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CIO Insights

A long hill to climb

Outlook and 2020 themes update

Letter to Investors

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A long hill to climb

Dealing with coronavirus remains an uphill slog. While many businesses are re-opening, numerous countries continue to battle rising infection numbers and are re-imposing (mostly regional) lockdown measures.

Against this uncertain background, however, markets have demonstrated a mixture of confidence and belief. They are confident that central bank and government economic policy support will continue. They also believe, on balance, that there will be further progress on reducing the spread of the coronavirus (e.g. through vaccination) and improving treatment for those afflicted by COVID-19.

We also believe that there will be further progress on containing the coronavirus and expect good news on vaccine development. But there will remain questions about vaccine effectiveness and how quickly production can be scaled up to meet demand. So this seems a good time to step back and discuss the climb ahead. In terms of economic output, Q2 2020 seems likely to prove the trough with a recovery already underway. But, as we explain in the next section, we still do not expect a sharp "V-shaped" recovery, even if the initial rebound is marked. Economic growth is likely to soon level out; we will probably not reach pre-crisis levels of output until 2022 and we still face some major challenges ahead (for example, around maintaining employment at acceptable levels in the face of rising government debt).

We called our 2020 outlook "The end of monetary magic?" and the coronavirus crisis has demonstrated both monetary policy's importance and its limits. Fiscal policy has emerged as the new policy tool of choice, targeted at particularly hard-hit sectors of the global economy in a way that the blunt instrument of monetary policy cannot be. But while "monetary magic" may be approaching its limits, highly accommodative monetary policy – most evident through low or negative interest rates – still defines the investment outlook.

This is a good time to consider the climb ahead – and understand why strategic asset allocation and ESG investment are central to the ascent

For an investor, this means being realistic about return expectations while being aware of the long-term issues underpinning markets. We highlight two factors that will continue to determine our investment approach: strategic asset allocation (SAA, page 10) and ESG investments (page 11). We think that these concepts will remain important as the investment environment evolves.

At the end of 2019, well before coronavirus hit the headlines, we identified six investment themes for 2020. These still remain highly relevant, as we explain from page 13 onwards. The pandemic has only reinforced the arguments behind many of them. The crisis has also shown, for a variety of reasons, the relevance of our long-term themes – built around a triangle of tech, demographics and ESG/sustaining the world we live in (page 19).

Where will we be in a year's time? In a different world, I think, but still a manageable one. Debt levels will be a concern and some trees will still be falling in the corporate forest (to use the great 19th century economist Alfred Marshall's analogy). Social and political pressures will have increased but we may have found some innovative methods to ameliorate them. I remain confident about the eventual post-coronavirus economic and political outcome, but it will take time.

Christian Nolting

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Instant Insights

Outlook in a nutshell

- Recovery in GDP will be slow: pre-crisis levels not reached until 2022
- SAA and ESG will remain two key factors in our investment approach
- Our 2020 themes stay highly relevant in the current environment

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Macro and markets

Growth outlook

Expectations have changed quickly during the pandemic. As the coronavirus crisis worsened, there was quick widespread acceptance that Q2 was going to be bad, with sharp falls in GDP unprecedented in recent times. We also quickly accepted that massive levels of government support would be needed to keep individuals and corporates afloat – even in the more laissez-faire economies.

The question now is whether expectations will rapidly change again, as recovery gets under way. In most economies, the initial recovery has not been sharp, hitting any hopes of a smooth or V-shaped recovery (i.e. one that takes us quickly back to pre-crisis levels of activity). Most economic actors are likely to remain cautious.

Consumers hold the key

Ultimately, the speed of recovery depends on the consumer. Recent data shows a sharp increase in national savings rates during the pandemic – in part due to forced savings under lockdown, in part (particularly the U.S.) due to households receiving welfare payments. As lockdowns have eased, savings rates are falling – but are not back to normal. Consumers may be discouraged from raising spending back to previous levels by both lower levels of government support in future – and potentially rising unemployment.

It would be strange if this sense of unease did not still permeate the corporate sector, whether or not the upward trend in companies' share prices continues. Recent data has shown sharp falls in orders and output and, while global supply chains have proved relatively resilient in the global pandemic, this will be a time for review and restructuring. Corporate investment, and goods exports, may not provide a great boost to growth in coming quarters.

Set against this, we would expect further increases in government investment and spending in many economies and for more explicitly Keynesian economic policies to be adopted, but this will not be a spending bonanza; the challenges are many and government finances are already under strain.

So all in all, we stick with our view that the initial recovery will be only partial, and that growth after that will be modest. Figure 1 shows expected annual growth rates. China might manage slight positive growth this year (on the basis of being "first in, first out" on coronavirus) but all other major economies will face big falls in 2020 GDP. Forecasts for these falls will become clearer as more Q2 GDP data is published – indicating the depth of the output trough – and we get a better idea of the likely strength of the Q3 and Q4 economic recoveries. In the case of the U.S., we do not expect positive YoY rates of economic growth until Q2 2021. The actual level of U.S. GDP is not expected to get back to its pre-crisis Q4 2019 level until Q1 2022.

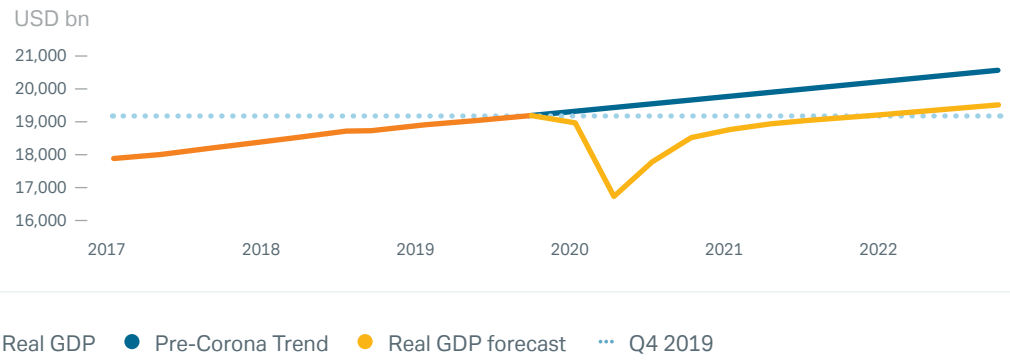
Figure 1: Our GDP growth forecasts for 2020 and 2021

Source: Deutsche Bank International Private Bank. As of May 28, 2020. Real change in %. All forecasts subject to revision.

	2020	2021
U.S.	-5.7	5.6
Eurozone (of which)	-7.5	4.5
Germany	-6.0	4.5
China	1.0	9.0
Japan	-5.5	3.3
World	-3.1	5.5

Figure 2: U.S. GDP struggles to reach pre-crisis levels

Source: Deutsche Bank International Private Bank. Based on our forecasts of May 28, 2020. All forecasts subject to revision.



The policy background

Getting even this anaemic level of recovery will require continuing and extensive policy support. The Federal Reserve cut rates twice in March in emergency responses to the deepening coronavirus crisis, as well as loosening monetary policy further in other ways. History suggests that rate cuts are less likely in the run-up to a U.S. election (November 2020) but this does not mean that other policy initiatives are off the table. Fed Chair Powell realises that he has to demonstrate continued Fed alertness through appearing open to further intervention as necessary – any sign of policy backsliding would risk a much worse replay of the "taper tantrum" of 2013.

Monetary and fiscal policy may be eliding

For its part, the ECB also seems unlikely to cut rates further under the Lagarde leadership, but we expect further liquidity measures to boost credit. The pandemic emergency purchase programme (PEPP) has been extended into 2021 and initial agreement has been reached on a European recovery fund, set to deliver EUR750bn in support through a mixture of grants and loans. Support from this source will however only come properly on stream in 2021.

Japan has been less hard-hit by coronavirus than many other developed economies, but the government's response is pushing up public debt levels and the Bank of Japan (BoJ) will have to manage this. So far, the BoJ has pursued a steady-as-she-goes approach, maintaining yield curve control. It is currently resisting calls for more monetary stimulus, but remains keen to support the financial sector and has also increased its coronavirus-related lending program to over USD1 trillion.

The situation faced by the People's Bank of China (PBoC) is rather different. Chinese economic recovery so far has been boosted by some broad commitments by the PBoC to use and develop new monetary tools as appropriate. The distinction between monetary and fiscal policy is perhaps even more blurred here than in the developed economies, given the variety of government agencies at work. Relending and rediscount rates were cut again at the start of July, but the PBoC has started to signal that the peak of stimulus may now have passed.

Emerging markets (EM) more broadly are at different stages of policy loosening. Some EM central banks – such as Indonesia and India – have continued with rate cuts and policy initiatives. Others have been much more cautious. This is still a story that is far from over, and much will depend on whether the cautious recovery in global demand can be sustained over the next few quarters – and whether further major coronavirus-related shutdowns can be avoided.

Policy risks

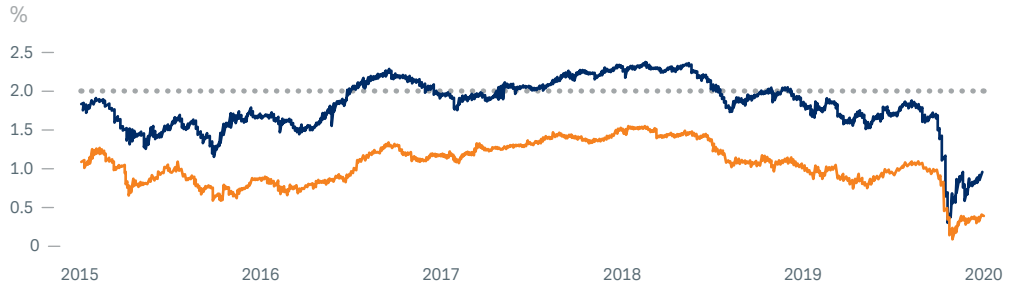
The crisis has prompted plenty of talk about inflation, but there is so far very little evidence of it. In most economies, the downward jolt to overall demand from the pandemic has more than offset any potential upward push on prices from supply disruption. Low oil prices (on a YoY comparison) have also helped to keep down headline rates of consumer price inflation, as have a fall in inflation expectations (Figure 3). We don't expect this situation to change soon. Headline monthly YoY rates of inflation have been temporarily negative in China and Japan, inter alia. Any eventual possible increases in headline YoY rates of inflation due to higher oil, food and some services prices are likely to be offset by downward pressures on many goods prices (due to overcapacity) and perhaps rents. We expect negative average annual rates of consumer price inflation in Japan and the Eurozone this year (both -0.3%) with some policy initiatives (e.g. the temporary VAT cut in Germany) adding to downwards pressures. We expect only mildly positive U.S. inflation (1.2%) but a slightly higher rate in China (2.8%). Reassuringly, there are few signs yet (a few crisis-hit countries apart) of higher inflationary pressure in emerging markets – the traditional inflation-harbingers of rapid M2 or credit growth, strong increases in agricultural or energy prices, or currency collapse are little in evidence, despite the crisis.

Trade conflicts could still erupt

Of course, the long-term inflationary impact of such a rapid increase in debt is still unknown. But we think that other issues could create more immediate risks to policy and global growth. Chief amongst these are trade conflicts. In the run-up to the U.S. election, President Trump is trying a difficult balancing act, saying that he wants to keep "Phase 1" of his U.S./China deal alive, while keeping political and economic pressure on China (as do his Democrat opponents). The risk is that trade tensions here spill over into other relationships (e.g. U.S./Europe). A number of geopolitical issues could also grow in importance (e.g. China/India).

Figure 3: Inflation expectations have fallen

Source: Deutsche Bank International Private Bank, Datastream. Data as of July 7, 2020.



5YR U.S. Inflation linked swap · 5YR Eurozone Inflation linked swap · Central banks' CPI target

Implications for markets

The S&P 500 hit its low point on March 23, 2020 and has risen around 40% since then. The bond markets had a perhaps even more traumatic March, but have also been pulled around by central bank policy intervention. Most markets are therefore in a generally positive mood at the moment, confident that the policy action will remain supportive.

This disconnect between buoyant markets and a seemingly hazy economic outlook is understandable but not ignorable and we do not think that the next 12 months will be straightforward.

Current equity market levels are currently above our 12-month equity forecasts and valuations on most measures appear stretched. This is even on the basis of our steadily raising what we think are the warranted price/earnings valuation levels for the lead index, the S&P 500, from 16x in 2013 to 20x now. We have also pushed forward the time horizon for our earnings per share forecast to three years to capture (we would hope) the full post-coronavirus recovery period. One argument for higher equity prices remains the lack of clear investment alternatives, but how much further this can drive markets upwards is unclear. Ultra-loose monetary policy and continued improvements in leading indicators could lead markets to overshoot in coming months, but we would be careful not to assume major sustained future gains. At this point, we would not have a strong regional preference. In the last few months, we have seen a short-lived market tilt towards value/cyclicals stocks, but we are now back to more of a quality growth orientation. We would keep an open mind on styles (as per our 2020 investment theme 4: Balance your style, page 15) but continue to have a preference at a sector level for healthcare and technology.

Figure 4: Equity market forecasts for end-June 2021

Source: Deutsche Bank International Private Bank. As of May 28, 2020.

U.S.	S&P 500	3,100	Switzerland	SMI	10,150
Germany	DAX	12,000	UK	FTSE 100	6,300
Eurozone	Eurostoxx 50	3,150	Emerging Markets	MSCI EM	1,000
Europe	Stoxx 600	370	Asia ex Japan	MSCI Asia ex Japan	660
Japan	MSCI Japan	950			

Fixed income recovery should have further to go

Fixed income markets have also recovered from their March lows, with spread tightening helped by further intervention from the Fed as well as the ECB. We think that there is some room for further spread narrowing from current levels, but this will be accompanied by risks (e.g. around defaults in the high yield space). Fed and ECB buying should however help prevent a further reversal.

We continue to see opportunities in emerging markets (EM) bonds, where high carry continues to compensate for apparent risks. Most economies have now built up a good record in debt management and most still find it easy to access markets when required. The EM corporate space includes a high proportion of investment grade issuers that can also access markets easily.

Figure 5: Fixed income forecasts for end-June 2021

Source: Deutsche Bank International Private Bank. As of May 28, 2020.

U.S.		
UST 2yr	U.S. 2yr yield	0.25%
UST 10yr	U.S. 10yr yield	0.9%
UST 30yr	U.S. 30yr yield	1.3%
USD IG Corp	BarCap U.S. Credit	165bp
USD HY	Barclays U.S. HY	640bp

Asia Pacific		
JGB 2yr	JPN 2yr yield	–0.2%
JGB 10yr	JPN 10yr yield	–0.1%
Asia Credit	JACI Index	350bp

Europe		
Schatz 2yr	GER 2yr yield	–0.8%
Bund 10yr	GER 10yr yield	–0.5%
Bund 30yr	GER 30yr yield	–0.1%
Gilt 10yr	UK 10yr yield	0.5%
EUR IG Corp	iBoxx Eur Corp all	150bp
EUR HY	ML Eur Non-Fin HY Constr. Index	600bp

Emerging Markets		
EM Sovereign	EMBIG Div	525bp
EM Credit	CEMBI Broad	450bp

With some possible exceptions (e.g. GBP), exchange rates proved relatively stable in the initial months of the pandemic, although we have since seen a fall in the value of the USD. Prophesies about the end of the USD as a global reserve currency have however proved wide of the mark in the past, and recent weakness may not be sustained. Underlying FX trends are likely to include a weakening of the CNY from current levels. We also see only a small increase in oil prices from current levels on a 12-month horizon, as supply moves back closer in line with demand (Figure 7), with gold also having only small potential gains from current levels – but maintaining its useful role as a portfolio diversifier.

Figure 6: Commodity and FX forecasts

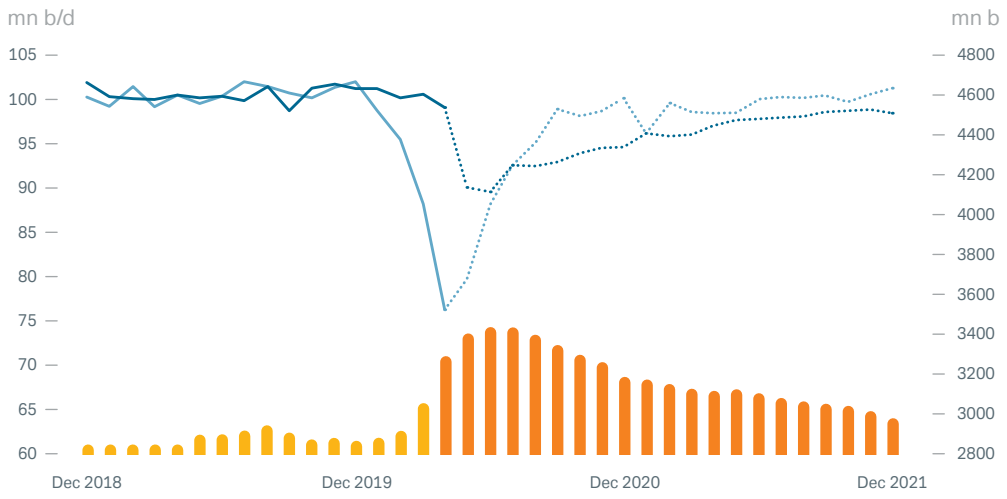
Source: Deutsche Bank International Private Bank. As of May 28, 2020.

Gold (USD/oz)	1,830	EUR vs. JPY	115
Oil (WTI, USD/b, 12 month forward)	43	EUR vs. GBP	0.90
EUR vs. USD	1.10	GBP vs. USD	1.22
USD vs. JPY	105	USD vs. CNY	7.30

Our asset class views are summarized on page 12.

Figure 7: Oil demand and supply come back into line

Source: Bloomberg Finance LP, IEA, OPEC, Deutsche Bank International Private Bank. Data as of July 7, 2020.



OECD Inventories (rhs) · OECD Inventories Forecast (rhs) · Global Supply (lhs) · Forecast Supply (lhs) · Forecast Demand (lhs) · Global Demand (lhs)

Box 1

Strategic asset allocation: managing uncertainty

Strategic asset allocation (SAA) lies at the heart of our investment process. We continue to believe that effective SAA will continue to account for most of a portfolio's returns over time, given the challenges around market timing (when to go in and out of markets) and individual stock selection, although these can still add value.

As is widely appreciated, there is no single optimum asset allocation. Investors have different investment preferences (e.g. around risk), face different challenges, and start with different sorts of investable assets. FX issues will also vary depending on the investor and their location.

What is also clear is that it makes no sense to base a strategic asset allocation around a single set of forecasts about where markets are going from here. As the coronavirus pandemic has reminded us all too clearly, no one can predict the future with perfect certainty and outcomes may not be expected. Given this inherent uncertainty, the focus should be on likelihood. When we forecast the three key variables for asset allocation (expected returns, volatility and correlations) we will be able to draw some conclusions from historical experience. But the important thing is to realise in which areas/relationships we can be reasonably confident and which are more tentative. Then we can start to build an asset allocation that should be more resilient to events ahead.

One example shows why factoring in uncertainty is important. Many core government bonds outside the U.S. currently seem likely to have negative yields for some time. Why then invest in bonds at all? (Rather than, for example, cash.) One obvious answer is that bond holdings should provide some diversification benefits, given likely yield moves in a risk scenario. But the argument for bonds is broader than this: looking at all the various possible future scenarios, our calculations suggest that the weighted average return on a portfolio including bonds is likely to be better than one with just an allocation to cash. This observation – the focus on expected weighted-average returns under different scenarios – can be applied to other asset classes (e.g. equities) too. As with our SAA approach generally, the underlying message is that it may be a good move to accept a small potential theoretical return disadvantage, in return for a larger potential return advantage, if things do not turn out exactly as expected.

Box 2

ESG: pandemic underlines importance

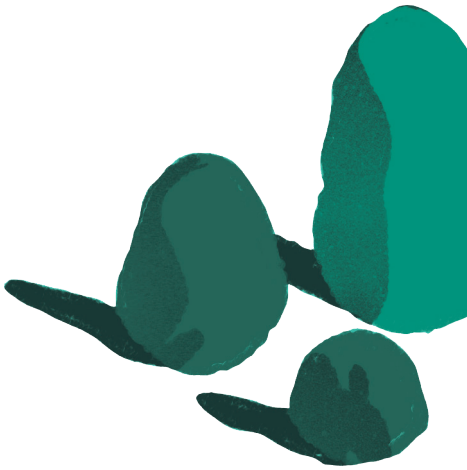
As the coronavirus pandemic spread, there were some fears that environmental, social and governance (ESG) controls might be eased, as individual countries looked for ways to revive economic growth through a beggar-your-neighbour approach to boosting competitive advantage (e.g. through pushing back environmental targets).

In the event, this hasn't happened although there remain risks around this. The crisis has however made one thing clear: in this time of crisis, companies with high ESG ratings have outperformed the overall market. In particular, good governance seems to have positioned them well (e.g. in terms of transparency) for general economic and business stresses.

Other factors suggest that ESG could become even more important. The coronavirus has highlighted the importance of environmental and social factors, as well as governance. Given the presumed source of coronavirus – zoonosis, the jump of infections between species – the pandemic has reinforced the case for habitat protection and management, adding to existing environmental concerns (the "E").

The economic impact of the pandemic and employment has underlined their social responsibilities of firms (the "S"). Moreover, if the crisis results in governments taking larger shares in individual firms to keep them going, governments may want to demand they adhere to social targets.

To return to governance (the "G"), recognition of its importance will outlive the current crisis. As we explain in our forthcoming special report, *The "G" in ESG: Governance – a question of balance*, the scope of governance has steadily expanded over time, with environmental issues and government (rather than just corporate) responsibilities now integral to it.



Asset class views in summary

Core government bonds: Limited scope for rising yields, in the absence of any pick-up in inflation. Increased government debt issuance could however eventually give investors pause for thought. German resolution of legal challenge to PSPP purchases reduces one risk, but (despite initial agreement on a recovery fund) Eurozone politics are still a risk.

Investment grade: Fed has now joined ECB in buying individual corporates, but with some scope for spreads to tighten slightly further. Sound technical background in U.S. and European supply moderating. Coronavirus concerns now assumed priced in, but rapid deterioration here (and in trade relations) would be negative.

High yield: Strong U.S. HY issuance has so far been well absorbed, but rising coronavirus infection rates are a concern. Higher oil prices have been a help, but investor inflows into the asset class have moderated. EUR HY expected defaults have moderated and primary market is picking up but selection and liquidity are key.

Emerging markets hard currency debt: Coronavirus and geopolitical risks remain but Asian debt appeals as a source of yield. EM spreads still lag DM peers, providing catch-up potential. New issuance has been manageable and high global liquidity a support too.

U.S. equities: 2020 S&P 500 earnings per share (EPS) now forecast at USD110 with likely trough in Q2. Leverage concerns around energy, industrials and consumer discretionary. We stay tactically cautious and would prefer defensives over cyclicals. We continue to favour healthcare and technology sectors.

European equities: Downward earnings revisions have now led to more realistic 2020 EPS estimates. Supportive fiscal policy, targeted on maintaining employment levels, will provide support but we don't expect earnings to be back to 2019 levels until 2023. Prefer quality and growth stocks.

Japanese equities: Slowdown of global growth of concern to export-oriented industries (e.g. autos and parts) but domestic economy less hard-hit by coronavirus than some others. Positive factors include strong balance sheets and low leverage but supply/demand picture could be clouded by BoJ becoming a major owner.

Emerging market equities: Valuations still attractive in absolute terms and vs. global equity market. But differentiation still key at country and sector levels. Hopes of earnings recovery also need to materialize. Risks include coronavirus second wave and trade disputes.

Gold: Any gains from current levels likely to be limited but still low interest rates and accommodative monetary policy should provide support. Safe haven appeal of gold may have its limits and price can be vulnerable to investors reducing positions for liquidity needs if market stress returns.

Oil: Some recovery in global demand and apparently good compliance with May's OPEC+ production cuts has sustained prices well above recent lows. U.S. shale output also proving responsive (both ways) to price changes. Price recovery could pick up pace later this year (12 month WTI forecast USD43/b).

2020 themes update

We launched our 2020 themes last December, when the existence of the SARS-CoV-2 virus was almost unknown. However, as the world struggles to return to normal, the themes still have considerable relevance for managing a portfolio.

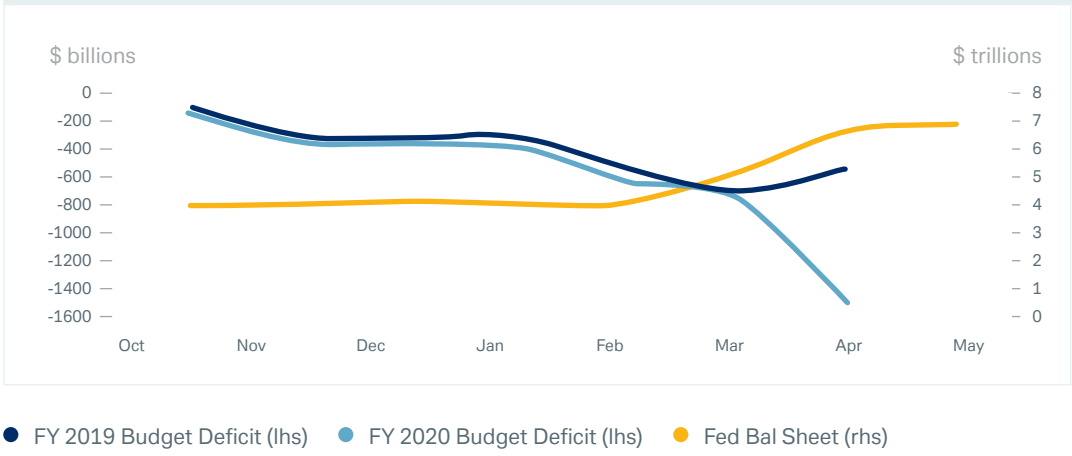
Theme 1: Policy pressures need prudent response

This first theme identified concerns around an over-dependence on monetary policy and structural challenges such as de-globalization and the need for well-considered ways of addressing them.

The desperate policy response to the coronavirus pandemic – which has forced central banks into yet more monetary stimulus, governments into unprecedented levels of fiscal support and many corporates into reconsidering their business models – has amplified these concerns. We had already discussed the problem of government deficits and debt in our 2019 special report "Peak debt: sustainability and investment implications". The coronavirus has accelerated existing long-term trends here. Figure 8 shows how policy and deficits are also causing a short-term dilemma for the U.S. (as they are for other countries).

Figure 8: U.S. monthly cumulative budget deficits, Fed balance sheet

Source: DWS, Deutsche Bank International Private Bank. Data as of July 7, 2020.



Past performance is not indicative of future returns. Forecasts are not a reliable indicator of future performance. Your capital may be at risk. Readers should refer to disclosures and risk warnings at the end of this document. Produced in August 2020.

History will probably judge the policy response to coronavirus as "prudent" – given the scale of the economic problem. But governments' prudence will be tested in the months and years to come. Slow and uneven recovery, combined with likely higher levels of unemployment, and perhaps "unknown unknown" policy side-effects, will add to pressures for yet more radical economic policy measures. Political problems – internal and external (e.g. around trade, Brexit etc.) – will also not go away.

A "prudent" response will also be needed to less narrowly economic policy issues. Government intervention in response to coronavirus is likely to involve increased state involvement and ownership of industry, perhaps adding to demands for the adoption of more explicitly "social" objectives or, for example, a rethinking of intellectual property rights. Positives can come out of this, but there are also major risks.

Investment implications: Even if it seems very likely that monetary policy will remain very loose, don't assume that other aspects of policy won't come under review – with problems for societies and markets. Governments may find a "prudent" response increasingly difficult to find. Expect some policy upsets and stay diversified.

Theme 2: Living with a low yields world

This theme has also been given an extra twist by coronavirus. When we launched the theme, we thought that monetary policy would keep yields low for some time. The coronavirus pandemic means that yields will remain lower for even longer. We are forecasting German and Japanese government bond yields both to be still negative in 12 months' time; U.S. 10-year yields will still be below 1% (Figure 5 above).

Coronavirus has also introduced new elements of risk into this low-yields world. First, it has provoked worries about systemic risk – as evidenced in the market ructions in March, quickly dealt with by central banks. Second, it has raised concerns about more specific risk – either around companies or specific countries – due to the economic and market impact of coronavirus. Third, it increased existing fears about the longer-term implications of deficits for the sustainability of government debt. Fourth, it has resuscitated worries that the ultra-loose monetary policy will lead to an eventual increase in inflation in the longer run, despite the evident downwards pressures on prices now.

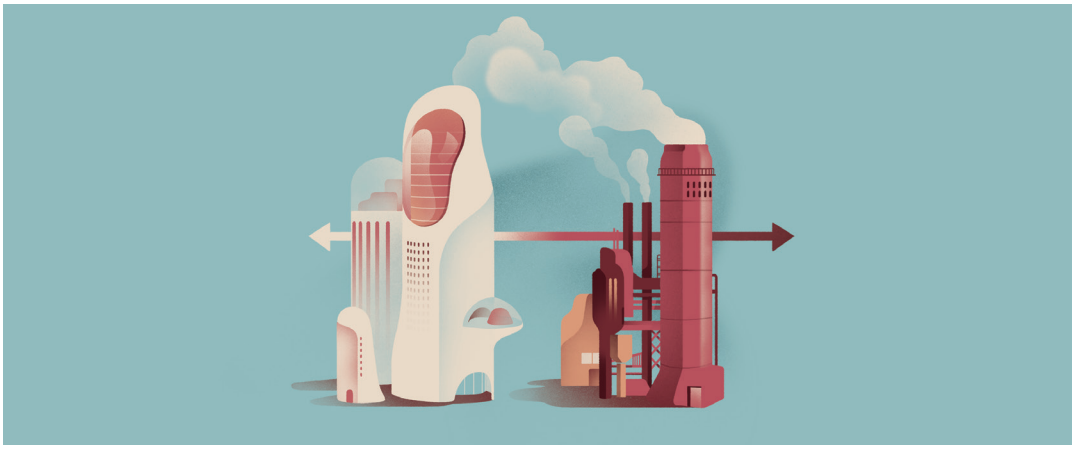
Investment implications: The point we made at the start of 2020 – that core bond holdings need to be justified – is still relevant. Core government bonds may be able to provide some portfolio diversification in the event of a market correction, but there are also risks involved in holdings that are too high. In our strategic asset allocation discussion above, we explain why even negative yielding bonds are still relevant in a portfolio as well as cash, given the need to manage uncertainty around future outcomes. Risk-adjusted returns from a portfolio that include government bonds may still be better than those of an SAA without them, but there will still be risks attached.

Theme 3: Find new income harbours

If yields are indeed set to remain low, where should one look for income in the fixed income space? At the time, we suggested that investors should look for higher yielding investments in emerging market and corporate bonds, while keeping an "open mind" as to where and what these investments might be.

Events this year have certainly underlined the need to keep an "open mind" around tactical opportunities. A sharp rise in corporate spreads (including investment grade) in March due to market stresses was reversed by policy intervention, generating opportunities. Central banks have become more and more involved in corporate bond markets, with the Fed following the ECB's earlier lead. Spread retracement created major opportunities after the March market crisis. Meanwhile, most emerging market bonds have had a better few months than might have been expected, helped by considered EM central bank responses, and little evidence of rising inflation or much higher levels of default.

Investment implications: Looking forward, we think that there is some room for spread tightening in both USD and EUR IG, although the gains here may be limited. There seems some further room for HY gains too, despite increased issuance in the U.S. Default rates are a potential issue here, and there are idiosyncratic risks. Within emerging market debt, the corporate as well as sovereign sector may appeal on a selective basis. Coronavirus issues cast a cloud over some sovereign EM debt but EM credit spreads offer some potential for further tightening, as global demand picks up, commodity prices gently recover and global liquidity remains high, thanks to highly accommodative central bank policies. Demand here has remained robust, against a background of generally declining inflation expectations.



Theme 4: Balance your style

At the start of 2020, we argued that equity investors should "balance" their style – in other words, should not place their faith entirely in one investment approach. As we noted at that time, equity markets had largely been driven up by "growth" stocks (equity in firms thought likely to grow

faster than the market as a whole). As we noted, "value" stocks (stocks trading lower than the price apparently justified by fundamentals) had not done so well. We believed that, with the valuation gap between "growth" and "value" stocks at record highs, a more balanced approach between "growth" and, particularly, high-quality "value" stocks might yield rewards.

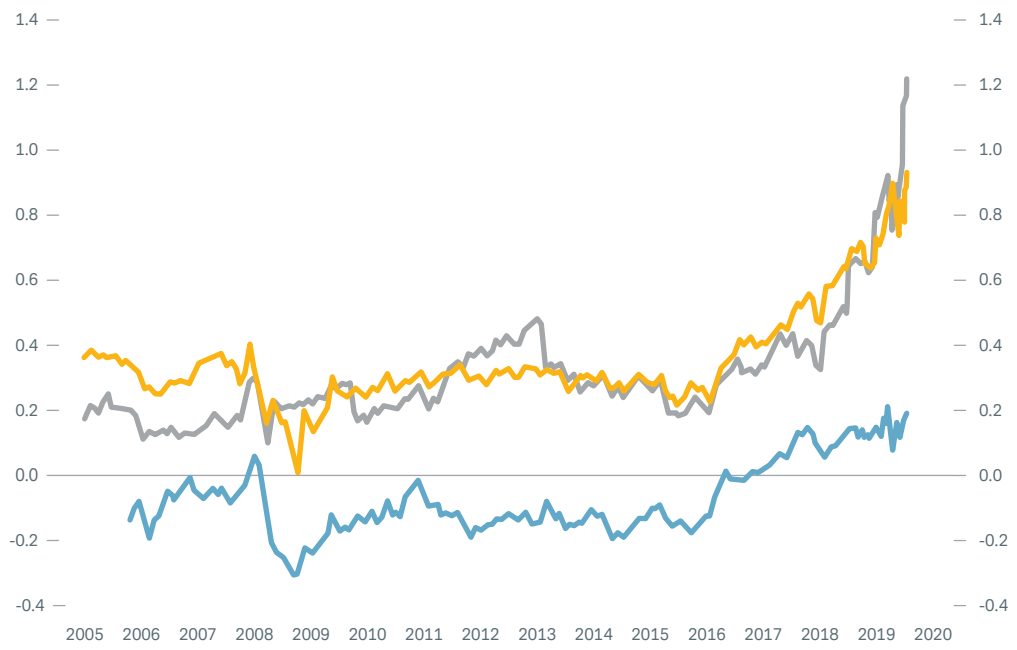
Equity markets have since then been on a roller-coaster ride, thanks to the spread of the coronavirus pandemic, but the case for a balanced approach remains. We saw a short-lived rebound in "value" stocks during Q2 but since then "growth" has outperformed again. Dividends have, to a great extent, fallen by the wayside with firms discouraged from paying them out by the prospect of greater economic pain ahead.

What happens from here is quite another question. At the start of Q3, market gains had taken markets to levels that appeared highly valued in terms of fundamentals (at least, in relation to earnings). Earnings expectations have steadily been declining, although there are hopes that Q2 2020 earnings will prove to be a trough.

Investment implications: This may have set the stage for a difficult few months, particularly as earnings start to identify clear winners and losers in each sector, but at a sector level our long-standing preferences for healthcare stocks remain. At a style level, "growth" stocks may appear highly priced vs. "value" on many measures but their free cash flow premium is not excessive on a historical basis (see Figure 9 below). Portfolios following a balanced approach might include both "growth" stocks and some selected resilient "value" stocks seen as likely to gain from the coming economic upturn.

Figure 9: "Growth" stocks valuation premium vs. "value": different measures

Source: DWS, Deutsche Bank International Private Bank. MSCI World Value vs. MSCI World Growth. Data as of June 27, 2020.



EV/FCF Premium (Excludes Financials) EV/Sales Premium P/E Premium

Theme 5: Politics tops policy

Our prediction for 2020 was that political actions would prove more important than economic and policy fundamentals in setting FX rates. This has happened, but in a way that was unforeseeable. Markets focused on the overall extent of the policy response to coronavirus rather than trying to differentiate between countries. So, while we have seen temporary risk-off flows into currencies such as the JPY, and a short-lived upwards spike in the DXY (the trade-weighted USD index) in early March then followed by recent USD weakness, currencies have not been so individually volatile as might have been expected.

What has happened instead is that currency pairs have, at least until recently, been driven largely by risk on/risk off sentiment, in relation to the U.S. stock markets. Risk on tended to drive the USD up; risk off weakened it. In the past month or so, we have seen USD weakness despite still generally risk on sentiment, but the role of fundamental exchange drivers, such as interest rate differentials, has generally not been that important.

Of course, fundamentals may start to re-assert themselves as the economic outlook becomes clearer and more attention starts to be paid to differences between national policy agendas: recent USD weakness may be a harbinger of this. But, in the interim, we could move into a world where politics has a greater impact both directly (in terms of the U.S. elections, foreign trade disputes, or geopolitical stress points elsewhere) and indirectly as the political implications of government economic policy interventions are mulled over. In Europe's case, one potential focus could be on the ECB and the evolution of EU recovery plans – which, despite recent advances, could still be subject to political forces.

Other currencies' vulnerability to economic and political developments may be exacerbated by the economic fall-out from coronavirus. One particular case is the GBP, where the threat of a "no deal" end to the Brexit transition period, combined with economic contraction and rapidly rising debt, continue to provoke bouts of currency volatility.

Investment implications: We do not expect a sharp fall in the USD from current levels; on a long-term horizon, gains against the EUR are possible. JPY to maintain its portfolio diversifier role. Gentle depreciation in the CNY is expected.

Theme 6: Long-term themes – Tech meets ESG

We launched two long-term investment themes for 2020: 5G Fast Forward and Resource Stewardship. The importance of both these themes has been magnified by the coronavirus crisis. Lockdowns and home working has underlined how dependent we are on digital communications, which 5G will play a key part of in future. But the consumer impact of 5G is only one side of the story: 5G will have a major impact on services providers (and thus industry alliances and the supporting infrastructure); on commercial productivity more generally (e.g. through how production facilities interconnect) and through helping accelerate the collection and use of big data.

The impact of the pandemic on Resource Stewardship will be more subtle but will be equally important. At a base level, the likely source of the pandemic has raised awareness of the dangers of encroaching on and exploiting natural habitats. More broadly, initial fears that the immediate needs of economic recovery might lead to a temporary relaxation of environmental standards seem to have been overstated. Increased government stakes in certain sectors may also encourage environmental targets and initiatives, as will a growing emphasis on governance in the wake of pandemic-related corporate stresses.

Box 3

Linking our long-term investment themes

Each year, we suggest themes for investors with a long-term investment horizon. These themes target structural, long-term changes in the economic environment. They are intended to be less exposed to the economic cycle and should provide positive diversification effects in a portfolio context.

Our current long-term themes are focused on the three underling factors of technology, demographics and sustaining the world we live in. We set them out, together with their launch year, in Figure 10 below.

Figure 10: Our long-term themes triangle

Source: Deutsche Bank International Private Bank. Data as of July 7, 2020.

Glossary

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

Bunds are longer-term bonds issued by the German government.

CNY is the currency code for the Chinese yuan.

The DAX is a blue-chip stock-market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange; other DAX indices include a wider range of firms.

The U.S. Dollar Index (DXY) is a weighted index based on the value of the U.S. dollar versus a basket of six other currencies.

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

An emerging market (EM) is a country that has some characteristics of a developed market in terms of market efficiency, liquidity and other factors, but does not meet all developed market criteria.

ESG investing pursues environmental, social and corporate governance goals.

EUR is the currency code for the euro, the currency of the Eurozone.

The European Central Bank (ECB) is the central bank for the Eurozone.

The EuroStoxx 50 Index tracks the performance of blue-chip stocks in the Eurozone and includes the super-sector leaders in terms of market capitalization.

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 Reserve (Fed) is the central bank of the United States. Its Federal Open Market Committee (FOMC) meets to determine interest rate policy.

GBP is the currency code for the British pound/sterling.

The FTSE 100 Index tracks the performance of the 100 major companies trading on the London Stock Exchange.

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.

Growth stocks are those of companies seen as likely to have above-average earnings or revenues growth.

High yield (HY) bonds are higher-yielding bonds with a lower credit rating than investment-grade corporate bonds, Treasury bonds and municipal bonds.

The International Energy Agency (IEA) is an intergovernmental agency studying energy-related issues.

An investment grade (IG) rating by a rating agency such as Standard & Poor's indicates that a bond is seen as having a relatively low risk of default.

JPY is the currency code for the Japanese yen, the Japanese currency.

The MSCI 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 EM Index captures large and mid-cap representation across 23 emerging markets countries.

Glossary

The MSCI Japan Index measures the performance of around 323 large and mid-cap stocks drawn accounting for about 85% of Japanese market capitalization.

The Organization of the Petroleum Exporting Countries (OPEC) is an international organization with the mandate to "coordinate and unify the petroleum policies" of its 12 members. The so-called "OPEC+" brings in Russia and other producers.

The People's Bank of China (PBoC) is the central bank of the People's Republic of China.

Price/earnings (P/E) ratios measure a company's current share price relative to its per-share earnings. In this context, LTM refers to last twelve months' earnings.

The S&P 500 Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

The Stoxx Europe 600 includes 600 companies across 18 European Union countries.

A strategic asset allocation (SAA) process involves setting preferred allocations for asset classes on a long-term time horizon.

The Swiss Market Index (SMI) includes 20 large and mid-cap stocks.

Treasuries are bonds issued by the U.S. government.

USD is the currency code for the U.S. Dollar.

A value-added tax (VAT) is levied on the value added at each stage of the production process.

Value stocks are those that appear to be trading lower than justified by their fundamentals (e.g. sales and earnings).

West Texas Intermediate (WTI) is a grade of crude oil used as a benchmark in oil pricing.

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