

# Our monthly market analysis and positioning



## IN A NUTSHELL

- The first half of 2022 was bad, the second quarter worse and June the worst. July hasn't started well either
- Inflation and hawkish central bank rhetoric have delivered the biggest hit to valuations so far but recession fears are now getting in on the act.
- Markets are likely to remain volatile in summer, as long as there is uncertainty about when inflation and the hiking cycle will peak. The war in Ukraine adds to uncertainty.

### Stefan Kreuzkamp

Chief Investment Officer and Head of Investment Division

## 1 / Market overview

The first half of the year is over. Optimists will feel the next six months have got to be better. Pessimists might see the first half as a foretaste of the second. The truth probably lies in the middle. The first half was bad in many respects, and some things will remain bad for a while. But economies and financial markets are reacting. Shifts in volumes and prices may in time prove the basis for recovery in economies and markets.

High and rising prices were the dominant theme in the first half of the year. Inflation rates have put so much pressure on central banks that they are now trying to compensate for their previous "only transitory" lethargy with increasingly hawkish rhetoric and, in the Fed's case especially, action. In June the Fed raised its key interest rate by 75 basis points, the most in 28 years.<sup>1</sup> But inflation alarm has not yet abated. A steady stream of new, higher-than-expected and indeed record figures in many regions have continued to fuel it. The European Union (EU) headline inflation rate was 8.6% in May, and the core rate 4.5%. In June, however, recession fears began to trump even the extreme concern about inflation, especially as Russia is now threatening Europe's energy supply security.

### 1.1 Record weak markets...

This toxic mix precipitated historically high losses across a wide range of asset classes in the first half of the year. The MSCI World AC index slipped by more than 20% from its previous high and went into bear market territory. The S&P 500 put in its worst half-year performance in 60 years, with the second quarter drop of -16.1% significantly worse than the -4.1% of the first quarter. In the case of the Dax the negative momentum was even more pronounced - it lost over 11% in June alone.<sup>1</sup>

Bond markets offered investors no protection whatsoever. They, too, suffered historically high losses. According to Deutsche Bank Research, U.S. government bonds suffered their worst first half in 244 years. For Eurozone government bonds, it was

<sup>1</sup>Source: Bloomberg Finance L.P.; as of 6/30/22

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the worst quarter this millennium. Yields provide another perspective on the slaughter. Ten-year U.S. yields have risen 2.6 percentage points since mid-2020, the most in one move since 1993. Bund yields haven't risen this fast (2.7 percentage points in just one year) since reunification.<sup>2</sup>

So where did investors find a measure of protection? Gold has lost a relatively modest 1.2% since the beginning of the year. This fall is likely due to real U.S. interest rates, which rose from minus 1.1 to plus 0.67%.<sup>2</sup> Meanwhile the idea that crypto currencies offer a more modern form of protection turned out not to be right: they correlated positively, not negatively, with investors' risk appetite and lost two-thirds of their value in the second quarter alone.

Though some commodities offered a refuge again, that was not the case for all of them. Oil and gas were the chief winners. In Europe, the price of natural gas rose by over 50% in June alone after Moscow reduced supply through the main pipeline to Europe. Compared with the previous year, prices have increased sevenfold. Brent crude oil was 45% more expensive at the end of June than a year ago. But it was also 6.5% cheaper in June than in May - the first monthly decline since November 2021.<sup>2</sup> More striking, however, were the price declines in other commodities. Wheat, while slightly higher than its price at the start of the year due to war-related shortages, fell by about a quarter in June. Copper, meanwhile, has become 17% cheaper this year and the price of steel lost 28% in the second quarter. Steel is now almost 10% cheaper than it was at the start of the year. These declines reflect the gloomier growth outlook for the global economy. And even though they are also declining we believe that they have some capacity to heal. They should take some of the heat out of inflation, making life somewhat easier for the central banks in the second half of the year, and offering some slight relief to consumers.

## 1.2 ... leave traces in the real economy. Or the other way around.

Central banks are also being helped in another way, perhaps thanks in part to their hawkish pronouncements: the U.S. housing market is already cooling significantly, measured in terms of new construction activity and home sales. Mortgage rates have risen steeply, from 3.25 to 5.83% this year.<sup>2</sup> Inflation expectations in the market have also cooled, from a high of 3.0% to 2.36% during the second quarter. Not only home builders are being affected by interest rate hikes and recession fears, but also companies. There has been an extreme rise in risk premiums on European high yield corporate bonds, from 271 basis points at the beginning of the year to 566 basis points at the end of June. In the U.S., these figures have also spiked, leading to even higher interest rates in absolute terms: almost 9% compared with around 4% a year ago.<sup>2</sup> And the economic slowdown anticipated by these figures became apparent in the second quarter in the form of declining purchasing managers' indices and record-low consumer confidence in the U.S. and Europe.

## 1.3 Records also with currencies.

At the end of June, the Euro and Swiss franc traded at parity for the first time, other than for a short period at the beginning of 2015 after the Swiss currency cap was abandoned. The British pound is also struggling against economic skepticism – at a rate of just USD 1.20 per pound it is wobbling at the historic lows first hit in 2016 after the Brexit referendum. Also historic is the weakness of the yen: at 136 yen per dollar, the currency is at its lowest level since 1998. Japan's central bank is an outlier, continuing to refuse to raise interest rates. The weakness of many currencies reflects the almighty strength of another: the dollar index has posted a gain of 9.4% since the beginning of the year.<sup>2</sup>

<sup>2</sup> Source: Bloomberg Finance L.P.; as of 6/30/22

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## 2 / Outlook and changes

Due to the market turmoil, interrupted gas supplies from Russia and, in particular, the more aggressive reaction from central banks, we adjusted our economic and interest rate forecasts, as well as our strategic targets, two weeks ago.<sup>3</sup> In particular, 2023 GDP growth rates for the U.S. and Europe were revised downward, equity price targets were lowered by 5 to 10%, and Bund yields were pushed upward. However, our U.S. 12-month bond forecasts remained largely unchanged, as in the U.S. we see a change in the pace of Fed rate hikes but an early end to the cycle, possibly as early as the first half of 2023, with the Fed funds rate then at 3.5 to 3.75%. We think this will be one of the key market issues for the remainder of the year: the degree to which central banks need to back up their words with action if the economy continues to cool significantly in coming months, or if inflationary pressures decline for other reasons. We continue to expect heightened volatility in coming months as both the markets and central banks evaluate the prospects for inflation, the economy and monetary policy. But we expect calmer markets in twelve months, which should then have a positive impact on valuations in different asset classes. At present, volatility in bonds and equities, as well as in commodities and currencies, is well above the average levels of the past decade.

Though the anxiety about inflation and recession is currently quite intense, it has not yet reached one quiet corner: the earnings expectations of equity analysts. Outside Asia, the expectations for earnings in 2022 have not yet moved downward this year. On average, the estimates for 2022 and 2023 MSCI World AC earnings are where they were at the start of the year. Predicted price-to-earnings ratios that look reasonably low should therefore be taken with a sizable grain of salt, in our view.

### 2.1 Fixed Income

While U.S. government yields are already trading close to our 12-month estimates, the picture is different for Bund yields, as the ECB has yet to start its rate hike cycle. The European government bond market is, in our view, therefore still unattractive from a strategic perspective. Tactically, we have downgraded most of the Bund yield curve to Neutral after the rapid rise in yields in May and June seemed excessive to us. Except for the 2-year maturity, where yields in our opinion have come down too much and do not adequately reflect the ECB's intended hiking path anymore. Since risk premiums in peripheral countries have corrected again after having spiked, we do not see any positioning opportunity here in the short term after the ECB was able to convince markets with its proposed "anti-fragmentation tool" – an idea it has put forward to limit yield rises in peripheral economies, especially Italy. The tool is expected to be unveiled at the next ECB meeting on July 21<sup>st</sup>. Current yields on corporate bonds look attractive on a 12-month horizon. But we do not rule out the possibility that risk premiums might widen further in the near term. However, the default rates currently being priced in do not always seem to consider the fact that most companies have strong balance sheets. That would suggest a neutral positioning is advisable, except for the U.S. investment grade segment, which we view negatively.

In currencies, the euro is struggling directly and indirectly with the impact of the war in Ukraine. As natural gas supply concerns growth, the market is starting to doubt that the ECB will get very far with its rate hike cycle. As a result, the euro traded below parity against the Swiss franc and very close to parity against the U.S. dollar in the first week of July. The short-term prospects are hard to forecast. We may see further lows, and so we have reduced EUR/USD to Neutral; but we see potential for a euro recovery from here. We also see catch-up potential for the Japanese yen from a tactical perspective given the sharp depreciation over the past few months, especially as the widening of the yield spread between U.S. and Japanese government bonds has recently turned negative.

<sup>3</sup> <https://www.dws.com/insights/cio-view/cio-flash/cwf2022/Target-adjustments/>

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## 2.2 Equities

In our view equities have mainly reacted to the rises in interest rates and yields this year so far and a possible recession is only slowly being priced in. At the same time many indices have already corrected to such an extent that individual economic data points could trigger small recovery rallies – better-than-expected purchasing managers' indices or lower inflation figures, for example. If only a mild recession is looming and the interest rate cycle and inflation are approaching their peak, an equity recovery could be more sustainable.

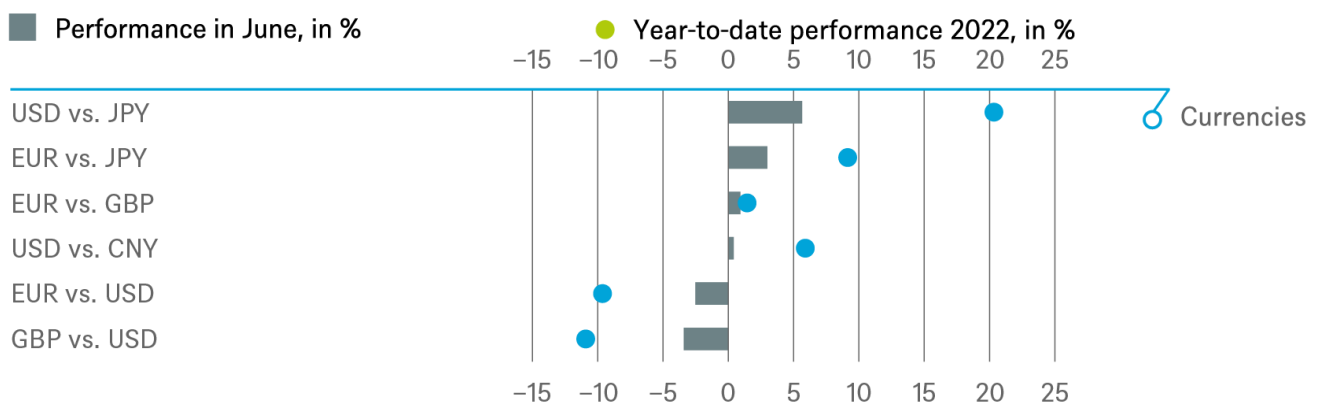
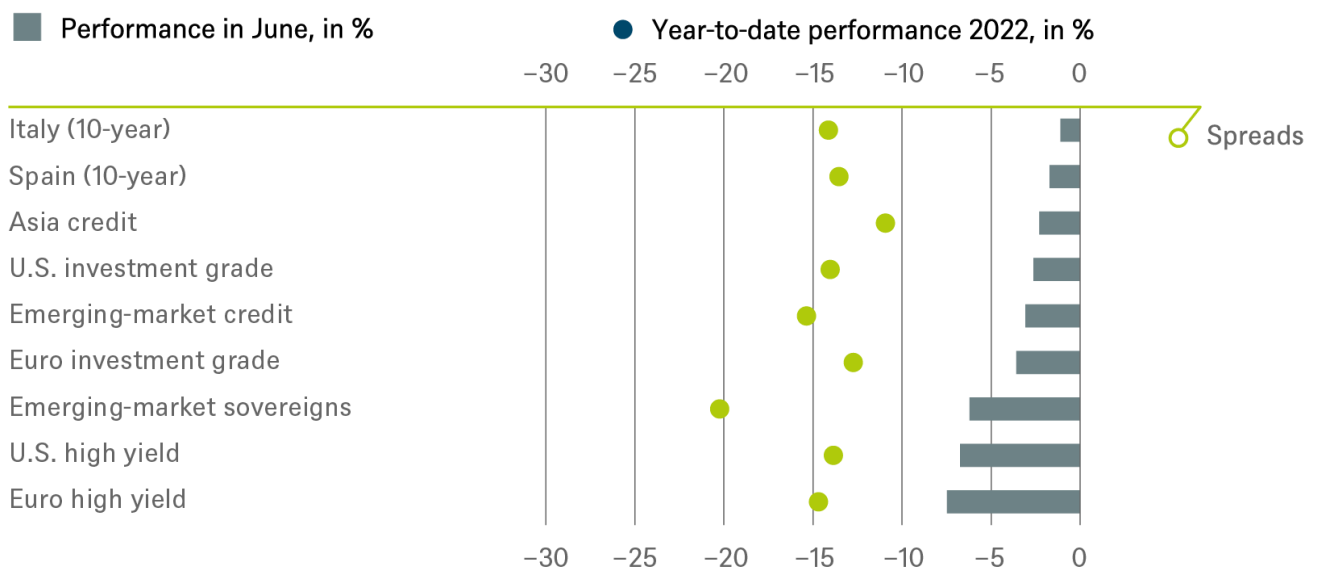
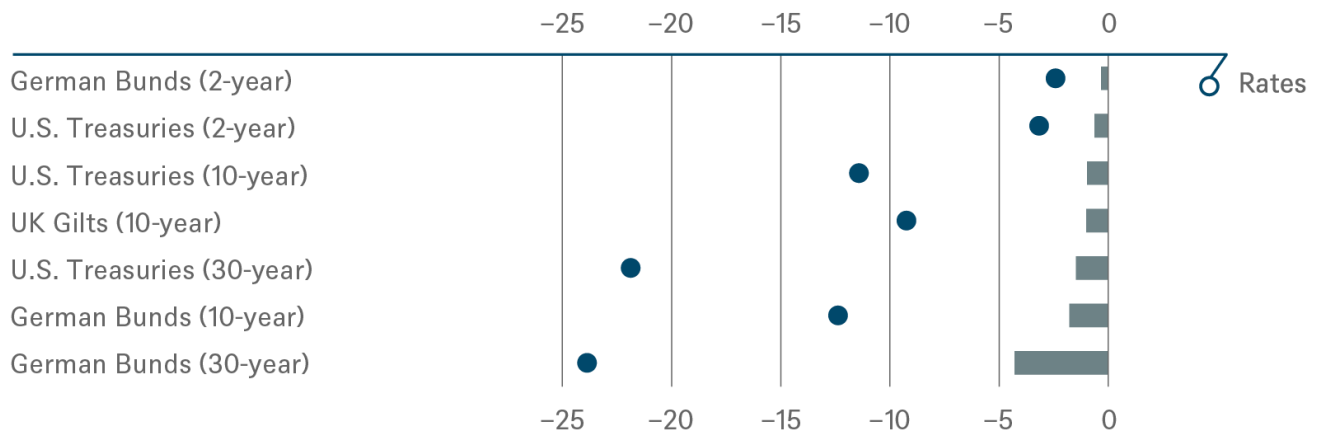
In June we shifted our view on the energy sector to positive. In our view the sector has corrected too much recently in response to the view that future demand growth will be weak. But on the supply side we believe there is structural under capacity: too little has been invested for too long. There are also a surprising number of production outages among established OPEC suppliers. All of this may prove positive for energy prices and energy stocks.

## 2.3 Alternatives

As explained above, we do not think the supply-demand picture currently supports significantly lower oil prices. In industrial metals, on the other hand, we think there will need to be greater investor conviction about the Chinese government's economic measures to generate a rally in prices.

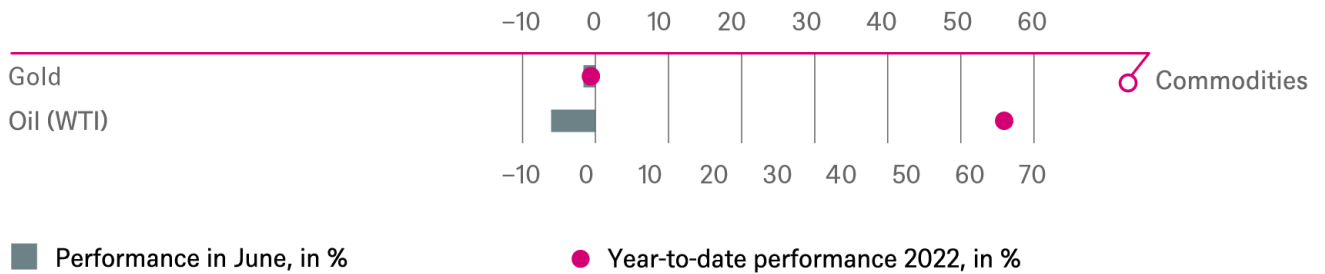
### 3 / Past performance of major financial assets

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



■ Performance in June, in %      ● Year-to-date performance 2022, in %

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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 June 2023
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)	●	●

Securitized / specialties	1 to 3 months	until June 2023
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 June 2023
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>	●	●

Style	1 to 3 months	until June 2023
U.S. small caps <sup>22</sup>	●	●
European small caps <sup>23</sup>	●	●

Spreads	1 to 3 months	until June 2023
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 June 2023
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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## 4.3 Alternatives

Alternatives	1 to 3 months <sup>2</sup>	until June 2023
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 June 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

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

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

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

The **Bloomberg Dollar Spot Index** measures the value of the U.S. dollar against 10 global currencies, both developed market and emerging market.

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

**Brent** crude is a grade of crude oil dominant in the European market.

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

**Core inflation** excludes items which can be susceptible to volatile price movements, e.g. food and energy.

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

A **crypto asset** is the digital representation of a value or contractual right that is created, transferred, and stored using distributed ledger technology (blockchain) and authenticated through cryptography.

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.

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

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.

**Headline inflation** is the raw inflation figure based on the consumer price index (CPI) and not adjusted for seasonality or for the often volatile elements of food and energy prices.

**Hawks** are in favor of a restrictive monetary policy.

**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 **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 Materials Index** captures large- and mid-cap securities across 23 developed- and 26 emerging-markets classified in the Materials 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.

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The **MSCI China Index** captures large- and mid-cap representation across China H shares, B shares, Red chips, P chips and foreign listings.

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

The **Organization of the Petroleum Exporting Countries (OPEC)** is an international organization with the mandate to “coordinate and unify the petroleum policies” of its meanwhile 12 members.

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

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

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.

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.

**Periphery bonds** are government bonds issued by smaller countries of the Eurozone, e.g. Ireland, Portugal, Greece; sometimes also Spain and Italy are included. Historically, the term 'Periphery' was based on the stage of economical development and is currently used to refer to the above mentioned countries.

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

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.

**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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