<sup>th</sup>, when troubles of a so-called regional bank<sup>1</sup> from Silicon Valley manifested itself in record-high volatility numbers in the Treasury market.<sup>2</sup> The fact that shortly afterwards, Credit Suisse (CS), one of the two large Swiss institutes, lost its independence after 167 years, shows how quickly things can deteriorate, especially in the banking sector. Questions about the stability of the banking system were quickly raised on both sides of the Atlantic; routine calls for help from government agencies and central banks swiftly became louder. But the latter, particularly at the European Central Bank (ECB) and the Federal Reserve (Fed), showed no signs of pivoting from their monetary policy path.

Instead, both the ECB and the Fed raised interest rates again roughly in lines with expectations. Moreover, central bankers pointed out that they had other instruments at their disposal to rescue individual financial institutions. After a brief moment of shock, that was ultimately a message well received by financial markets. What frightened some investors more, however, was the handling of the Swiss authorities of Additional-Tier 1 (AT1) bonds – a type of debt intended to absorb losses when a bank fails that has become common in Europe since 2008.<sup>3</sup> Contrary to market understanding, AT1 bonds issued by CS were written off in full (at least CHF 16 billion), even as the bank's shareholders received CHF 3 billion worth of new shares. That shook the confidence of many investors in AT1s, reminding them that even government agencies can be quite unpredictable in times of financial stress, leaving legal niceties to be sorted out in courts years later.

Nevertheless, we do not think that this will spell the death knell for AT1 bonds and similar types of equity-like bond assets. In general, we see the events of March not just as a reminder of risks, but rather as a necessary and expected by-product of the current monetary tightening cycle. Higher rates eventually tend to leave real wounds in the financial system. However,

<sup>1</sup> The term "regional" should not hide the fact that the bank in question had more than \$200 billion in total assets.

<sup>2</sup> The Move Index rose to 200, a level it had previously reached only once in its history, at the turn of the year 2008/2009.

<sup>3</sup> The idea behind AT1s and similar instruments was to introduce an additional risk buffer in order to ideally avoid the need for government financed bail-outs. If the core capital ratio falls below a certain level, AT1 bonds (most of which are a subset of so-called contingent convertible or CoCo bonds) are initially converted into equity and may be written off completely if the viability of the bank in question continues to deteriorate.

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tighter financial conditions are essential for getting inflation under control. At the same time, we think that European banks in particular are in a more solid position than in 2008. Of course, that does not mean we can rule out further accidents, either in banking or in other, less supervised corners of the financial system. After all, this has been the speediest rate hiking cycles many countries have experienced in their modern monetary history. Some further fall-out would not and should come as surprises in coming months. In addition to keeping an eye on banks and other financial institutions, real estate companies, for example, may also be vulnerable to some forms of maturity transformation risks. A look at the stock price weakness of many large European real estate companies confirms that fears of rapidly increasing refinancing costs exceeding the rental returns for some property companies are becoming more widespread, even as, from a longer-term perspective, real estate looks like an increasingly plausible beneficiary of investing in inflationary times.

## 1.2 March mainly caused a stir for bonds; Gold made it back above USD 2000/oz

Despite a rough month for bank stocks, equities proved quite resilient overall.

Glancing at charts of leading global equity indices, such as the S&P 500, one would be hard pressed to describe the recent month as especially tumultuous. Indeed, the first quarter as a whole saw solid returns (in local currencies) for the S&P 500 index (plus 7.5%), Europe's Stoxx 600 (plus 8.6%) and Japan's Nikkei 225 (plus 8.5%). Partly, that was due to interest rate expectations moving lower following the banking turmoil and growing recession fears. Lower rates expectations, in turn, helped secular growth stocks, notably in technology. The Nasdaq Composite (plus 17%) had its best quarter in almost three years.

To be sure, the seeming stability at the level of large cap indices hides plenty of variation, with U.S. banks losing an average of 18% during the quarter and European banks losing about two thirds of their previous gains in March. Small cap stocks also had it rough, perhaps reflecting concerns about tightening lending standards. Especially in Europe, they could be prime beneficiaries if the feared credit crunch fails to materialize.

Meanwhile, bonds went on a rollercoaster ride by the standards of fixed income asset classes. Just before the Silicon Valley bank turmoil, 2-year Treasury yields rose to a post-2007 peak of 5.07%, amidst expectations of the Fed raising rates to almost 5.7%. That swiftly reversed, allowing Treasuries to deliver their best monthly performance in 3 years since March 2020. For the quarter as a whole, credit saw solid gains on both sides of the Atlantic.

Gold benefited from its safe haven appeal, advancing 8% during the quarter. Not so much the dollar, which was particularly weak on the days of greatest bond market and banking stress. By contrast, the yen was sought after, perhaps because the Bank of Japan (BoJ) still ultra-loose monetary policies has no scope for renewed cuts, unlike the ECB and Fed.

Excluding precious metals, commodities saw price declines over the course of the quarter, with Brent crude oil prices down 7%, after already ending 2022 on a weak note. Over the weekend, OPEC+ nations announced production cuts at the start of April, overing an additional reminder on just how unsteady some currently see the economic outlook.

## 2 / Outlook and changes

Overall, we stick to our big, strategic calls. To put it briefly, not least as we last updated these only two weeks ago<sup>4</sup>: following historically speedy and aggressive monetary tightening, it was only a matter of time until we might see something along the lines of the recent banking sector turmoil. We expect major central banks, led by the ECB and the Fed, to await firm evidence of inflationary pressures easing, before contemplating any interest rate cuts. While accidents can never be fully ruled out at such delicate turning points, we continue to think that a full-blown credit crunch is very unlikely. There will be a tightening of lending standards, which looks set to be both painful – and necessary.

<sup>4</sup> Investment Traffic Lights (dws.com)

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## 2.1 Fixed Income

How much of a slowdown in economic activity is the banking turmoil causing? Even a few weeks in, it remains hard to tell from recent data and high frequency economic indicators. For now at least, labor markets continue to look quite strong on both sides of the Atlantic. Of course, wages and employment tend to be lagging behind economic activity. Still, it is probably too early for either the Fed or the ECB to consider their jobs in containing inflation to be done.

### Government Bonds

Against this backdrop, short-dated U.S. Treasuries remain a viable consideration to hedge downside risks, with 2-years yielding 4% after the hefty rate increase of the past 12 months and despite the flight to safety in recent weeks. After a tumultuous few weeks in Europe, we have moved back to neutral for 2-year German Bunds, partly because we would expect further signs of stabilization in European banking to continue to push yields back upwards. Among other sovereigns, we would signal out Spain as especially attractive, given the overall support from the EU and various Eurozone mechanisms are likely to keep a lid on spreads.

### Investment Grade Credit

We remain constructive on Eurozone IG Credit. However, we acknowledge that following the sharp squeeze rally since the middle of March, a big chunk of the gains may already be behind us. For US IG Credit, we tactically take a neutral stance, not least as corporate debt issuance appears to be back in full swing.

### High Yield Credit

Following the recent spread widening and stabilization of the market for Eurozone High Yield credit, we are constructive on the segment from both a tactical and strategic perspective. Most European corporates have shown high levels of resilience. Default rates look likely to remain low. And while there are plenty of macro and financial risks and every likelihood of some continuing volatility, we would not expect spreads to test the March lows again any time soon. The outlook is more balanced for U.S. high yield, partly due to differences in sector composition.

### Emerging Markets

During the recent turmoil, credit spreads on EM corporate debt widened a sharp 50 basis points since early March, reflecting broader economic concerns around increased recessionary fears and weakness in industrial commodities. In our view, further spillover risks into EM are mitigated by healthy EM banking systems and overall solid bottom-up credit fundamentals, making current levels an attractive tactical entry point. We remain neutral on EM sovereigns: with plenty idiosyncratic country factors, selection, rather than the overall stance, remains key within this asset class.

### Euro vs. dollar

We expect the dollar to continue to weaken against the euro and the yen, partly because we would expect any early signs of economic slowing to first materialize in the U.S.. Moreover, interest rate hikes in the Eurozone might continue for a little longer than in the US.

## 2.2 Equities

From a 12-month perspective, we are once again quite cautious on global equities, following their recent recovery. To wit, the S&P 500 Index ended March trading in line with our 12-month target, which has itself been unchanged since June 2022. This means that returns will largely have to come from dividend payments. With hardly any potential for margin improvements, particularly in the U.S., one has to largely look elsewhere for earnings growth or valuation upside.

### U.S. Market

We expect the full impact of restrictive monetary policies to stretch out over an extended period, limiting economic growth. Political risks could also move back into focus, with the U.S. debt ceiling looming in coming months and the presidential election cycle about to get started. In the medium term, however, U.S. equities should resume shinning, not least given the multitude of innovative companies in emerging sectors, such as artificial intelligence.

### European and German Markets

We continue to stick to our tactical call in favoring European equities, having lifted our 12-month target to 480 for the Stoxx 600 and 16,300 for the DAX. In a nutshell, our case remains that while European valuation discounts relative to the U.S. have finally started to shrink, they remain far higher than usual during the past 20 years. Within Europe, we reiterate the attractiveness of small and mid-cap stocks.

### Emerging Markets

Especially in Asia, we continue to consider it likely that emerging market equities will benefit from improving macro prospects in China, as well as earnings momentum which should prove rather better over the medium term than in developed markets.

## 2.3 Alternatives

### Real Estate

In the short-term, property valuations are likely to remain under pressure, not having kept pace with increases in prime yields. In essence, uncertainty remains high and buyers and sellers are not fully aligned yet, which is reflected in limited transaction volumes. We would reiterate, however, from a longer-term perspective, real estate looks like an increasingly plausible beneficiary of investing in inflationary times and that coming months could provide attractive entry points.

### Infrastructure

Overall, infrastructure remains well-placed to accommodate higher rates and inflation. Significant levels of policy support are in place across Europe and the U.S. to allow investors to target energy transition investments at scale. Still, a careful analysis and selection is required, not least given the potential for regulatory headwinds and elevated capital and material input cost pressures. At the same time consumer demand facing segments (such as power generation serving spot markets) are seeing price and revenue pressures, after last year's bumper revenues.

### Gold

After a rather lackluster run in 2022, gold shines again in 2023. Hard to say how and why, exactly, the precious metal responds positively to some episodes of stress in the financial system, geopolitical risks and high inflation, while failing to do so in others. From a portfolio perspective we like gold, precisely because it is not strongly correlated to any other single asset class for any prolonged period of time. For illustration, just look at the changing correlation with real 2-year U.S. Treasury yields in recent years.

### Oil

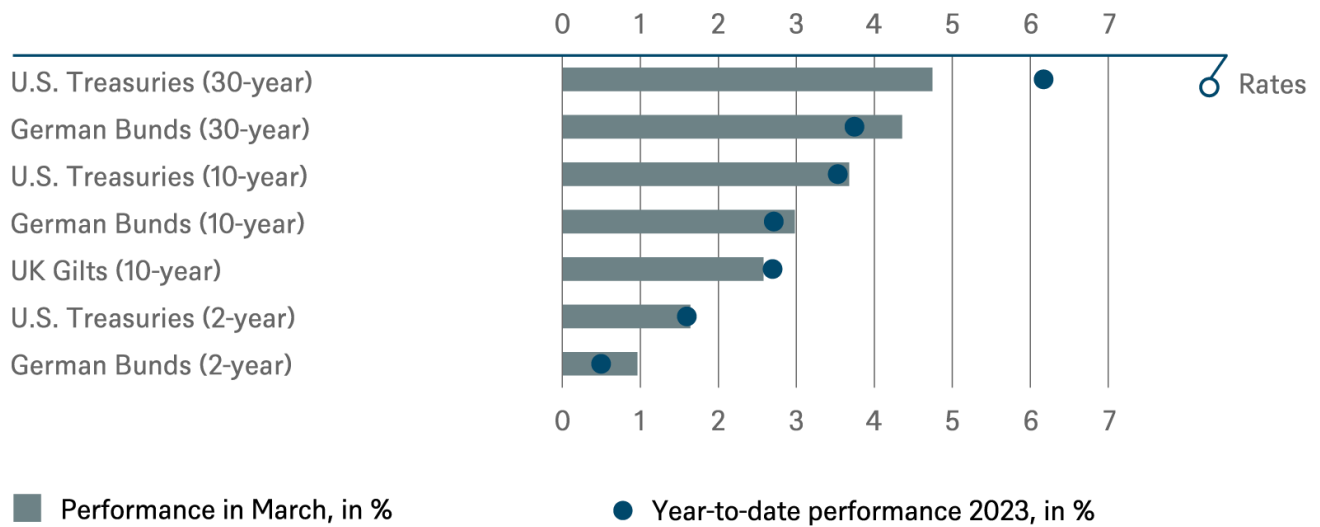
In our view, the surprise voluntary production cut announcement by OPEC+ nations signals willingness from the participating countries to maintain Brent price above 80 USD per barrel. The cuts may bring the expected oil deficit forward to earlier in 2H2023. We see this move as a confirmation of our view of the balanced and price supportive oil market by year end 2023.

## 2.4 DWS High Conviction

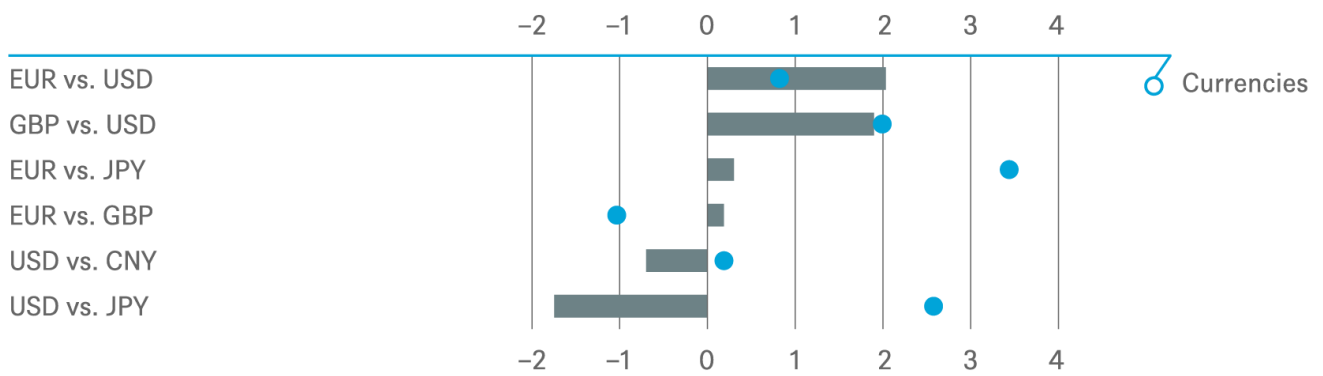
As highlighted above, we currently see Eurozone credit, in both the HY and IG segments, as stand-out picks in terms of their risk/reward profile. This is mirrored by our continuing preference for European equities, particularly small and mid-cap stocks. Emerging markets too are throwing up interesting opportunities on both the corporate bond and the equities side.

### 3 / Past performance of major financial assets

Total return of major financial assets year-to-date and past month



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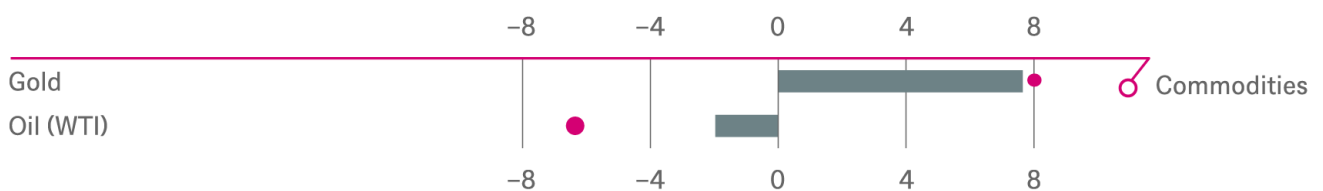
■ Performance in March, in %

● Year-to-date performance 2023, in %



■ Performance in March, in %

● Year-to-date performance 2023, in %



■ Performance in March, in %

● Year-to-date performance 2023, in %

Past performance is not indicative of future returns.  
Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 3/31/23

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## 4 / Tactical and strategic signals

The following exhibit depicts our short-term and long-term positioning.

### 4.1 Fixed income

Rates	1 to 3 months	until Mar 2024
U.S. Treasuries (2-year)	●	●
U.S. Treasuries (10-year)	●	●
U.S. Treasuries (30-year)	●	●
German Bunds (2-year)	●	●
German Bunds (10-year)	●	●
German Bunds (30-year)	●	●
UK Gilts (10-year)	●	●
Japanese government bonds (2-year)	●	●
Japanese government bonds (10-year)	●	●

#### Secritized / specialities

	1 to 3 months	until Mar 2024
Covered bonds <sup>1</sup>	●	●
U.S. municipal bonds	●	●
U.S. mortgage-backed securities	●	●

### 4.2 Equities

Regions	1 to 3 months <sup>2</sup>	until Mar 2024
United States <sup>3</sup>	●	●
Europe <sup>4</sup>	●	●
Eurozone <sup>5</sup>	●	●
Germany <sup>6</sup>	●	●
Switzerland <sup>7</sup>	●	●
United Kingdom (UK) <sup>8</sup>	●	●
Emerging markets <sup>9</sup>	●	●
Asia ex Japan <sup>10</sup>	●	●
Japan <sup>11</sup>	●	●

Spreads	1 to 3 months	until Mar 2024
Spain (10-year) <sup>1</sup>	●	●
Italy (10-year) <sup>1</sup>	●	●
U.S. investment grade	●	●
U.S. high yield	●	●
Euro investment grade <sup>1</sup>	●	●
Euro high yield <sup>1</sup>	●	●
Asia credit	●	●
Emerging-market credit	●	●
Emerging-market sovereigns	●	●

#### Currencies

	1 to 3 months	until Mar 2024
EUR vs. USD	●	●
USD vs. JPY	●	●
EUR vs. JPY	●	●
EUR vs. GBP	●	●
GBP vs. USD	●	●
USD vs. CNY	●	●

#### Sectors

	1 to 3 months <sup>2</sup>
Consumer staples <sup>12</sup>	●
Healthcare <sup>13</sup>	●
Communication services <sup>14</sup>	●
Utilities <sup>15</sup>	●
Consumer discretionary <sup>16</sup>	●
Energy <sup>17</sup>	●
Financials <sup>18</sup>	●
Industrials <sup>19</sup>	●
Information technology <sup>20</sup>	●
Materials <sup>21</sup>	●

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Style	1 to 3 months
U.S. small caps <sup>22</sup>	●
European small caps <sup>23</sup>	●

### 4.3 Alternatives

Alternatives	1 to 3 months <sup>2</sup>	until Mar 2024
Commodities <sup>24</sup>	●	●
Oil (WTI)	●	●
Gold	●	●
Infrastructure	●	●
Real estate (listed)	●	●
Real estate (non-listed) APAC <sup>25</sup>		●
Real estate (non-listed) Europe <sup>25</sup>		●
Real estate (non-listed) United States <sup>25</sup>		●

<sup>1</sup>Spread over German Bunds. <sup>2</sup>Relative to the MSCI AC World Index (only for the tactical signals).<sup>3</sup>S&P 500, <sup>4</sup>Stoxx Europe 600, <sup>5</sup>Euro Stoxx 50, <sup>6</sup>Dax, <sup>7</sup>Swiss Market Index, <sup>8</sup>FTSE 100, <sup>9</sup>MSCI Emerging Markets Index, <sup>10</sup>MSCI AC Asia ex Japan Index, <sup>11</sup>MSCI Japan Index, <sup>12</sup>MSCI AC World Consumer Staples Index, <sup>13</sup>MSCI AC World Health Care Index, <sup>14</sup>MSCI AC World Communication Services Index, <sup>15</sup>MSCI AC World Utilities Index, <sup>16</sup>MSCI AC World Consumer Discretionary Index, <sup>17</sup>MSCI AC World Energy Index, <sup>18</sup>MSCI AC World Financials Index, <sup>19</sup>MSCI AC World Industrials Index, <sup>20</sup>MSCI AC World Information Technology Index, <sup>21</sup>MSCI AC World Materials Index, <sup>22</sup>Russell 2000 Index relative to the S&P 500, <sup>23</sup>Stoxx Europe Small 200 relative to the Stoxx Europe 600, <sup>24</sup>Relative to the Bloomberg Commodity Index, <sup>25</sup>Long-term investments.

#### Tactical view (1 to 3 months)

The focus of our tactical view for fixed income is on trends in bond prices.

- Positive view
- Neutral view
- Negative view

#### Strategic view until March 2023

- The focus of our strategic view for sovereign bonds is on bond prices.
- For corporates, securitized/specialties and emerging-market bonds in U.S. dollars, the signals depict the option-adjusted spread over U.S. Treasuries. For bonds denominated in euros, the illustration depicts the spread in comparison with German Bunds. Both spread and sovereign-bond-yield trends influence the bond value. For investors seeking to profit only from spread trends, a hedge against changing interest rates may be a consideration.
- The colors illustrate the return opportunities for long-only investors.
  - ● Positive return potential for long-only investors
  - ● Limited return opportunity as well as downside risk
  - ● Negative return potential for long-only investors

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## Glossary

**Additional Tier 1 bonds**, or AT1s for short, are part of a family of bank capital securities. They are bonds issued by banks that contribute to the total level of capital they are required to hold by regulators.

The **Bank of Japan (BoJ)** is the central bank of Japan.

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

The **Bloomberg Commodity Index (BCOM)** traces 23 commodities and reflects commodity futures price movements.

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

The **Dax** is a blue-chip stock-market index consisting of the 40 major German companies trading on the Frankfurt Stock Exchange.

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

A **dividend** is a distribution of a portion of a company's earnings to its shareholders.

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

The **Euro Stoxx 50** is an index that tracks the performance of blue-chip stocks in the Eurozone.

The **European Central Bank (ECB)** is the central bank for the Eurozone.

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

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

**High-yield** bonds are issued by below-investment-grade-rated issuers and usually offer a relatively high yield.

**Inflation** is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

**Investment grade (IG)** refers to a credit rating from a rating agency that indicates that a bond has a relatively low risk of default.

The **Japanese yen (JPY)** is the official currency of Japan.

The **MSCI AC World Communication Services Index** captures large- and mid-cap securities across 23 developed- and 26 emerging-markets classified in the Communications Services sector.

The **MSCI AC World Consumer Discretionary Index** captures large- and mid-cap securities across 23 developed- and 26 emerging-markets classified in the Consumer Discretionary sector.

The **MSCI AC World Consumer Staples Index** captures large- and mid-cap securities across 23 developed- and 26 emerging-markets classified in the Consumer Staples sector.

The **MSCI AC World Energy Index** captures large- and mid-cap securities across 23 developed-markets classified in the Energy sector.

The **MSCI AC World Financials Index** captures large- and mid-cap securities across 23 developed- and 26 emerging-markets classified in the Financials sector.

The **MSCI AC World Health Care Index** captures large- and mid-cap securities across 23 developed- and 26 emerging-markets classified in the Health Care sector.

The **MSCI AC World Index** captures large- and mid-cap companies across 23 developed- and 24 emerging-market countries.

The **MSCI AC World Industrials Index** captures large- and mid-cap securities across 23 developed- and 26 emerging-markets classified in the Industrials sector.

The **MSCI AC World Information Technology Index** captures large- and mid-cap securities across 23 developed- and 26 emerging-markets classified in the Information Technology sector.

The **MSCI AC World Utilities Index** captures large- and mid-cap securities across 23 developed- and 26 emerging-markets classified in the Utilities sector.

The **MSCI AC Asia ex Japan Index** captures large- and mid-cap representation across 2 of 3 developed-market countries (excluding Japan) and 8 emerging-market countries in Asia.

The **MSCI Emerging Markets Index** captures large- and mid-cap representation across 23 emerging-market countries.

The **Nikkei 225** is a price-weighted index of Japan's 225 most important listed companies.

**OPEC+** is an informal alliance of OPEC members and other oil-producing countries, led by Russia, aiming to coordinate their production strategies.

The **Russell 2000 Index** 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.

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The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

The **Stoxx Europe 600** is an index representing the performance of 600 listed companies across 18 European countries.

The **Stoxx Europe Small 200** is an index representing the performance of 200 small capitalization companies across 17 European countries.

The **Swiss Market Index (SMI)** is Switzerland's most important equity index, consisting of the 20 largest and most liquid large- and mid-cap stocks.

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

**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.

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