

Our monthly market analysis and positioning



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IN A NUTSHELL

- Market confidence has been severely shaken by bank collapses in March. How much of the recent GDP growth scare will stick remains to be seen.
- We made our forecasts before the market rout. But our 12-month view into the future remains moderately confident.
- We anticipate further volatility and believe a well diversified portfolio is the best way to deal with uncertainty.

1 / Market overview

1.1 Central Banks' rapid rate moves begin to cause turbulence

Market volatility reveals weaknesses in the financial sector; systemic risks, however, are lower than in 2008

If one wanted to summarize market sentiment in March in an index, the MOVE¹ would be a good choice. It measures nervousness in the U.S. government bond market by tracking the implied volatility of options written on Treasuries. It has risen from 120 at the beginning of March to around 200 by mid-month. This is its highest since the fall of 2008 – when it rose as high as 250. Even during the market panic in March 2020, it only reached 164. This is an indication of the severity of the withdrawal symptoms as the market is deprived of the sweet drug of liquidity.

The rate hike cycle, with the U.S. Federal Reserve (Fed) increasing the price of money by 4.75 percentage points in less than a year, is the sharpest in more than 40 years. Given the unusual terrain in which the ECB, too, has operated for more than a decade – with zero or negative interest rates – one might expect the jump in the ECB deposit rate from -0.5 % to 3.0 % in just nine months to also have some explosive effect. But so far, compared to March 2020, the recent market turmoil has been mild. Diversification has paid off. Asset classes considered safe, such as government bonds, gold, and defensive equity sectors, have gained value. And we remain relatively relaxed on comparisons with the 2008 financial crisis that have been prompted by bank failures in the U.S. and the prominent difficulty of a bank in Europe. Particularly in Europe, a raft of changes has made systemic crisis seem far less likely today. There are now higher capital and liquidity requirements for banks, negligible involvement of the interbank market in short-term funding, a shift of large parts of derivatives trading to clearing houses and, last but not least, a significantly expanded set of emergency instruments in the hands of central banks. These reforms should help prevent a repeat of 2008.

However, the spillover to Europe of the banking crisis sparked by regulatory gaps in the U.S. means that the previously clear outperformance of European equities compared to the U.S. has largely reversed² in March. Emerging markets, too, have also proven unable to maintain their good start to the year beyond January 19, once again being adversely affected by developments in developed economies. Fast interest rate moves on both sides of the Atlantic (for example, 2-year U.S.

¹ ICS BofA Move Index

² As of March 16, both the S&P 500 and the Stoxx 600 were nearly one percent ahead in dollar terms year-to-date

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Treasury yields fell by 100 basis points in a couple of days) were preceded by ambiguous macroeconomic signals. In the U.S., for example, there are increasing signs of an economic slowdown, but the February inflation release showed little progress in combating core inflation. U.S. labor markets are still buoyant in absolute terms, but the number of temporary workers has been trending downward for about a year, as has the number of workers quitting to take up better offers. Quick shifts in market expectations concerning future Fed hikes shows how difficult investors are finding it to interpret the state of the economy. In Europe meanwhile the joy of beating growth expectations that had previously been severely downgraded has given way to a realization that in absolute terms the economy remains quite tepid.

Ultimately, the stress in the banking sector on both sides of the Atlantic may have been inevitable. In the history of vigorous Fed rate hike cycles there have always been victims. Financial conditions, especially lending standards, are now likely to tighten, which will eventually affect economic growth. But tighter financial conditions will also help central banks fight inflation.

While we continue to expect only a slight downturn in Europe and a mild recession in the U.S., the market has become much more cautious, if one takes two data points from Wednesday at face value. The Fed is now expected to raise interest rates only once more and then cut rates a full four times before the end of the year. And the oil price, which is often seen as an economic barometer, has fallen by 13 dollars to 73 dollars per barrel in March, to its lowest level since December 2021.

2 / Outlook and changes

As this is the quarterly edition of the investment traffic lights, we focus as usual on the strategic, i.e. 12-month targets, decided at the beginning of March. Our share price targets were moderate, with returns largely fed by dividend payments. For bonds, we expected yields to rise slightly, but this still provided a respectable total return given the high current yield. Some of the price targets now look very ambitious after some very volatile days. Our government bond yield forecasts have also now moved well away from market levels. But this reflects the current highly volatile markets.

2.1 Fixed Income

Government Bonds

We now expect the Federal Reserve System (Fed) terminal rate to reach 5.25-5.5% later in the second quarter. Inflation appears to be sticky and there is some further upside risk for US Treasuries. We raised our forecast to 4.4% for 2-year maturities and to 4.3% and 4.4% for 10 and 30-year Treasuries, respectively. The curve is expected to steepen again, from the current strong inversion to a de facto flat curve in 12 months' time.

Stubborn inflation in Europe may force the European Central Bank (ECB) to hike even more. We expect another 150 basis points in hikes, taking the key deposit rate to a terminal rate of 4%. Given these risks we expect Treasury markets haven't yet seen their yield peaks. For March 2024 we think that the 2-year Bund will be at 3.2% and we now forecast 2.9% for both 10 & 30-year Bund yields. We expect the 10-year Italy spread to widen again moderately to 220 basis points over Bunds in March 2024. This is manageable for Italy in terms of debt sustainability. For Spain we expect the 10-year spread at 100 basis points. The Bank of England (BoE) is in a dilemma, fighting strong UK inflation but mindful too of the risks of recession while also keeping mortgage refinancing costs in focus. The Bank of Japan (BoJ) is monitoring closely the unusually high inflation rates of around 4% in a historically deflationary country.

Investment Grade Credit

Despite the outlook for elevated inflation and a soft economic environment we are decreasing our spread target for U.S. Investment Grade (IG) modestly, from 130 to 110 basis points, thanks to stable ratings and fundamental strengths in leverage and liquidity, and the global demand for yield. The outlook for the eurozone is similarly positive: Here, a sluggish economic environment is beneficial for the asset class. But the high volatility in the bond market is less helpful.

High Yield Credit

The appeal of carry applies all the more to high-yield bonds. We do not expect a clear trend in spreads. In the U.S. we prefer the higher-rated stocks, while in Europe we are avoiding real estate, manufacturing and retail.

Emerging Markets

Our 12-month spread forecast for Emerging Markets (EM) sovereign bonds is 470 basis points, which yields an attractive carry. We like the broad issuer base, especially for EUR bonds. Given the geopolitical challenges, we remain selective on countries. We are positive on Asia overall due to the reopening of China. We prefer HY over IG issuers.

Currencies

We think that the more hawkish ECB (also in relation to the Fed) should drive the Euro to our new strategic target of 1.10. The reopening of the Chinese economy should mean the Renminbi stabilizes further and we now forecast a rate of 6.95 versus the U.S. dollar, compared to 7.35 before.

2.2 Equities

The key message of our 2023 outlook – “There Are Powerful Alternatives (TAPAs)” to equities in the bond market – remains valid. Higher interest rates should limit the valuation upside for equities. Furthermore, as economic momentum remains low, we foresee flat earnings in 2023 and earnings per share (EPS) growth limited to around 5% in the medium term. Therefore, we leave our S&P 500 March 2023 target unchanged at 4,100. According to our model, the S&P can only reach 5,000 in the coming 12 months if U.S. yields fall to 2.5% and EPS growth accelerates to 10%. Both these assumptions look very improbable to us.

European valuation discounts to the U.S. have started to shrink but are still almost 2 standard deviations higher than in the past 20 years. We are therefore sticking to our tactical call to overweight European equities and are slightly lifting our index targets (Stoxx 600 target 480, DAX target 16,300). We are encouraged by the positive earnings revisions in the pan-European banking sector. International fund flows and the fading energy crisis remain supportive. Within Europe we reiterate the attractiveness of small and mid-cap stocks and see a good entry point into a structurally winning trend. Valuations remain attractive.

Similarly, we reiterate our constructive EM and Asia ex-Japan call, which is supported by improving macro trends in China. We expect 5.5% GDP growth in China this year.

Communication Services remains our preferred global sector. Earnings expectations for media & entertainment stocks (75% of the sector's market cap) are now no longer excessive and telecoms (25% of the sector market cap) should report improved cash flows going forward, thanks to lower 5G capital expenses and improved pricing power in Europe. At the sub-sectoral level, we like automobiles, energy services, Nordic and pan-European banks, biotechnology, agrichemicals, aerospace & EM semiconductors.

2.3 Alternatives

Real Estate

Investment performance has stumbled as property prices correct in response to rising interest rates. However, fundamentals remain solid, with low vacancy rates and healthy rent growth across most sectors and regions. Despite a mild recession in the U.S., we expect markets to remain tight as construction slides. A “flight-to-quality” of tenants toward energy- and water-efficient buildings with good air quality is supporting office refurbishment, especially in Europe. We continue to favor the residential sector for its demographics and industrial sector because of e-commerce globally and see an attractive entry point in European logistics. We remain negative on the U.S. office sector while Europe and APAC office space appears more resilient.

Infrastructure

On a longer-term horizon, infrastructure remains well-placed to accommodate higher rates and inflation, given the strong performance seen in 2022. Competition for large-cap investments should remain intense, with record-breaking fundraising

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across fewer funds. Significant levels of policy support are in place across Europe and the U.S. to allow investors to target energy transition investments at scale. As infrastructure projects are now facing competition from bonds from an investor perspective, we believe the emphasis should be on projects that can best deal with inflation, as this is the differentiator to bonds.

Gold

Geopolitical risks, stubborn inflation, the Fed approaching peak levels in its hiking cycle, and stress in the banking sector are all tailwinds for gold. It has already proven to be a good hedge in the volatile market days in March. Ongoing high demand from retail and central banks adds up to a positive outlook.

Oil

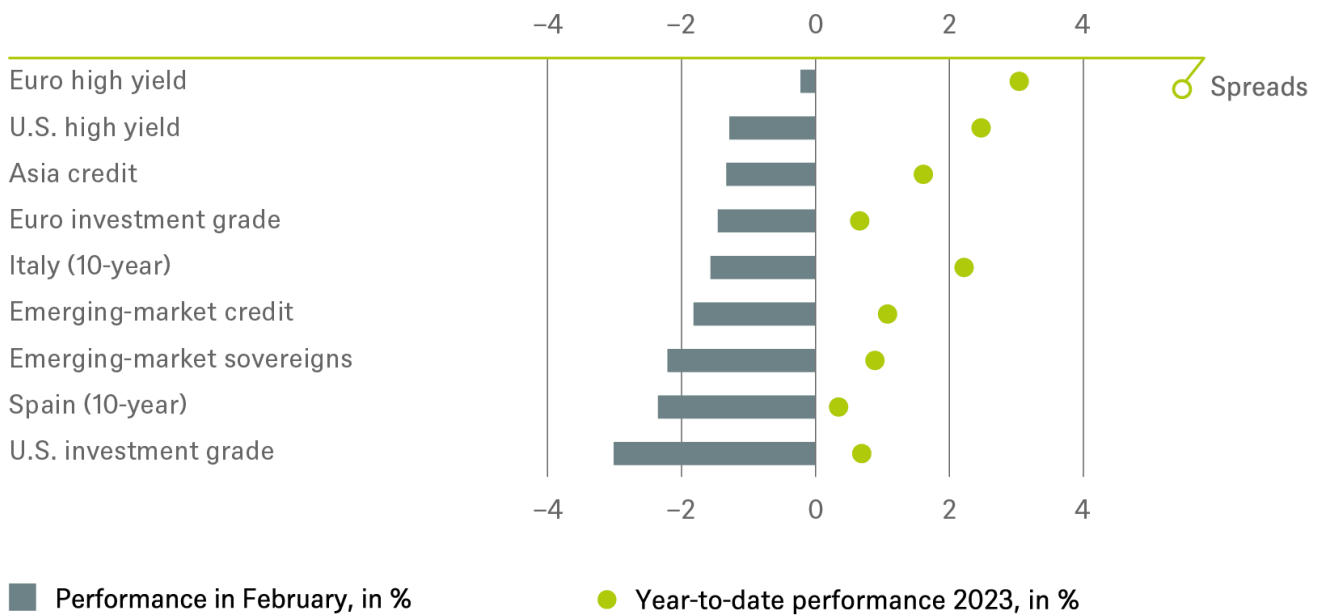
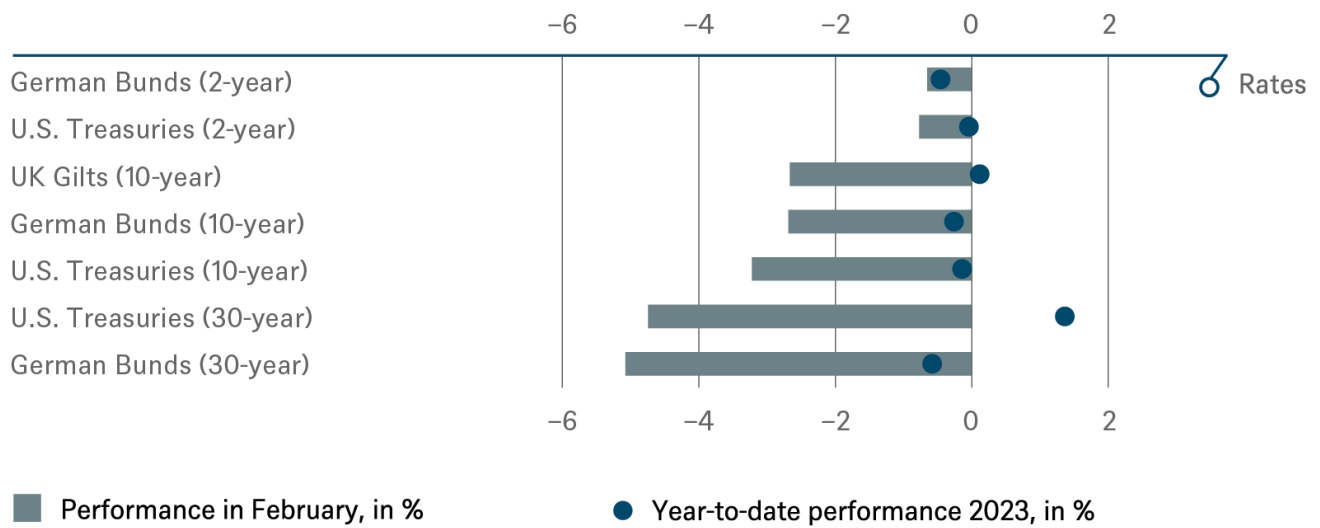
We have a pretty bold oil call, calling for U.S. dollar 100 per barrel for Brent crude in one year's time. China's reopening will lead to higher demand and OPEC+ is still restricting output, which is also still hampered by years of underinvestment. Recent weakness of the oil price because of GDP growth worries is making for better entry points. The Chinese focus on boosting consumer spending should also boost energy demand from additional travel. As for our natural gas outlook, a mild winter and conservation efforts reduced demand for gas meaningfully. Asian demand has yet to return, allowing European countries to restock via LNG. We are thus negative on natural gas.

2.5 ESG

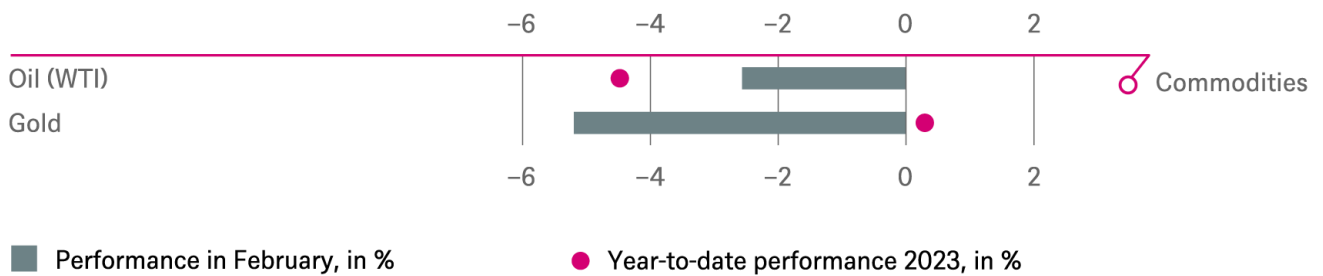
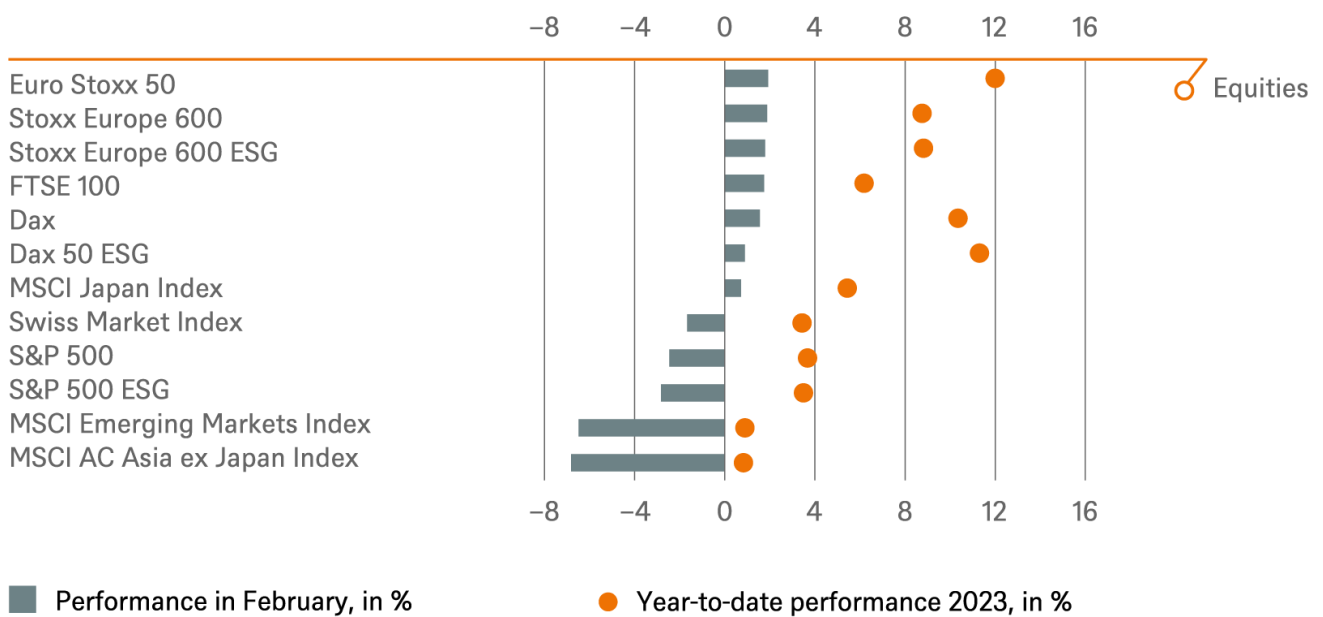
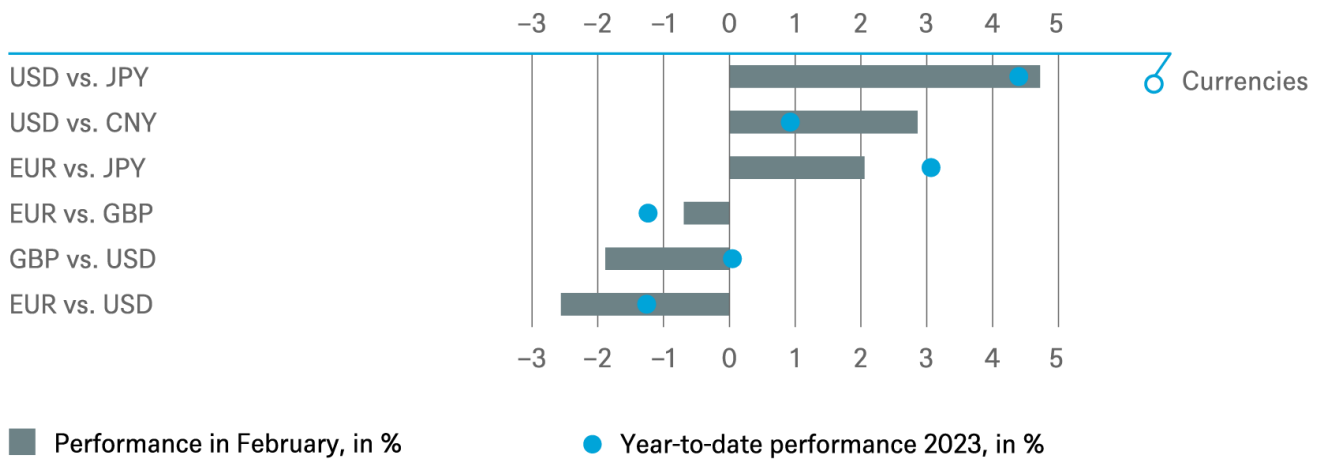
The recent decline in European gas prices has made it more economically viable to switch from coal to gas for power generation. This will likely lower the incremental demand for EU allowances. Furthermore, expected resumption of nuclear and hydro-generation could weigh negatively on the gas price in the near to medium term. On the other hand, an improved macroeconomic outlook and lower-than-expected renewable or gas generation could support prices for emission allowances. A caveat maybe prudent to add: when it comes to price forecasting, we find that those commodities with higher levels of volatility, such as European carbon prices, have significantly higher associated forecasting errors.

3 / Past performance of major financial assets

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



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Past performance is not indicative of future returns.
Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 2/28/23

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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)	●	●

Securitized / specialities	1 to 3 months	until Mar 2024
Covered bonds ¹	●	●
U.S. municipal bonds	●	●
U.S. mortgage-backed securities	●	●

4.2 Equities

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

Spreads	1 to 3 months	until Mar 2024
Spain (10-year) ¹	●	●
Italy (10-year) ¹	●	●
U.S. investment grade	●	●
U.S. high yield	●	●
Euro investment grade ¹	●	●
Euro high yield ¹	●	●
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 ²
Consumer staples ¹²	●
Healthcare ¹³	●
Communication services ¹⁴	●
Utilities ¹⁵	●
Consumer discretionary ¹⁶	●
Energy ¹⁷	●
Financials ¹⁸	●
Industrials ¹⁹	●
Information technology ²⁰	●
Materials ²¹	●

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Style	1 to 3 months
U.S. small caps ²²	●
European small caps ²³	●

4.3 Alternatives

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

¹Spread over German Bunds. ²Relative to the MSCI AC World Index (only for the tactical signals).³ S&P 500, ⁴Stoxx Europe 600, ⁵Euro Stoxx 50, ⁶Dax, ⁷Swiss Market Index, ⁸FTSE 100, ⁹MSCI Emerging Markets Index, ¹⁰MSCI AC Asia ex Japan Index, ¹¹MSCI Japan Index, ¹²MSCI AC World Consumer Staples Index, ¹³MSCI AC World Health Care Index, ¹⁴MSCI AC World Communication Services Index, ¹⁵MSCI AC World Utilities Index, ¹⁶MSCI AC World Consumer Discretionary Index, ¹⁷MSCI AC World Energy Index, ¹⁸MSCI AC World Financials Index, ¹⁹MSCI AC World Industrials Index, ²⁰MSCI AC World Information Technology Index, ²¹MSCI AC World Materials Index, ²²Russell 2000 Index relative to the S&P 500, ²³Stoxx Europe Small 200 relative to the Stoxx Europe 600, ²⁴Relative to the Bloomberg Commodity Index, ²⁵Long-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 2024

- 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

The **Bank of England (BoE)** is the central bank of the United Kingdom.

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.

In financial markets, a **clearing house** acts as an intermediary between buyers and sellers, ensuring that both will honor their contractual obligations.

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

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

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 **European Union (EU)** is a political and economic union of 27 member states located primarily in Europe.

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

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 **Move Index** is a volatility index developed by Merrill Lynch that reflects the implied volatility for U.S. government bonds with different maturities.

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 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.

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

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 **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 **spread** is the difference between the quoted rates of return on two different investments, usually of different credit quality.

Standard deviation is often used to represent the volatility of an investment. It depicts how widely an investment's returns vary from the investment's average return over a certain period.

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.

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.

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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