Quarterly CIO View | Letter to Investors
Client audience: Retail

DWS

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Still looking pretty good

The investment environment is not free of challenges. It never is. At the moment, there is a lot going for investors in our core scenario. The prerequisite, however, is that the AI investment boom doesn't falter.

"Investors currently have little reason to complain. There are decent returns on the bond markets and the rate cut cycle has begun in many regions. On the stock markets, U.S. tech stocks in particular are benefiting from the AI hype, while European companies are experiencing a more classic cyclical upswing. We see the potential for medium to high single-digit returns in our core scenario, provided geopolitical crises do not escalate."

Björn Jesch
Global Chief Investment Officer

The crisis mode is behind us and the global economy is returning to normal. Global growth is settling at around 3% and inflation, we believe, will be below the 3% mark in the major economies this year. After the "abnormal" times Covid brought and that Russia's invasion of Ukraine still brings, and all the fear of stagflation or outright recession, this might be called Goldilocks. And indeed, our most recent strategy meeting was characterized by fewer controversies than for a long time. The longest discussion centered on whether the U.S. Federal Reserve (Fed) would make three or four interest rate cuts in the next twelve months. And yet this "normalization" feels strange to many. You fear that in three months' time you will ask your colleagues: "Do you remember how we discussed the number of interest rate cuts and just a short time later the U.S. bond/stock/real estate market came crashing down in our faces – in the midst, possibly, of a worsening or entirely new geopolitical crisis?"

The major global pain points are well known. 1. The U.S. stock market boom depends on just a bubbly handful of companies. 2. The U.S. election has the potential for nasty surprises. 3. U.S. national debt continues to rise with seemingly no prospect of improvement, no matter who becomes the next president. And more and more countries are turning away from the dollar. 4. The current higher interest rates may show themselves in company bankruptcies and consumer restraint. 5. And on top of all this, the European elections and the snap French elections show the European Union's (EU) fragility.

However, there are good reasons why the markets have ignored all the problems and kept rising: 1. The price rallies of the large U.S. tech companies have so far been underpinned by corresponding profit increases. And in 2025 we expect their profits to rise by another 20%. 2. We also expect a close election result and a divided Congress, which will limit the next president's room for maneuver – and, probably, the damage he can do. 3. Despite record debt, there is no sign of a shift away from U.S. investments. The dollar is strong and the abundant supply of U.S. Treasuries from a deficit-ridden government is being met with strong demand. U.S. financial markets are booming. 4. In the U.S., in particular, the debt structure of companies and homeowners looks significantly different than in 2007. Households are financed to a smaller extent by debt, and much of their debt is fixed for the long term, at low interest rates[1]. 5. Extreme parties failed to gain a breakthrough in the European elections, and in some countries even recorded losses. In France we consider a victory by Le Pen's right-wing Rassemblement National to be unlikely. But there is no assurance on one front: the biggest geopolitical risk, the war in Ukraine.

For our twelve-month forecasts a balancing act is required. We cannot ignore the positive momentum in the U.S. resulting from the triumphant artificial intelligence (AI) hype, the lack of any recession so far, and the economic recovery in Europe and Asia. But we cannot simply extrapolate the past few months. The signs of an economic slowdown in the U.S. are multiplying;

[1] At the same time, high current mortgage rates are a problem for new home buyers.

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trade disputes are getting worse, not better; and stock valuations are lavish. The bottom line in our view is that it's important to be ready for all eventualities, through broad diversification.

What does all this mean for our investment outlook? We expect 3 further interest rate cuts by the European Central Bank (ECB) and the Fed (two cuts for the former this year, one for the latter). For government bonds, this should result in a steepening of the yield curve – and the expected additional price increase at the short end makes us prefer this segment. When it comes to corporate bonds, Investment Grade (IG) bonds remain our favorites in Europe, and we find much to interest us in the High Yield (HY) segment in emerging markets (EM). We see high single-digit return potential for equities, and in the U.S., it continues to be the tech sector that can provide these strong profit increases. If AI and tech were to falter, the outlook would become less good. We do not see scope for a further increase in valuation multiples: they, and profit margins, are already high. As a counterweight to U.S. tech stocks, we are focusing in particular on European equities. We also continue to look to gold for diversification.

A pessimistic view would see the current investment environment as the calm before the storm. An optimistic take is that the past crises have been handled well and economies continue to show their ability to adapt. We generally tend to take an optimistic view, but we are not blind to the risks.

Glossary

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

Diversification refers to the dispersal of investments across asset types, geographies and so on with the aim of reducing risk or boosting risk-adjusted returns.

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

The European Central Bank 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.

Geopolitical risk a risk that an investment's returns could suffer as a result of political changes or instability in a country.

The term Goldilocks economy refers to a state of the economy, where there is neither a threat of inflation due to an overheating economy, nor a threat of a recession.

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.

Stagflation is the combination of the words „stagnation" and „inflation," referring to a period where inflation is high while the economy is stagnating.

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.

A yield curve shows the annualized yields of fixed-income securities across different contract periods as a curve. When it is inverted, bonds with longer maturities have lower yields than those with shorter maturities.

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