DWS

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AI must fix it

No economic slump, falling inflation and the first interest rate cuts. Not a bad environment for capital investments, especially bonds. AI must deliver soon for equities.

"Restrictive monetary policy has largely done what it aimed to: reduce inflation. Accordingly, we expect interest rate cuts this year. But the future interest rate path is not yet fully determined – because the prospects for growth and inflation remain uncertain."

Björn Jesch
Global Chief Investment Officer

The formulation of DWS's new 12-month forecasts this quarter was preceded by a particularly lively discussion. The backdrop for our stock market return forecasts is a macroeconomic environment that looks favorable overall. After the fastest interest rate hike cycle in many decades, it is a case of mission almost accomplished. Inflation is coming down (we expect 2.8% and 2.5% for the U.S. and the Eurozone on average in 2024) without economic growth coming to a complete halt (our expectation: 1.8% and 0.7%, respectively). And apart from some U.S. regional banks, the collateral damage from the interest rate hikes has so far been limited.

But could there be worse to come, especially in the U.S.? Is it really the case that higher interest rates have already filtered through to all relevant parts of the economy? Aren't the leading indicators still pointing to a slowdown (we also expect U.S.-growth to slow to 1.6% in 2025)? And, more fundamentally: when will the U.S. have to pay the bill for its record deficits? – a budget deficit estimated at 6.2% of gross domestic product (GDP) in 2024 and 2025, after 6.5% in 2023 – which are largely being financed by foreign countries (the trade deficit was over 3% in 2023). America's highly expansive fiscal policy might also lead to a second wave of inflation. Those are the many sources of risk. But productivity growth offers a potential source of optimism. Artificial intelligence (AI) could help ensure higher margins and lower inflationary pressure. But to imagine that AI will have this impact on the whole economy now seems premature.

The stock market, however, loves to dream – and, at present, the so-called Magnificent 7 technology-heavy U.S. stock market heavyweights, are the stuff of dreams. Stock market ebullience, meanwhile, is doing its bit to prop up the economy. The positive wealth effect from rising share prices is just what the doctor ordered to steer consumers away from depression and keep them spending, now that all those nice savings from the Covid period have been used up. But for the market as a whole we see rather meagre earnings growth this year and only a slight acceleration next. We are nevertheless raising our share price targets by roughly 10% because the risk premium for equities, especially in the U.S., has fallen, for three reasons. First, there is a sharply reduced probability of recession in our view. Second, the index seems set to become less prone to cyclical swings as the proportion of tech-related companies (with increasing recurring revenue streams) is further increasing and thus earnings are set to be less cyclical because of the high role played by IT investments. And third, the implicit option on AI potential.

In these circumstances we favor the telecommunications services and consumer discretionary sectors. Regionally, we see catch-up potential in Europe, particularly in banks. Although we are positive on Japan and India, there is still a big drag on the entire Asian region from China, where declining economic growth is encountering a difficult capital market environment.

Bonds are generally considered less volatile than equities, but they too have seen a lot of volatility recently. Within less than six months the market has swung from predicting one to three then back to one Fed Funds interest rate cuts by June 2024. Our view, given that the core inflation rate is only slowly falling below 4%, is that there will be just three interest rate cuts in the U.S. by March 2025, and we forecast four interest rate cuts by that time in the Eurozone.

Overall, this means that our outlook is very favorable for bonds. For government bonds, we prefer the short end, while for corporate bonds we prefer investment grade bonds in the U.S.

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and Europe, on a risk-adjusted basis, to High Yields. We also see good earnings opportunities in Asian bonds.
In the alternatives sector we remain positive on gold, which is benefiting from a stabilizing interest rate environment and continued high central bank and Asian retail purchases. For property we think 2024 could be a really interesting entry year. The price slump should be largely over although there could initially be a longer period of bottoming out. In the medium-term healthy demand and, above all, recently very weak supply argue in favor of rising prices. Logistics and residential remain our favorites. Infrastructure should also benefit from the fact that higher bond yields are not expected for the time being and price adjustments are likely to have largely taken place. Our favorites are selected projects from the green energy, digitalization and transport segments.

In summary, we would emphasize that the reduction in inflation desired by the central banks is beginning to happen. But stock markets' current euphoria contrasts with meagre economic growth prospects in the next two years, and companies' profit margins are already very high, giving little scope for them to rise. However, as the past six months alone have shown, equities remain the best vehicle for participating in a technological wave, in our view. And at the same time bonds also offer a very adequate return these days, along with some alternative investments – and so investors have a good range of options to choose from at present.

Look at our forecasts to see our 12-month outlook in numbers.

Glossary

Artificial intelligence is the theory and development of computer systems able to perform tasks normally requiring human intelligence.

A budget deficit is created whenever the spending in a public budget exceeds the income within a given time period.

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

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.

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

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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