CIO View

CIO Flash

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Marketing material

DWS

Are we entering a bear market?

Trading on Monday continued where it ended on Friday. Where will it stop?

IN A NUTSHELL

— The weekend did not provide relief from the market turbulence. With the VIX climbing to levels above 60 intraday, we expect volatility to remain elevated.
— The main drivers of today's turmoil seem to be continuous weak economic data, a surging Japanese yen and rising tensions in the Middle East, as well as a shift in investor sentiment.
— While now also in the United States high interest rates are finally showing the intended effect of slowing down the economy, we do not anticipate an ad-hoc rate cut by the Federal Reserve. Furthermore, we deem a full-blown bear market unlikely.

No brake for investors

Following the market movements from Friday and over the weekend, Monday was not offering any relief. In the early hours Japan's equity markets experienced their largest losses since 1987, with the spiking yen being one of the main reasons . The benchmark volatility index VIX is experiencing high volatility itself by jumping from the mid-twenties to above 60 in a few hours, the highest reading since the outbreak of the Covid pandemic in early 2020. The popular "Trump trade," which has dominated market sentiment in recent weeks, has reversed course. This shift has contributed to sending U.S. small-cap stocks, the U.S. dollar and cryptocurrencies deeply into the red.

Speaking more broadly, the market came to the realization that the "bad-news-is-good-news" mantra might better be turned into the new reality: bad news is, well, bad news. In addition to the bad macro news flow from Friday, the seasonally low liquidity also played its part in the market downturn.

Starting with the S&P 500 in the U.S., we see a market that was priced for perfection, with investors exhibiting a high degree of complacency reflected, for instance, in the low levels of the VIX over the past months. A narrow margin for error in the major stock index was reflected in a forward price-to-earnings (P/E) ratio of 21.5, which is significantly higher than its long-term average. While the earnings season has been solid, concerns are mounting about the ability to recoup the extensive capital expenditure (capex) spending related to Artificial Intelligence.

On the macro front, last week's jobs data is finally confirming the impact of the Federal Reserve's (Fed's) interest-rate hikes. While the market is reacting to the news as if it were a revelation, it is not entirely surprising to us – the laws of economic gravity apply to the U.S. just as they do to any other nation. This shift is further driven by the realization that the fiscal stimulus that has propped up the economy is fading, and the full impact of the Fed's (i.e., monetary) tightening is being felt.

Adding to that were several other factors, like the mentioned summer slump in liquidity, the Bank of Japan's (BoJ's) surprising rate hike (pushing up the yen), and escalating tensions in the Middle East. Recent events there are heightening the risk of a major

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military conflict. The release of Monday's U.S. service sector PMI numbers, coming in slightly higher than anticipated, was the first good news of the day.

"Abnormally good or abnormally bad conditions do not last forever."

So, what is the path going forward? We expect the Federal Reserve to continue on its expected path, with a panic-driven response being unlikely. A 50 basis points (bps) cut or an inter-meeting cut would signal a significant shift in policy, which we believe the Fed will try to avoid. Instead, our baseline scenario remains that the Fed will stick to a more gradual approach of cutting rates three times by 25bps over the coming months, likely to be starting in September.

While a U.S. recession is not our base-case scenario, it cannot entirely be ruled out. The bond market, with 10-year Treasury yields at 3.70%, is already reflecting a very high recession probability. However, even if a recession were to materialize, it is likely to be a mild one given the overall strength of the economy and solid private-sector balance sheets.

At the time of writing, the S&P 500 has experienced a pullback of around 7% from its recent high. On the back of our baseline economic scenario as well as our earnings forecasts, we still don't expect an outright bear market, defined as a decline of 20% or more, which would be taking the index below 4,500. Quoting Benjamin Graham[1]: "Abnormally good or abnormally bad conditions do not last forever." However, we are keeping a close eye on the risks inherent in the recent aggressive market moves, including highly leveraged players being forced to cut positions. Therefore, we are also closely monitoring indicators that capture systemic risks.

[1] Quote from Security Analysis, McGraw Hill (1951)

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Glossary

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

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

Capital expenditure (Capex) are funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment.

The CBOE Volatility Index (Vix) is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index. It is a popular measure of the volatility of the S&P 500 as implied in the short term option prices on the index.

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

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

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

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

The Purchasing Managers' Index (PMI) is an indicator of the economic health of the manufacturing sector in a specific country or region.

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

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).

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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