Research Institute

DWS Long View

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Marketing material

DWS

Long View Q2: Equity concentration risk & long-term estimates for Value, Growth and Small Cap

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- Return forecasts for the next decade are similar versus the end of Q1, although the return outlook between equities and fixed income has continued to narrow
- The concentration risk of the S&P 500's "Great 8" is comparable to the 2000 tech bubble in terms of Technology sector exposure and risk contribution
- We are expanding the Long View equity coverage to include Value/Growth and Size, with a positive strategic outlook for Value over Growth and small over large cap
- Bond risk premia do not reflect significant inflation risk premia which have narrowed over the past year. The shrinking inflation risk premia suggest that nominal treasuries may still possess strong diversification characteristics versus risk assets.

Summary

In this report, we present the DWS long-term capital market assumptions for major asset classes as of the end of June 2024 while exploring the risks to these forecasts.

After some modest weakness in early April, global equities rebounded quite strongly, bringing year-to-date returns into double digits. For Q2, the MSCI All Country World ("ACWI") Index returned 2.9%, led by continued strong returns from the S&P 500, which was up 4.3%. Developed International equity returns were more challenging in Q2, down -0.3%, while Emerging Markets were the strongest performing segment of global equities, up 5.3% for the quarter.

Global fixed income markets were sideways in Q2, with the Bloomberg Global Aggregate Bond Index and the Bloomberg US Treasury Index each returning about 0.1%. Bond markets were a tale of two periods, facing challenging returns in the first 3 weeks of April with stubborn inflation driving US Treasury yields higher (peaking at 4.70%). However, a softer GDP print in the latter part of April followed by weaker than expected labor data in May saw US Treasury yields reverse course lower. Equity returns seemingly behaved in tandem with bond yields, where higher yields posed challenges to equity prices while a shift back toward easier monetary policy expectations seemed to provide support for equity prices.

After two years of persistent inflation and an inverted U.S. Treasury yield curve, there are finally imminent signs of policy rate cuts from the Federal Reserve later this year. Tight global equity risk premia—especially so in the US—and tight corporate credit spreads paint a benign economic outlook and a reasonable expectation around increasingly accommodative Fed policy over the coming quarters, reflected in the gradual normalization in nominal Treasury yields. As elevated equity prices have been driven disproportionately by a small subset of technology-focused US companies referred to as the "Great 8," questions around equity concentration risk have also become increasingly top of mind for investors.

Our 10-year forecasts continue to look increasingly favorable toward fixed-income that reflects higher starting yield levels but bear the risk of owning nominal return assets. In particular, the strategic return outlook for US high yield bonds is now comparable to that of US equities, reflecting higher real yields than we've had since the Global Financial Crisis ("GFC") in contrast with multi-decade-low equity risk premia driven in part by optimistic valuations for megacap tech names.

Our models now forecast an annual local currency return of 6.0% for the MSCI All Country World Index ("ACWI") over the next decade, versus 6.1% three months prior as well as an increase for the Global Aggregate Bond Index from 3.5% to 3.7%. At an aggregate level, we estimate the forecasted rate of return on a diversified portfolio at 5.7%*, unchanged from the level at the end of Q2.

*Source: Bloomberg as of 30 June 2024. DWS Calculations for a strategic asset allocation that targets volatility of 10%.

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Table 1: DWS Ten-year annualized forecasted local currency returns

	As of 30 June 2024	Δ since 31 Mar 2024
ACWI Equities	6.0%	-0.1%
World Equities	6.0%	0.0%
EM Equities	6.2%	-0.5%
US Equities	5.9%	-0.2%
Europe Equities	6.4%	0.2%
Germany Equities	5.4%	0.3%
UK Equities	7.7%	0.0%
Japan Equities	4.0%	0.6%
EUR Treasury	2.7%	0.3%
EUR Corporate	3.5%	0.2%
EUR High Yield	5.2%	-0.6%
US Treasury	4.4%	0.1%
US Corporate	5.2%	0.2%
US High Yield	6.1%	0.3%
EM USD Sovereign	7.4%	0.2%
World REITS	4.9%	0.1%
United States REITS	5.3%	0.0%
Global Infra. Equity	7.9%	0.3%
US Infra. Equity	7.9%	-0.2%
Private RE Equity US	4.2%	0.3%
EUR Infrastructure IG	3.6%	0.3%
Private EUR Infra. IG	4.7%	0.3%
Hedge Funds: Composite	5.4%	0.2%
Broad Commodities Futures	5.2%	-0.3%

Source: DWS Investments UK Limited. 10Y Forecast as of 30 June 2024. Due to various risks, uncertainties and assumptions made in our analysis, actual events or results or the actual performance of the markets covered may differ materially from those described.
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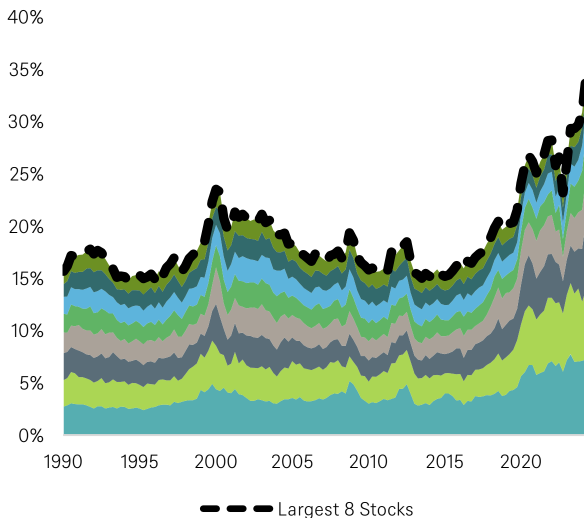
Any hypothetical results presented in this report may have inherent limitations. Among them are the sharp differences which may exist between hypothetical and actual results which may be achieved through investment in a particular product or strategy. Hypothetical results are generally prepared with the benefit of hindsight and typically do not account for financial risk and other factors which may adversely affect actual results of a particular product or strategy.

1 / Equity risk contribution

1.1 The growing importance of the Great 8

As global equity markets continue to make new highs seemingly almost every day, the focus of investors is around the disproportionate return contribution of mega-cap, technology-focused companies. While the so-called "Great 8" (Amazon, Apple, Google, Meta, Microsoft, Nvidia, Tesla, and Netflix) is distributed across multiple sectors and offer a range of goods and services, there are two common traits that these megacap companies share: 1. disproportionately high return contribution (and correspondingly elevated valuations) over the past few years and 2. a significant bias toward technology and more recently Artificial Intelligence themes within their business models. The Great 8 make up a combined nearly $14tr in equity market capitalization as of the end of Q2 and account for nearly one-third of the S&P 500's aggregate market value. While the concentration among the largest constituents within the S&P 500 has historically reached quite high levels, the extent of this overrepresentation of just a few companies is at historical highs as shown in Figure 1.

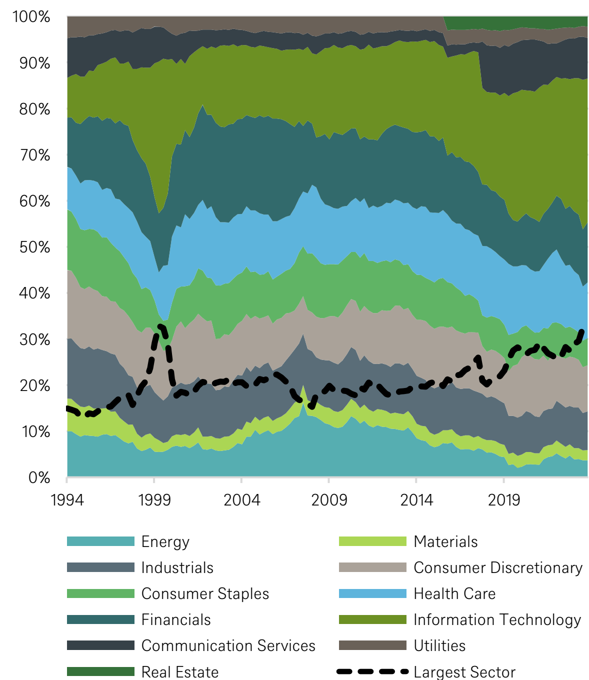
Figure 1: Weight of largest 8 companies as a percentage of the S&P 500 Index has reached historical highs



Source: Bloomberg L.P., DWS calculations as of 30 June 2024.

Beyond the concentration among these largest 8 companies, a concern for diversified equity investors also revolves around the technology-dominant bias of large-cap and mega-cap indices. Figure 2 illustrates that the weight of the largest sector within the S&P 500, Information Technology, has now reached historically high levels commensurate with the 2000 technology bubble.

Figure 2: Sector composition of the S&P 500 Index (%)



Source: Bloomberg L.P., DWS calculations as of 30 June 2024.

Furthermore, as previously noted, the reach of technology firms now extends beyond the Information Technology sector, with tech giants like Amazon and Google among others occupying space in Consumer Discretionary and Communication Services sectors, respectively.

Aside from the 2000 technology bubble, previous iterations of the S&P 500 consistented of broader sector diversification among the giants of industry. In the early 1990s, for example, the largest companies consisted of Exxon, IBM, General Electric, AT&T, Altria Group, and Walmart, giving investors diversified exposure across various segments of the economy. The combination of high market weight and similar technology-related focuses begs the question of how much risk concentration exists in the current equity market.

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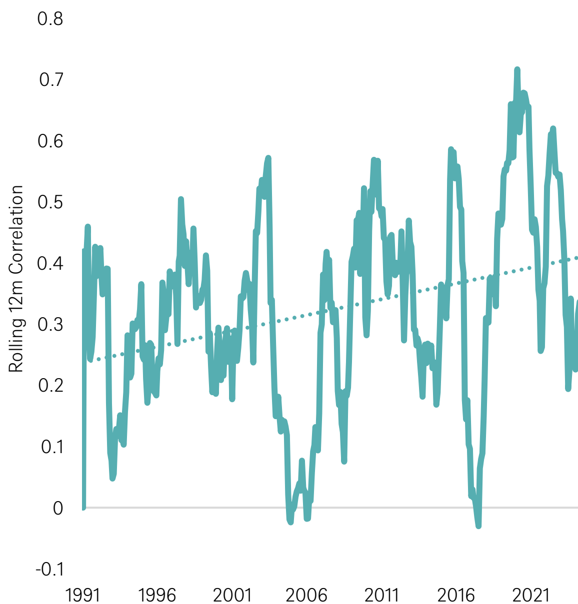
1.2 Historical equity risk concentration and valuation differentials

For a full appraisal of the concentration risk that exists in today's US equity market, we should focus on how much ***risk*** is coming from these companies rather than how much return has been contributed by these names. While returns can be outsized over even extended periods of time, perpetually higher excess compounded returns would eventually lead to impossible equity prices. Alternatively, correlations and volatilities of equity indices and individual stocks have empirically demonstrated more of a tendency toward long-term means or trends. What we find in Figure 3 is a positive albeit weak trend in the correlation between the largest 8 companies.

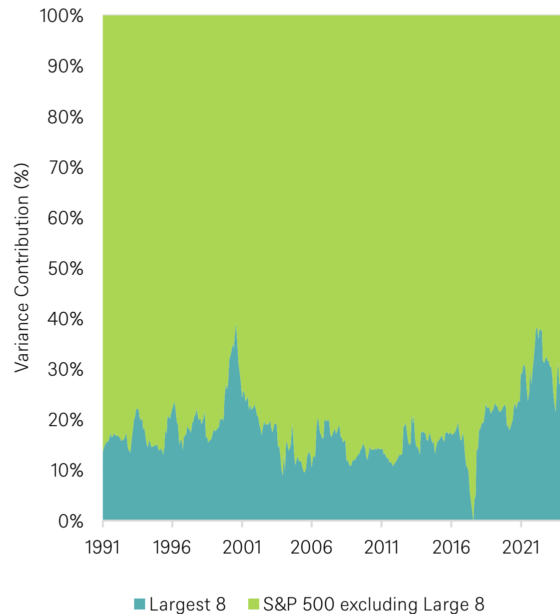
Figure 3: Average pairwise correlation (12m rolling) of the Largest 8 stocks



Source: Bloomberg L.P., DWS calculations as of 30 June 2024.

Finally, we can measure the extent of risk concentration among the Great 8 by looking historically at how much of the S&P 500's total risk or variance was contributed by the largest 8 companies. Figure 4 shows that about one-third of the S&P 500's variance over the past 12 months was due to the largest 8 companies, which consisted of seven of the "Great 8" technology behemoths as well as Berkshire Hathaway. Interestingly, the 33% of the S&P 500's variance that these 8 names constituted was only slightly higher than their 29.6% weight in the index.

Figure 4: Rolling 12-month variance contribution largest 8 companies versus the rest of S&P 500 Index



Source: Bloomberg L.P., DWS calculations as of 30 June 2024.

Prior peaks in risk contribution among the largest 8 companies had occurred during the technology bubble at the end of 1999 as well as in the summer of 2022 when a sharp selloff in US Treasury yields disproportionately hurt growth technology names.

The comparison with the TMT bubble of 1999/2000 naturally leads to the question of valuation: Indeed, the median forward 12M P/E of the 8 largest stocks in the US equity market is now more than 50% higher than the median valuation of the rest, double where the premium stood on the eve of the pandemic in 2019, and compared to a slight discount of the 8 largest stocks ten years ago. However, as Figure 5 shows, the discrepancy was far more dramatic during the TMT bubble (when the eight largest stocks had a 177% valuation premium).

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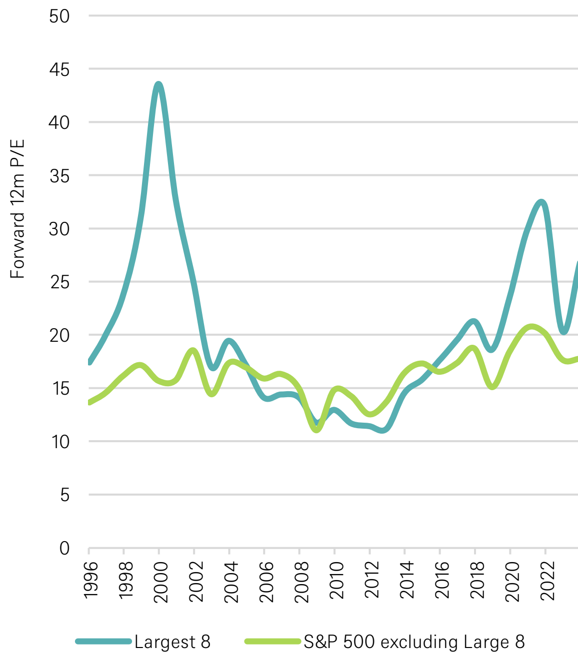
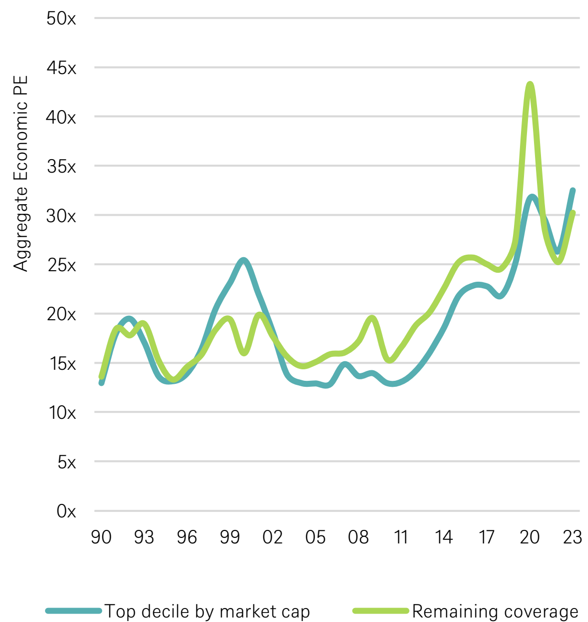
Figure 5: Median forward 12M P/E for the Largest 8 stocks versus rest of the S&P 500



Source: FactSet, DWS calculations as of 21 August 2024, annual data.

Moreover, some of the current valuation premium is an optical illusion created by accounting data, due to the changing mix of the largest companies and their increasing reliance on technology, in particular. As Figure 6 shows, DWS's proprietary CROCI valuation framework (which capitalizes intangibles such as R&D and brands as an economic asset, amongst other adjustments to accounting data, to arrive at an Economic P/E ratio) results in a valuation of the largest companies not starkly above the rest of the market – the key trend is that valuations overall have risen strongly over the past decade, driven by declining equity risk premia and increased risk appetite (which incidentally is not fully captured by the accounting data).

Figure 6: Bipolarity in valuation between megacaps and the rest not as stark as during TMT, based on CROCI valuations—but overall market valuations have risen strongly



Source: DWS, CROCI Outlook 2014 *The pendulum's swing back to value?*, Aggregate data of companies in CROCI's global coverage. Data as available on 03 January 2024. The top decile is arrived at using the market cap of the entire CROCI non-financial coverage universe.

All in all, the tendency for the current technology-oriented Great 8 stocks to exhibit similar characteristics with regards to certain risk factors such as discount rates or sentiment around artificial intelligence perhaps indicates a higher degree of risk in certain macroeconomic scenarios, although the aggregate variance contribution does not necessarily look outsized relative to the constituent weights.

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2 / The strategic outlook for equity styles: value, growth and size indices

2.1 Expanding the Long View equity universe

Over the past few years, we've selectively expanded our equity model coverage to encompass a growing universe of investment styles. In 2021, we first introduced our ESG index forecasts, and then expanded coverage to include estimates for High Dividend indices for a few select countries and regions in 2022. Consistent to both of these inclusions was the utilization of the same building-block approach we apply to traditional market capitalization-weighted equity index return forecasts, which allows for simple, transparent return pillars that are comparable across styles and regions.

As certain trends continue to play out in the market, in particular recent challenges for the Size and Value factors, investors are posing the question whether something has fundamentally changed the validity of the Fama-French three-factor model. While the question of persisting factor-based alpha remains outside of pillar-based forecasting methodology, we can expand our coverage of factor indices to apply our methodology to Value versus Growth and Size. By comparing the return forecast pillars between these factors and their anti-factors, we can contrast where return drivers might be materially different both between these indices and relative to their own histories.

2.2 Value vs growth forecasts

In this update, we introduce long-only MSCI Value and Growth indices across World, US and European markets.

The MSCI Value and Growth indices are designed to divide constituents of an underlying market capitalization-weighted index into a value index and a growth index. Each style index is constructed with the aim of representing 50% of the free float-adjusted market capitalization of the underlying broad index. At the security level, an equity can be present in only the value or the growth index at full weight, or in both value and growth indices at a partial weight, depending on where it sits on a hypothetical value-growth matrix (based on its value and growth scores calculated from the underlying fundamental metrics listed below). Crucially, a security can end up being included only in the Value index purely based on very poor Growth scores (and vice versa). This juxtaposition of Value and Growth as antitheses of each other is not particularly helpful (and in fact some of the most interesting securities will be those looking reasonably attractive from both angles, as DWS's CROCI Group has frequently argued[1]—and that's before we even get to criticisms of using standard accounting data to identify these investment styles); however, it is a long-established practice in benchmark construction and factor investing.

The underlying metrics used by MSCI to calculate a security's Value score are:

1. Book Value to price;
2. 12-month forward earnings to price;
3. Dividend yield.

The Growth score of individual securities is based on:

1. Long-term forward earnings per share (EPS) growth rate;
2. Short-term forward EPS growth rate;
3. Current Internal Growth Rate;
4. Long-term historical EPS growth trend;
5. Long-term historical sales per share growth trend.

Turning to our long-term capital market assumptions underlying our Long View, Figure 7 shows the relative contribution of our respective return building blocks for both Value and Growth indices across regions and Figure 8 illustrates the aggregate difference in Value versus Growth pillars for MSCI World.

[1] See CROCI Outlook: *The pendulum's swing back to value?*, Feb 2024, and CROCI Focus: *Two decades of CROCI Strategies*, July 2024.

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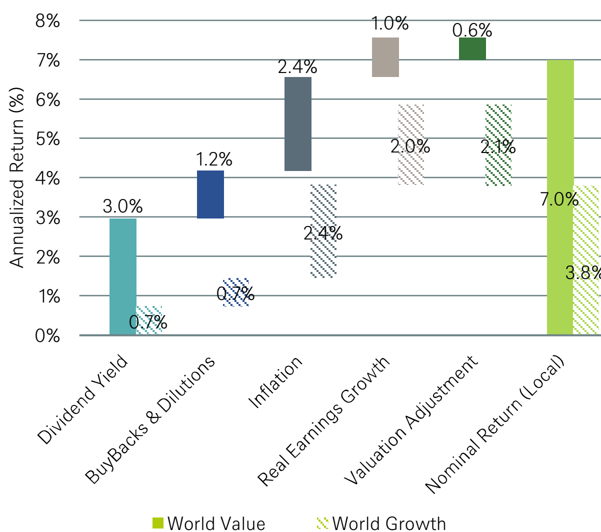
Figure 7: Breakup of 10-year forecasted hypothetical annualized returns for Value and Growth indices

	Dividend Yield	Buybacks and Dilutions	Inflation	Real Earnings Growth	Valuation Adjustment	Nominal Return (Local)
World Value	3.0%	1.2%	2.4%	1.0%	-0.6%	7.0%
World Growth	0.7%	0.7%	2.4%	2.0%	-2.1%	3.8%
US Value	2.4%	2.2%	2.5%	1.1%	-0.6%	7.6%
US Growth	0.4%	1.1%	2.5%	2.3%	-2.5%	3.7%
Europe Value	5.1%	0.2%	2.3%	0.7%	-0.3%	8.0%
Europe Growth	1.7%	0.4%	2.3%	1.4%	-1.0%	4.8%

Source: Bloomberg L.P., DWS calculations as of 30 June 2024.

Figure 8: Breakup of 10-year forecasted hypothetical annualized returns for World Value and World Growth



Source: Bloomberg L.P., DWS calculations as of 30 June 2024.

When comparing forward-looking return drivers between Value and Growth, we find some key differences.

1. For the income pillar, World Value sees a much higher contribution to return than does the World Growth Index —due to both dividend and net buyback yield being higher. Value companies generally maintain higher earnings yields (as a function of lower valuations) and also tend to distribute more free cash flow to shareholders through higher dividend payout ratios or share buybacks. The higher contribution from buybacks may surprise some investors, given the sector composition of the two indices (and the overweight in the Tech sector, often associated with preferring buybacks)—see Figure 12.

2. For the growth pillar, we assume that inflation has the same effect in the expected return estimates of both style indices. Although pricing power will vary between companies, our inflation forecasts are at the macro level rather than for individual goods or services. For earnings growth, based on internal calculations, we estimate the "earnings beta" of the Value Index to be 0.7x the earnings of the broader market weighted index, and an earnings beta of around 1.4x for the World Growth Index. In practical terms, this means that we estimate 0.7% real earnings growth p.a. for the Value index and around 1.4% real earnings growth p.a. for the Growth index for every percentage point of real earnings growth in the broader market index. The latter earnings growth estimate for broad market cap weighted indices is itself a function of our proprietary 10-year real GDP estimates, as regular readers will know.

3. For the valuation pillar, the valuation of Growth Indices has run up significantly in the wake of the AI-driven rally of the last couple of years. Based on our valuation methodology, the expected valuation contribution is significantly negative for the World Growth Index, whereas the World Value Index is close to (but still slightly more expensive than) its historical valuations, so the valuation contribution is only slightly negative. It is also noteworthy that the delta in the valuation pillar contribution between the World Value and Growth Indices is currently the highest it has been since Dec-2007 except during the covid pandemic (see Figure 11).

Historically, the real earnings growth of the Growth Index has been almost twice that of the Value Index. Despite this, the substantial negative contribution of the valuation pillar to Growth Indices as well as lower income pillar contributions result in a final 10Y expected return for the World Growth Index of 3.8% p.a. versus 7% p.a. for the World Value Index (all figures in local currency).

Academic theory suggests the multi-decade outperformance of the value factor versus the growth factor. While growth stocks are expected to and also have historically higher growth rates, investors tend to overpay for growth. Further, increased competitive intensity as well as regulatory risk can lead to the high growth expectations not fully materializing.

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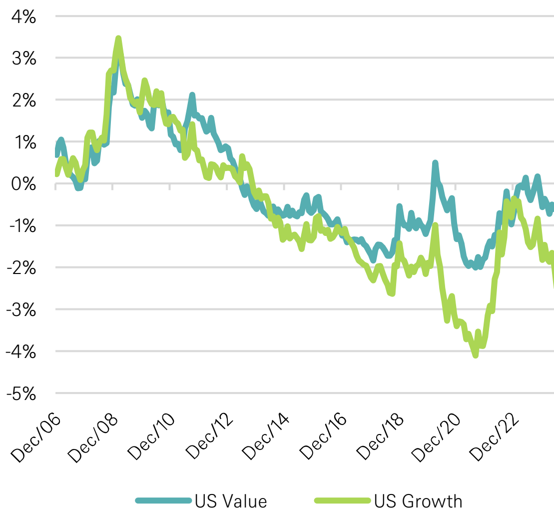
Figure 9: Valuation Pillar Contribution: World Value vs. World Growth

Source: Bloomberg L.P., DWS calculations. From 31 December 1997 to 30 June 2024.

Figure 10: Valuation Pillar Contribution: US Value vs. US Growth



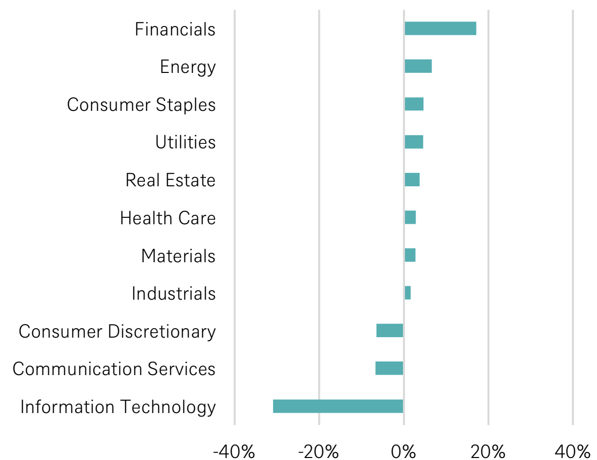
Source: Bloomberg L.P., DWS calculations from 31 Dec 1996 to 30 June 2024.

Figure 11: Valuation Pillar Differential: World Value vs. World Growth

Source: Bloomberg L.P., DWS calculations. From 31 December 1997 to 30 June 2024.

Sectoral differences between World Value and Growth also help to explain some of the more dramatic valuation gap that has emerged in recent years. At the global level, Value indices are significantly heavier tilted toward Financials and much less weighted toward Information Technology, the former of which has experienced significant post-GFC regulations and the latter which has performed tremendously well on the back of optimism around AI and related technologies (see Figure 12).

Figure 12: Relative Sector Positioning MSCI World Value Index vs. MSCI World Growth Index



Source: MSCI, DWS calculations as of 30 June 2024.

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2.3 Size forecasts

Small Cap indices had been under our coverage in the DWS Long View since 2019. In the previous Long View methodology, valuation, growth, dividend yield, and net buybacks of the small capitalization regional indices were taken to be the same as their corresponding large capitalization counterpart (and then a single global "small cap premium" estimate derived from realized performance differentials was added). This led to imprecise estimations in situations where (a) when there was a huge divergence in index performance of large and small cap indices thereby impacting valuations and dividend yields and (b) the regional small cap indices were assumed to benefit from net buybacks (along with their large-cap counterparts–especially in the US), while empirical evidence instead suggested that small cap investors experienced net dilutions in reality: small cap companies tended to raise more capital through issuing new shares than they returned to shareholders through buybacks.

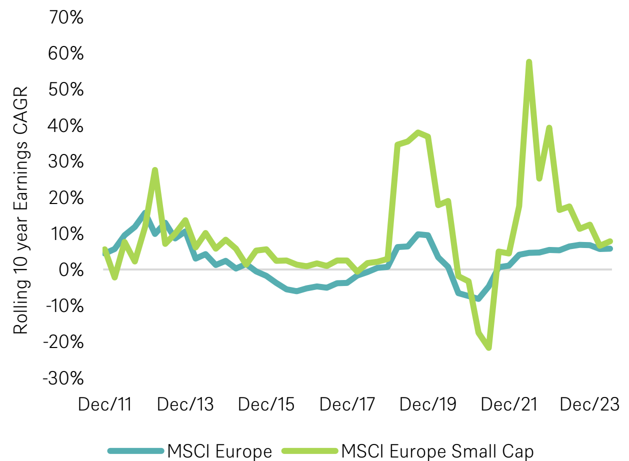
To remove such distortions, in the revised methodology which we use now, the income (dividend yield and net buyback/dilution yield) and valuation pillars are calculated directly using bottom-up data for all the regional small cap indices. For the contribution of real earnings growth, on the other hand, we now recognize that the average earnings growth for small capitalization indeics is much higher and more variable than its large capitalization counterpart[2] (see Figure 13 and Figure 14. With the above analysis, we estimate an "earnings beta" of 2x, i.e. for every percentage point of real earnings growth in a regional large-cap index (driven by our underlying 10Y GDP estimate), we now assume that the real earnings of the corresponding small cap index will grow by 2% p.a.

As all the drivers have now been calculated independently and reflect the actual economics of the small cap indices, there is no need for a separate small cap premium factor anymore (which essentially captured the residual unexplained out/underperformance of small caps in the old approach).

Figure 13: Comparison of US Large and Small Cap 10-year earnings growth rates

Source: Bloomberg L.P., DWS calculations from 31 December 1999 to 30 June 2024.

Figure 14: Comparison of Europe Large and Small Cap 10-year earnings growth rates



Source: Bloomberg L.P., DWS calculations from 31 December 2001 to 30 June 2024.

[2] While the Equity model uses real earnings growth , the graphs presented here exhibit nominal earnings growth. However, as realized inflation has been positive in this period, the ratio of real earnings between large cap vs. small cap will increase further when the same anlalysis is done with real earnings growth rate.

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Figure 15 shows the comparison between the expected returns of Small and Large capitalization indices for various regions. We currently estimate between 50 bps (Europe) and 180 bps (US) higher 10Y annualized return potential for Small Caps relative to Large Caps—despite the significant dilution through capital issuance (compared to buybacks in Large Caps, especially in the US), which has been more than offset by higher assumed real earnings growth and especially by more supportive valuations of Small Caps (relative to their own history).

Figure 15: Breakup of 10-year forecasted hypothetical annualized returns of Small and Large Capitalization indices

	Dividend Yield	Buybacks and Dilutions	Inflation	Real Earnings Growth	Valuation Adjustment	Nominal Return (Local)
ACWI Small Cap	2.2%	-0.7%	2.4%	3.0%	0.6%	7.5%
ACWI	1.9%	1.1%	2.4%	1.5%	-0.9%	6.0%
MSCI World Small Cap	2.1%	-0.9%	2.4%	2.8%	0.8%	7.3%
World	1.8%	1.3%	2.4%	1.4%	-0.9%	6.0%
US Small Cap	1.6%	-0.7%	2.5%	3.2%	1.2%	7.7%
US	1.3%	1.7%	2.5%	1.6%	-1.1%	5.9%
Europe Small Cap	3.4%	-1.8%	2.3%	2.0%	1.0%	6.9%
Europe	3.2%	0.3%	2.3%	1.0%	-0.4%	6.4%

Source: Bloomberg L.P., DWS calculations as of 30 June 2024.

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3 / Long View Forecasts

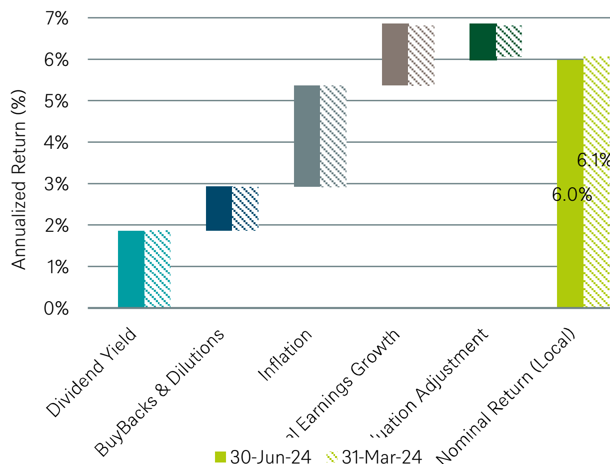
3.1 Equity Forecasts

For our equity return forecasts, Figure 17 illustrates the changes to our return pillars for our 10-year MSCI All Country World local currency return forecast. Forecasted returns for global equities were relatively unchanged, declining incrementally to 6.0% from 6.1% at the end of the year. Valuations were the primary driver of modestly lower return forecasts, with the valuation adjustment component going from -0.8% to -0.9%, reflecting slightly more challenging equity valuations as a result of a moderate appreciation in equity prices in Q2.

Figure 16: Pillar decomposition for equities

Source: DWS Investments UK Limited.

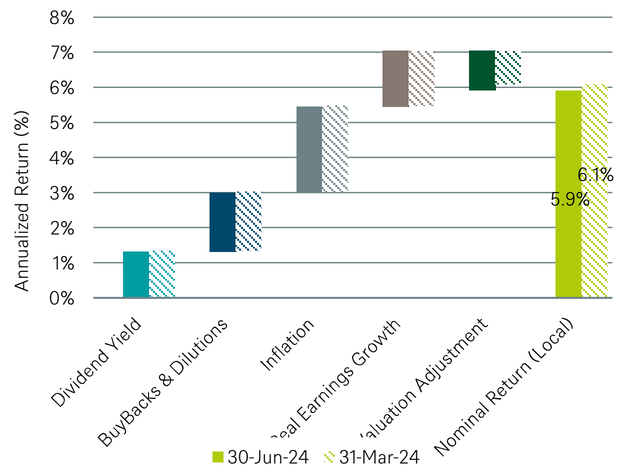
Figure 17: MSCI All Country World: Contribution to 10-year forecasted hypothetical annualized returns



Source: DWS Investments UK Limited. Data as of 30 June 2024.

Our US equity forecasts are also modestly lower relative to the end of March. Similarly to MSCI ACWI, the 10-year return forecasts for MSCI USA decreased modestly from 6.1% to 5.9%, driven by the valuation adjustment going from -0.9% to -1.1%, following the rally in US equity prices in Q1 as shown in Figure 18.

Figure 18: MSCI USA: Contribution to 10-year forecasted hypothetical annualized returns

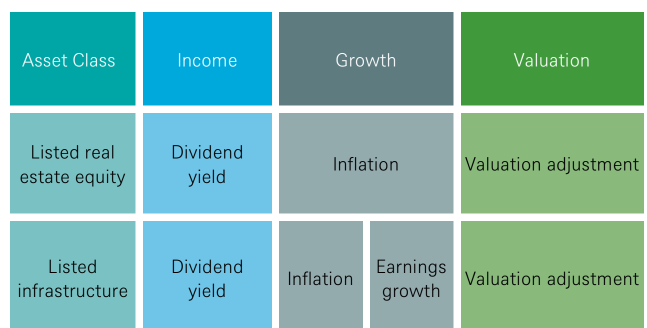


Source: DWS Investments UK Limited. Data as of 30 June 2024.

3.2 Liquid Real Assets Forecasts

While REITs and Infrastructure both leverage very similar pillars to equities (see Figure 19), returns are derived largely from income via dividend distributions as shown in Figure 20 and Figure 21.

Figure 19: Pillar decomposition for REITs and Infrastructure



Source: DWS Investments UK Limited.

Across liquid real assets, our return forecasts are within a reasonable range as compared to traditional markets. Global REIT returns are expected to provide less incremental yield spread

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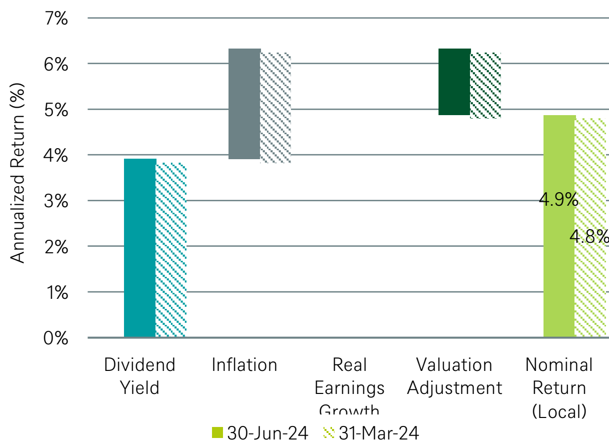
given higher real interest rates while our Infrastructure equity outlook provides a potential return outlook commensurate to or modestly above traditional public equity markets.

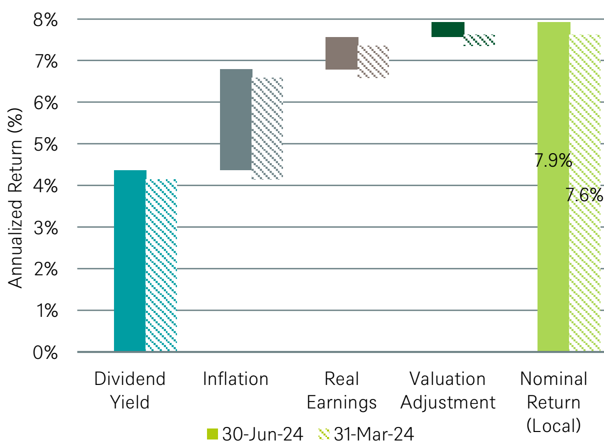
Relative to the previous quarter, our 10-year return forecast for Global REITs increased marginally from 4.8% to 4.9%, reflecting slightly higher dividend yield contribution (3.9% versus 3.8% at the end of Q1). Global Infrastructure forecasted returns improved modestly from 7.6% to 7.9%, reflecting an increase in dividend yield contribution from 4.1% to 4.4%.

Figure 20: Global REITs: Contribution to 10-year forecasted hypothetical annualized returns



Source: DWS Investments UK Limited. Data as of 30 June 2024.

Figure 21: Global Infrastructure: Contribution to 10-year forecasted hypothetical annualized returns



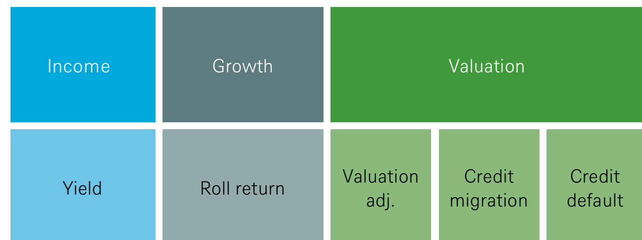
Source: DWS Investments UK Limited. Data as of 30 June 2024.

3.3 Fixed Income Forecasts

Despite a somewhat volatile quarter for interest rates, US Treasury yields were only modestly higher over the course of Q2. In April, the 10-year US Treasury yield moved sharply higher from 4.20% to a peak of over 4.70% following stubborn inflation data. However, yields normalized in late April and through the end of Q2, as the domestic economy showed signs of slowing down with softer than expected GDP in conjunction with with weaker than expected payrolls. In aggregate, the 10-year (up from 4.20% to 4.40%) and the 2-year (up from 4.62% to 4.75%) Treasury yields ended Q2 modestly higher with expectations around a possible September Fed rate cut.

This modest selloff in US Treasury yields extends this period of yield curve inversion between the 10-year and 2-year points to about two years, the longest in modern history. With the effects of tight monetary policy helping to gradually quell growth and inflation, US Treasury yields continue to look more attractive in both real and nominal terms than they have since before the Global Financial Crisis and the initial rounds of Quantitative Easing policy. As a result, fixed income investors face a more sanguine strategic outlook, both in absolute terms and relative to equities, than they have in well over a decade. The net effect of the modest move higher in interest rates is reflected in higher yield contributions to our strategic return outlook for sovereign bonds. Starting yield is by far the most important driver of return contribution in our building blocks shown in Figure 22.

Figure 22: Pillar decomposition for Fixed Income



Source: DWS Investments UK Limited.

The 20bps move higher in the 10-year US Treasury yield in Q2 increased yield contribution for our Bloomberg US Treasury Bond Index forecast from 4.3% at the end of March to 4.4% at the end of Q2. This has moved our total return forecasts for the US Treasury Bond index higher to 4.4% as shown in Figure 23.

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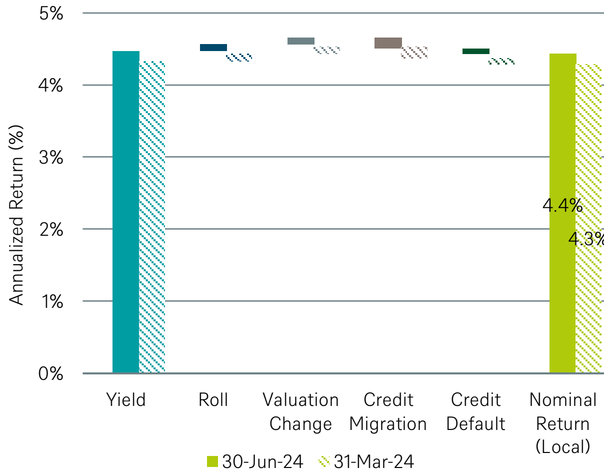
Figure 23: US Treasury Bond Index: Contribution to 10-year forecasted hypothetical annualized returns

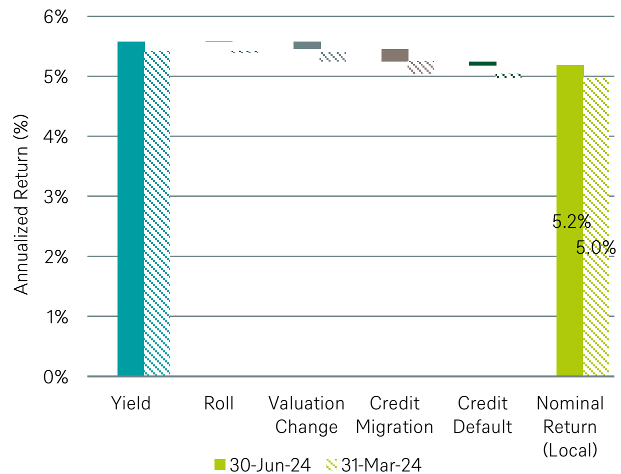


Source: DWS Investments UK Limited. Data as of 30 June 2024.

Return forecasts across corporate credit markets reflect a small move higher in credit spreads bolstered by a larger move higher in risk-free yields. Broadly speaking, corporate credit spreads were marginally higher in Q1, with the US Investment Grade Corporate OAS moving from 0.90% to 0.94% and the US High Yield Corporate OAS moving from 2.99% to 3.09%. The widening in spreads combined with the increase in US Treasury yields across the curve results in higher starting yield levels for longer-duration corporate credit asset classes such as investment grade corporates, while most spread-sensitive shorter duration high yield bond yields are largely unchanged.

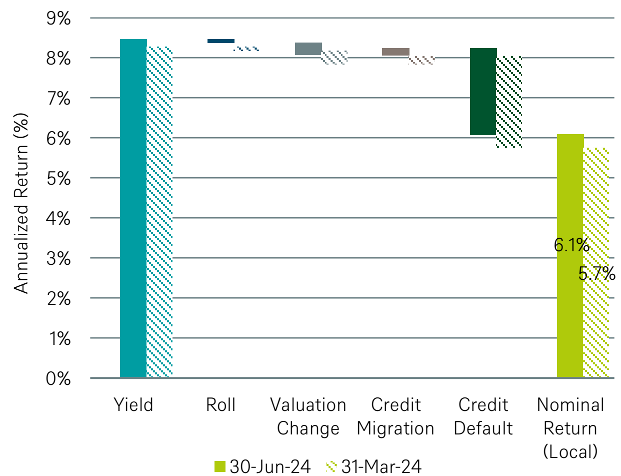
Over the course of Q2, our total return forecast for US Investment Grade Corporate Bonds increased from 5.0% to 5.2% (reflecting an increase in the yield pillar contribution from 5.4% to 5.6%) and our US High Yield Corporate Bond forecast increased from 5.7% to 6.1% (with the yield pillar contribution increasing from 8.3% to 8.5%). Figure 24 and Figure 25 show US Investment Grade and US High Yield return forecasts, respectively. The high starting nominal yield for US High Yield in contrast with historically tight equity risk premia for US equities results in a very similar strategic return outlook between the S&P 500 and the Bloomberg US High Yield Index now after these two estimates had been converging towards each other for several quarters.

Figure 24: US Investment Grade Corporate Bond Index: Contribution to 10-year forecasted hypothetical annualized returns



Source: DWS Investments UK Limited. Data as of 30 June 2024.

Figure 25: US High Yield Bond Index: Contribution to 10-year forecasted hypothetical annualized returns



Source: DWS Investments UK Limited. Data as of 30 June 2024.

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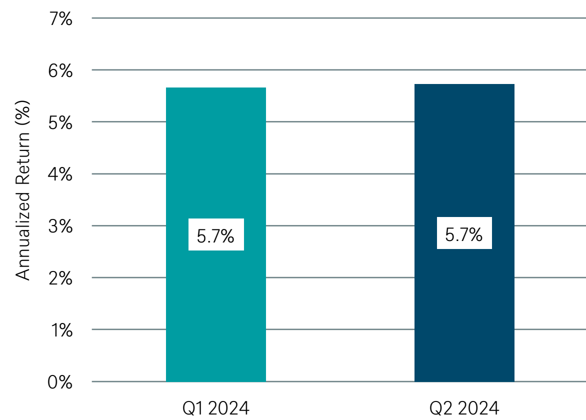
4 / Conclusion

Return forecasts across asset classes are relatively unchanged compared to the end of Q1, but modest tightening in already demanding equity premia combined with somewhat higher government yields has further narrowed return forecasts between equity and fixed income asset classes. US Large Cap valuations continue to reflect immense optimism around Artificial Intelligence both in terms of macroeconomic impact and corporate profitability while other segments of the market such as Value and small domestically-oriented companies continue to lag. The same is true across credit markets, where Investment Grade and High Yield corporate bond spreads remain tight relative to history but look somewhat reasonable in comparison to growth equity cost of capital.

Whether these optimistic valuations will materialize into continued outsized earnings growth remains to be seen, but what we can be a bit more certain of is the attractiveness of real and nominal bond yields at levels not seen in more than a decade. And as expectations around global central bank easing solidify amid real evidence of slowing inflation, the return prospects for medium-to-longer-duration bonds looks quite compelling for income investors.

As such, the strategic outlook for investors reflect these higher real yields but tighter equity and credit risk premia. As a result, our 10-year return forecasts shown in Figure 26 illustrates our 10-year return forecasts for a moderate strategic asset allocation multi-asset[3] portfolio, with little change over the most recent quarter.

Figure 26: 10-year forecasted hypothetical annualized returns of moderate strategic asset allocation in local currency



Source: DWS Investments UK Limited. Data as of 31 March 2024.

[3] Moderate strategic asset allocation refers to a portfolio that targets annualized volatility of roughly 10%

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