Deutsche Bank
Wealth Management

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Americas

CIO Insights

A glass half full?
Volatility and opportunity

Letter to Investors

A glass half full?

Christian Nolting
Global CIO

It is quite normal for different individuals or institutions to make varying assessments of a particular situation. In a sense, this is a fundamental driver of financial markets, making it possible for there to be both willing buyers and willing sellers simultaneously. Differing perceptions may also help prevent, through restraining the growth of a herd mentality, extreme market swings.

Varying perceptions of the current market situation are particularly understandable, as there are a number of clear positives co-existing with several potential negatives – and not in a way that is easily reconcilable. Positives include increasingly synchronised global growth and rising corporate earnings. Negatives include fears around the extent of future Fed rate hikes based on the assumption of a very strong U.S. economy, the possibility of a further escalation in U.S. / China trade tensions and some concerns around the tech sector.

So should we be optimists and, to use the proverbial phrase, see the present situation as a "glass half full"? Or should we be pessimistic and see it as a "glass half empty"?

I would argue for tempered optimism and the "glass half full" assessment, but with a number of caveats. In essence, this is because I see recent market moves as representing a shift back towards a more typical market environment – with higher volatility generating risks but also a range of opportunities. This shift is also, I think, unavoidable as we move slowly towards the end of the post-global financial crisis quantitative easing era, and the suppression of asset class volatility that this implied.

I also find it difficult to get too depressed against a background of strong economic data and continued corporate earnings growth, although high expectations here do create their own risks, particularly around future earnings disappointments. But perhaps the real question that I ask myself is whether the possible negative factors identified above – overly-rapid Fed rate hikes, tech regulation, and trade tensions – should also be seen as simply part of this shift back to a more typical world, where economic policy is not preoccupied with the monetary angle, or are instead more existential threats. History casts a long shadow here: as we all know, Fed rate hiking during the exuberance of the 1920s was followed by market and economic collapse and also an increasingly fragmented global trade regime.

I see recent market moves as representing a shift back to a more typical market environment - with higher volatility generating risks but also a range of opportunities.

As we said previously "Forewarned is forearmed": selectivity, active management and in particular risk management will be important.

Although it is crucial to watch how inflation develops, I find it difficult to believe that the Fed will be caught out this time around. With trade, I also hope that reason will eventually win through – although I think that the way that the dispute has evolved to encompass technology transfer and investment means that a solution could take some time to find. And with tech, while a debate around regulation seems both unavoidable and necessary, given the increased importance of the sector in our economic and political lives, it need not derail its long-term momentum.

Optimism must not result in complacency, however. Last December, we published our “10 Themes for 2018”. The first of these – “Forewarned is forearmed” – cautioned that then-low levels of volatility were unlikely to be sustained through 2018 and advised investors to think about reconfiguring portfolios in anticipation of this. This prediction has been borne out and we continue to think that selectivity, active management and, in particular, risk management will be important in navigating the current environment. Other still highly relevant issues highlighted in “10 Themes for 2018” include the need to explore investment alternatives, to be very selective in fixed income, and to accept that multiple factors will drive exchange rates this year. An update on all “10 Themes for 2018” starts on page 5.

Christian Nolting

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Global CIO

Please click here or use the QR code to see a video of Christian discussing foreign trade and U.S./China tariff tensions.

Instant Insights: Letter to Investors

- Economic and corporate earnings growth make this a glass "half full" rather than "half empty".
- Inflation needs to be watched, but the Fed won't be caught out this time around.
- Optimism must not result in complacency, however: our 10 Themes for 2018 suggest ways to go.

Past performance is not indicative of future returns. Forecasts are not a reliable indicator of future performance. Readers should refer to disclosures and risk warnings at the end of this document. Produced in April 2018.

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Inside the cover

Investors may see the current situation as a glass half-full, presenting many opportunities, or half-empty, presaging a downturn. Whichever way, tremors from uncertainty are creating ripples on the water's surface.

Ten Themes

Ten Themes for 2018: Update

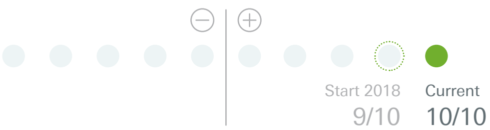
As we move into the second quarter of 2018, we look at our 10 Themes for 2018 and assess them in the light of recent economic and market developments. So far, they have stood up well to the test of time.

Please click here or the use the QR code to access our annual outlook for 2018, which includes a full explanation of our 10 Themes.

01

Forewarned is forearmed

Volatility out of the box

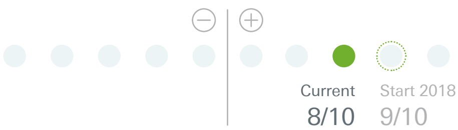


At the start of the year, we warned that then-low levels of volatility were unlikely to continue and suggested that now was the time to start thinking about reconfiguring portfolios to protect against upset. This scenario did not take long to materialize: after their strongest January since 1997, equities then posted their first 10% correction in two years as volatility rose to the highest level since 2015. Going forward, volatility should remain elevated in an environment of rising interest rates, central bank tightening, elections, policy risk in the U.S. (i.e. tariffs) and heightened geopolitical risk (i.e. North Korea/ Middle East). Because of these risks, tactical positioning and effective risk management remain crucial.

02

Growth gazumps geopolitics

Economic advance continues



We thought that while geopolitical and domestic political concerns would continue, growth momentum in the major developed and emerging market economies would come out on top. This has been the case so far this year with, for example, the IMF forecasting that economic growth would accelerate in the U.S., Europe and Japan in 2018, with global growth rising to a cyclical high. Economic momentum experienced year-to-date has already led us to upgrade our own GDP growth forecasts for the U.S. and Europe. As the long-time leader of global growth, tax reform, increased fiscal spending and deregulation should continue to support U.S. expansion. Recession probabilities in all the major developed and emerging market economies remain negligible. This backdrop of global synchronized economic recovery should continue to favor equities (including small and midcaps) over bonds.

The charts compare our degree of conviction at the start of this year (circled grey dot) and currently (green dot).

03

Central banks in transition

Turning point draws closer

Current 9/10 Start 2018 9/10

We argued at the start of the year that global central banks would remain generally accommodative even as they started the slow process of normalizing their balance sheet. We thought that their caution would continue to support risky assets overall, although uncertainty around the FOMC's composition and other central banks' leadership could worry markets. So far, personnel changes have been handled well, with the makeover of the Federal Reserve well underway under the new leadership of Jerome Powell. The ECB transition will occur later this year. Fed rate rises still seem likely to be repeated but slow although, with central bank balance sheets still on target to peak later this year, markets are aware that the turning point is drawing closer. The transition to a less accommodative monetary policy is therefore proving a slight headwind for equities (which can probably be overcome by strong earnings) and bonds (with higher interest rates).

04

"Flashlight" fixed income

Returns to remain challenged

Start 2018 8/10 Current 9/10

At the start of the year, we believed that a selective approach to fixed income would likely be necessary in 2018. We thought that government bonds were likely to struggle in 2018, and that while there would continue to be high quality carry opportunities, the overall return profile in credit would be less attractive than in 2017. This has proved to be the case. As expected, accelerating economic growth, a modest uptick in U.S. inflation, deficit-financing of U.S. tax cuts and an unfavourable supply/demand bond dynamic (as QE purchases fade) have placed upward pressure on interest rates. With the low level of rates making sovereign bonds sensitive to even small upward movements, they have performed negatively year-to-date. In an asset class where returns are expected to remain challenged, EM hard currency bonds could continue to offer the highest upside potential.

05

Still some oxygen for equities

All eyes on earnings

Start 2018 8/10 Current 10/10

Global equity markets hit multiple record highs in 2017, but we thought that there was room for further, probably smaller, gains on the back of continued economic and earnings growth. Increased volatility in February-April has indeed sharply reduced returns this year in comparison with 2017. As we also expected, selectivity has proved critical, with the dispersion of sectoral performance increasing. But, looking through the volatility, a healthy global synchronized earnings expansion should continue to support equity prices in an environment where multiples are likely to contract modestly: in this context, Q1 2018 corporate earnings will be important.

06

The "New" EM Asia equity market

Growth case holds up

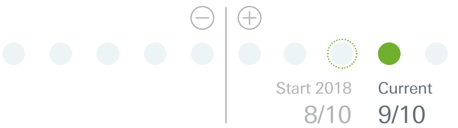
Start 2018 8/10 Current 9/10

At the start of the year, our enthusiasm for EM Asia equities was underpinned by four main factors: expectations of solid regional economic growth, double-digit earnings growth, attractive valuations and the region's exposure to the tech sector. So far, despite the volatility, EM Asia equities have continued to outperform developed market equities. We expect this outperformance to continue, given expected developments in the factors listed above. The global synchronized recovery should continue to drive earnings growth, with valuations still attractive on a historical basis. While our expectation of a stronger U.S. dollar may pose some headwinds for this asset class, they should be overcome.

07

Explore investment alternatives

Keep a broad mind

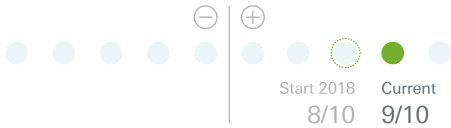


We thought that expectations of slimmer pickings in equities and fixed income, along with the expected increase in volatility, should encourage exploration of investment alternatives for diversification and other purposes. Hedge funds and some other alternatives might be able to mitigate downside risk, with opportunities in other specific areas such as hybrids, convertibles and floating rate bonds. A selective approach on real estate (by type or geography) could yield results, as might non-traditional alternative approaches such as factor investing and big data. We think that this still holds true, particularly as we expect volatility to remain elevated for some time. In fact, two of the suggested alternative assets (floating rate bonds and convertibles) have been among the best performing fixed income sectors year-to-date.

08

Dynamic FX drivers

Down but not out

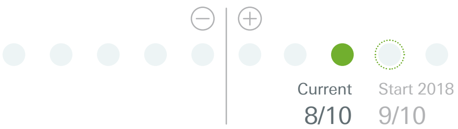


Our central FX scenario for 2018 was that rising interest rate differentials and stronger U.S. growth would support the U.S. dollar in 2018, but with alternative drivers such as central bank rhetoric, political initiatives and fund flows also impacting exchange rates. So far, the U.S. dollar has not strengthened as expected, and has been one of the worst performing major currencies year to date, taking it to near its lowest level in three years. However, we believe that the recent weakness in the U.S. dollar is not in line with fundamentals and that the dollar should regain strength into year-end due to the growth and interest rate differentials factors noted above. A more hawkish Fed is increasingly in contrast with a still-accommodative BoJ and ECB. Positioning in the currency also looks stretched: net longs in the U.S. dollar (particularly against the euro) are near their lowest level on record.

09

Oil déjà vu

Price brakes still exist

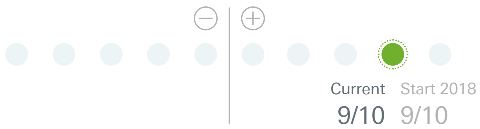


We did not expect a further sustained surge in oil prices, but cautioned that oil market dynamics were shifting. So far in 2018, increased demand, a normalization of global inventories and geopolitical factors (in particular, raised Middle East tensions and declining Venezuelan oil production) have pushed oil prices to nearly their highest level in three years. However we think that prices will be contained by a further rise in U.S. production – the EIA is now forecasting that this will rise to a record high of 11.4mn b/d by the end of this year. Our expectation of a stronger U.S. dollar will also hamper oil prices, due to the negative correlation between the two asset classes. We have a 12-month (end-March 2019) target of $60/b.

10

Tomorrow’s themes today

Long-term drivers remain



At the start of this year, we reiterated our long-term secular themes focusing on infrastructure, cyber security, global aging and millennials and added two additional themes: smart mobility (i.e. technological innovation around transport) and artificial intelligence (AI). Despite recent market volatility around the tech sector, we believe that the fundamentals driving these longer term secular themes are still highly important and that these areas are close to becoming portfolio “staples” for investors. Fund flows to these themes should remain supportive as awareness of these powerful trends become increasingly mainstream.

Instant Insights: Ten Themes for 2018

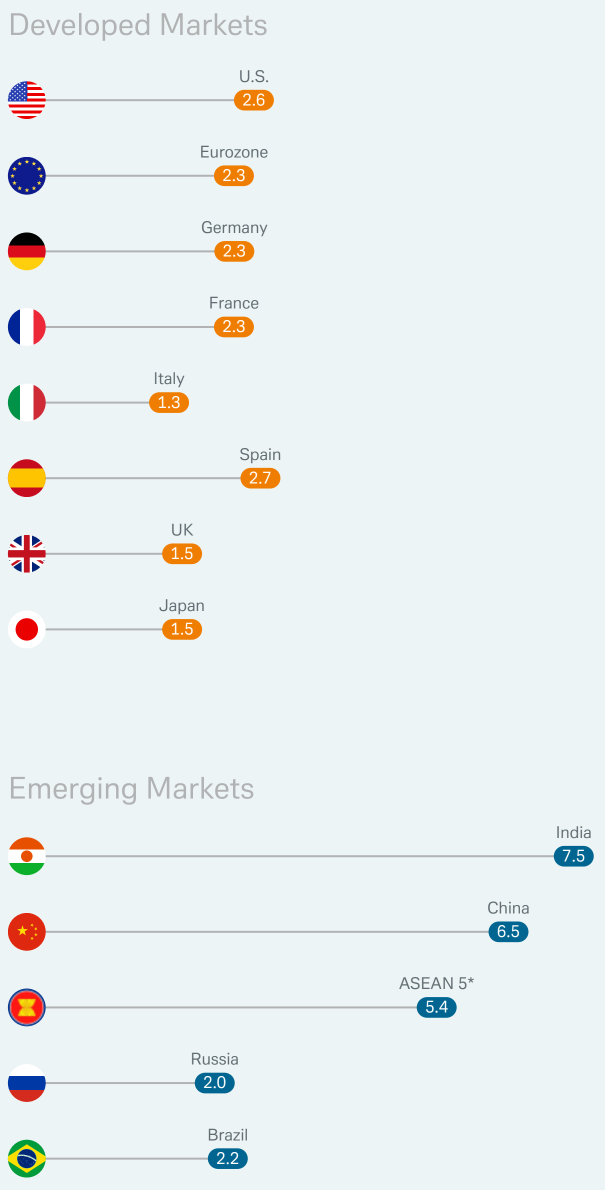
- Higher volatility was anticipated and themes reflect this.
- Case for exploring investment alternatives remains.
- Fundamentals still driving long-term themes.

Macroeconomics

Sunny skies behind the clouds

Further evidence of strong growth in the U.S. and elsewhere is pushing back geopolitical gloom. Instead, many are increasingly concerned about sunburn – through economic overheating and sharp subsequent policy tightening. Two other current concerns are trade protectionism and the U.S. budget deficit.

Figure 1:
Growth forecasts for 2018
Source: Deutsche Bank Wealth Management.
Data as of April 13, 2018.
* The ASEAN 5 are Indonesia, Malaysia, the Philippines, Singapore and Thailand.



Expectations rise

Economic growth this year looks likely to beat earlier expectations in both the U.S. and Europe. We have revised upwards our U.S. 2018 GDP growth forecast from 2.3% to 2.6% (calendar year), and that for the Eurozone from 2.0% to 2.3%.

The tone of the debate is also changing. Previously, it was dominated by concerns that economies could underperform. Now there is a worry that growth could, in the U.S. at least, beat expectations – triggering some panicked policy tightening, with possible negative implications for the markets.

U.S. overheating

Is U.S. growth likely to come in much faster than expected? Well, our forecasts already assume a mild accelerated growth – in the sense that we expect growth to remain above trend, labor markets to continue to firm and labor costs and inflation to move up (if not dramatically). But note that effective U.S. tax rates are not coming down too much and that in any case fiscal multipliers tend to be smaller when the economy is near full employment, and financial conditions could become less supportive as the Fed keeps tightening. What is also interesting is that inflation expectations in the U.S. are proving hard to move up, the Phillips curve is proving quite flat (implying that lower levels of unemployment won't provide an upwards jolt) and there also looks likely to be a modest recovery in the economy's supply side potential. So, all in all, we would put the probability of such an upside shock of just 15-20%.

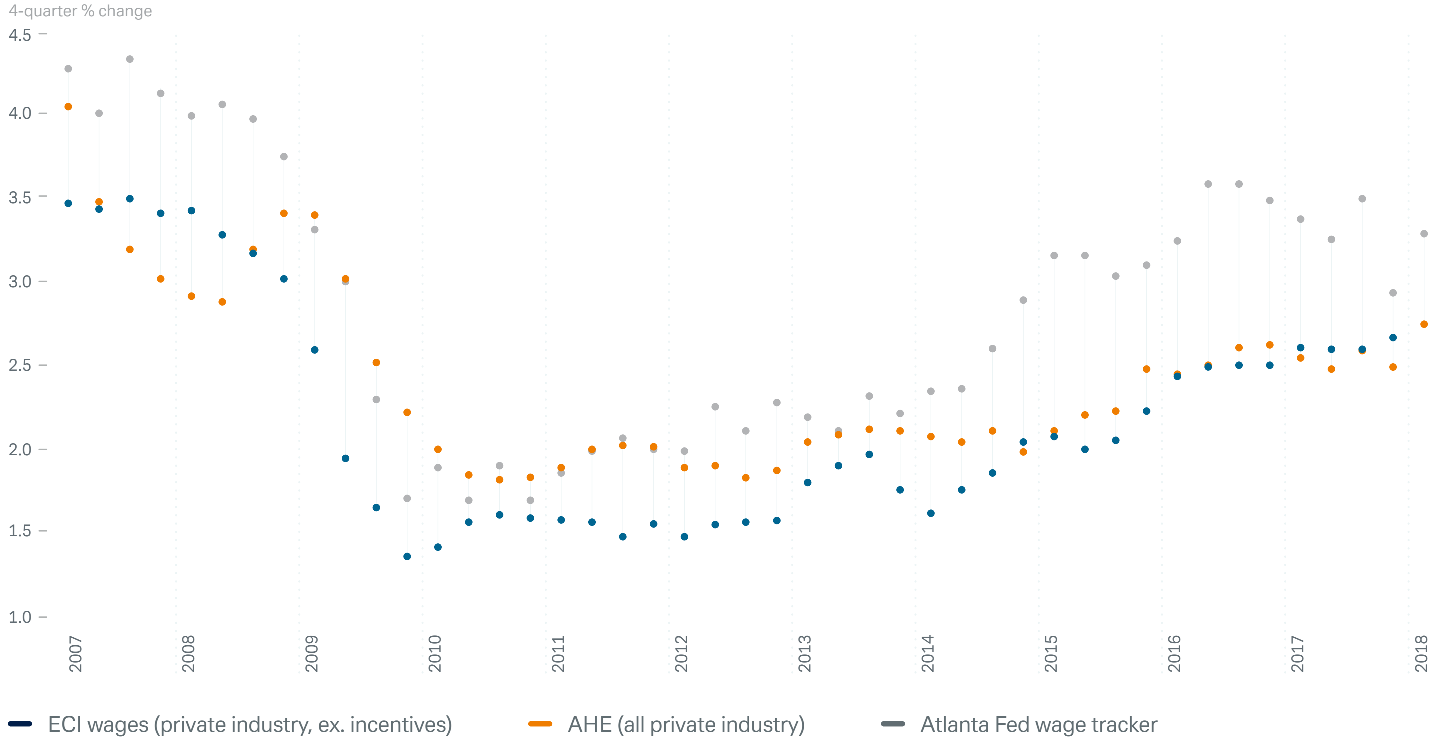


Figure 2:
U.S. labor costs are moving upwards

Source: Deutsche Bank Wealth Management. Data as of March 9, 2018. ECI refers to the Bureau of Labor Statistics Employment Cost Index. AHE refers to Average Hourly Earnings.

Eurozone inflation

In the Eurozone, the chance of an upside shock also looks small. As elsewhere, higher oil and base metal prices (due to a lack of investment since 2007-2008) have the potential to drive prices up. But in Europe, another source could be higher house prices and rents, or construction costs. But these take time to feed through into inflation and would likely vary considerably between countries in the region. Some upward pressure on inflation is likely from labour costs, which are picking up, especially in Germany. Over the medium term, inflation could also be pushed up by high levels of capacity utilization in the big four Eurozone economies. But, overall, overheating in the Eurozone – and a panicked ECB response – does not look likely in the coming year.

Japanese policy

Data out of Japan has been less commented on, but remains solid with positive rates of quarterly GDP growth and household income and spending increasing. The global environment has been positive for Japan in recent quarters although structural problems continue and inflation remains well below the 2% target – despite the upward impetus until recently from a weaker Japanese yen and commodity prices. The reappointment of Kuroda for a further term suggests that existing monetary policies will be sustained.

Chinese deleveraging

We continue to expect a gradual, well-controlled slowdown in Chinese growth. The People's Bank of China has a tightening bias in monetary policy since the start of 2017 and broad-based deleveraging continues. State-owned enterprise reform has gained strength and new financial sector regulations are expected to complete the financial framework. Despite this policy change, total investment has been relatively stable in recent months and private consumption has been robust, with anecdotal evidence of a fall in the savings ratio.

Please click here or use the QR code to read our recent special report China after the NPC - Fast forward to the future?

Two clouds of concern

Global trade under fire

Clouds in the sky include concerns around trade wars and the U.S. budget deficit. Regarding foreign trade, recent tit-for-tat tariff increases by the U.S and China, with the threat of more to come, have again raised fears that we are only a few steps away from a damaging series of bilateral trade wars. The current situation is not bad: global trade rose strongly last year and a number of new bilateral trade agreements are getting closer (for example, between the EU and Japan). So far, key trade arrangements or bodies such as NAFTA and the WTO have survived unscathed. However, even before the latest announcement, the U.S. administration had demonstrated a desire for change, quitting the 11-country Trans Pacific Partnership and increasingly focusing on anti-dumping duties against individual products (e.g. solar panels) that could be implemented without the approval of Congress.

What happens next? Our main scenario is that the U.S. stays in NAFTA and the WTO and avoids a trade war. To put it simply, the U.S. benefits from global trade and good relations with China. U.S. exports to China have risen by around 500% since China's accession to the WTO in 2001; exports to other destinations have increased by only 90%. Several major U.S. firms have greater revenues from the Chinese than their domestic market; many others draw a significant share of their earnings from China. If efforts by China to smooth down any conflict go poorly, there could be a thinly-concealed hint of retaliation against these firms. The U.S. will also be aware that China is an important buyer of U.S. Treasuries.

U.S. budget bloat

We look at the U.S. budget deficit in a later section, Fixed income and foreign exchange. But what is clear is that recent rises in the deficit thus pre-date the current administration and can in part be blamed on a combination of a slight slackening in spending restraint and longer-term pressures from entitlements and demographics. As well as the shorter-term impact of a higher deficit on market sentiment, there must be a concern that persistently large borrowing over the long term must absorb more of the limited pool of savings, leaving less available to finance productive investment – and that this "crowding out" will eventually hurt the country's long-term growth potential and living standards.

Instant Insights: Macroeconomics

- Growth momentum looks strong, particularly in the U.S.
- Watch inflation, but it will probably not lift off.
- Well-controlled Chinese growth slowdown is likely.

Multi Asset

Now put it in perspective

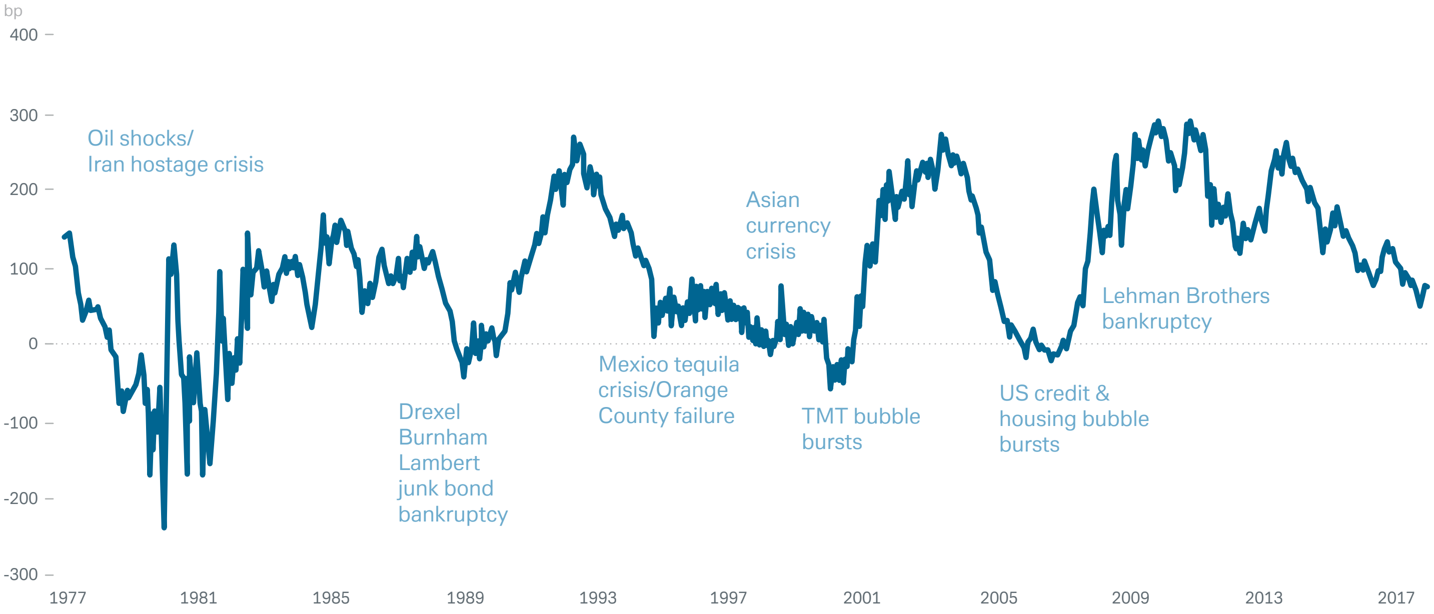
Larry V. Adam
CIO Americas and Global Chief Investment Strategist

Multi asset portfolios will have to cope with higher levels of volatility than last year and, most likely, lower levels of returns. But it remains important to step back and evaluate current market conditions in a longer-term historical context, rather than in relation to the recent exceptional environment. The overall environment remains supportive.

We are coming out of an exceptional environment, where a simple balanced portfolio (60% equities and 40% bonds) has delivered risk-adjusted returns significantly above their long-term average. But with expected returns now appreciably lower, you may need to take on more risk to achieve an acceptable level of returns. As we have noted before, increasing the level of risky assets in a portfolio may add to the case for active risk management.

However, it remains important to put things in perspective. Equity markets may yield lower gains than last year, but our forecasts for most asset classes are still within their long-term average. And, even though volatility, rates and (to a lesser extent) inflation are on the way up, the overall environment should remain supportive for risky assets. Synchronised global growth is a reality, with very few countries expected to be in recession. Corporate earnings

Figure 3:
U.S. 2Y-10Y yield curve flattening: still some way to go
Source: Bloomberg, DWS, Deutsche Bank Wealth Management. Data as of February 2018.



are rising. And, despite central bank moves to tighten policy, financial conditions generally remain easy. In reality, the spikes in volatility earlier this year signal a move into a more normal medium volatility regime. Recent worries around specific issues such as yield curve reversion are probably overdone: history reminds us that yield curve inversion is not an unusual phenomenon and the current situation still has some way to go.

There remains a strong case for equities within a multi asset portfolio

A supportive environment cannot, however, exclude risk. We know that late cycle corrections can be sharp, although they also tend to be short-lived. And the return of volatility reminds us that market reversals can be triggered by geopolitical or corporate news as well as policy tightening. Markets may also be vulnerable to elevated expectations on macroeconomic data or corporate earnings not being met.

Equities vs. fixed income

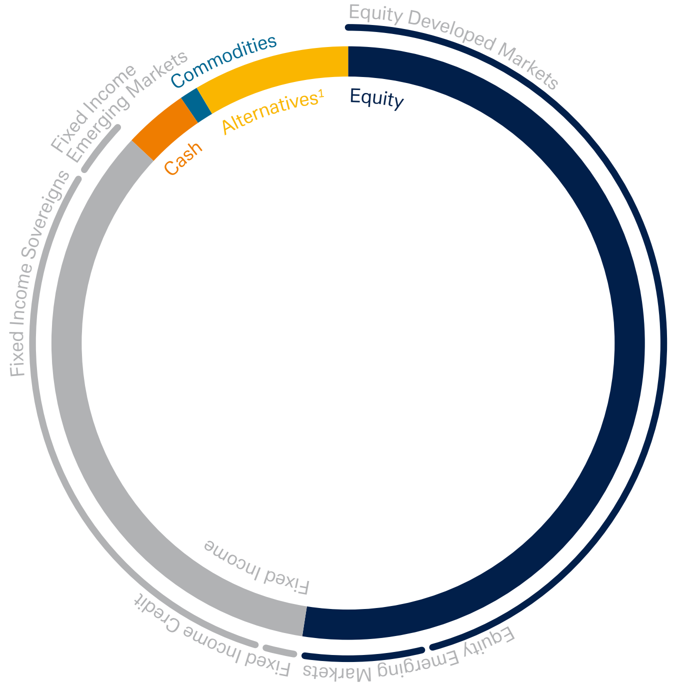
Even so, there remains a strong case for equities within a multi asset portfolio. Continued global GDP growth and further improvements in corporate earnings should help offset fears around rising volatility. Valuations also no longer appear particularly stretched in most markets but there will be temporary setbacks and higher volatility overall compared to 2017.

On the fixed income side, we think that higher future inflation levels could weigh on the markets, as could uncertainty over Fed intentions, given its new leadership and FOMC members' raised "dot plot" forecasts. We would be underweight on sovereigns within a multi asset portfolio and cautious on high yield. Investment grade could fare a bit better than high yield but hopes for this asset class are still centred on emerging markets hard currency debt. With regard to interest rate sensitivity, we have slightly tempered our short duration stance given recent volatility and yield moves.

Liquid alternatives

We are broadly neutral on commodities within a multi asset portfolio context, given our expectations that any increases in the oil price will not be sustained. But liquid alternatives could be worth a second look: we are neutral/positive on Equity Long/Short, Discretionary Macro, CTA and Event Driven given higher market volatility in an environment that could be more supportive of some non-traditional investment strategies. We are neutral on equity market neutral and credit, and negative on distressed.

Figure 4:
Asset allocation (balanced portfolio, as of March 29, 2018)



● Equity		
	Developed Markets	46.0%
	Emerging Markets	6.5%
● Fixed Income		
	Credit	2.0%
	Sovereigns	29.5%
	Emerging Markets	3.0%
● Cash		3.5%
● Commodities		1.0%
● Alternatives		8.5%

Footnote: Asset allocation as of March 29, 2018. [1] Alternative investments are not suitable for and may not be available to all investors. Restrictions apply. Sources: U.S. Regional Investment Committee, Deutsche Bank Wealth Management. This allocation may not be suitable for all investors. Past performance is not indicative of future returns. No assurance can be given that any forecast, investment objectives and/or expected returns will be achieved. Allocations are subject to change without notice. Forecasts are based on assumptions, estimates, opinions and hypothetical models that may prove to be incorrect. Investments come with risk. The value of an investment may fall as well as rise and your capital may be at risk. You might not get back the amount originally invested at any point in time. Readers should refer to disclaimers and risk warnings at the end of this document.

Equities

Continuity with added volatility

Equity markets should go higher, despite increased volatility. Earnings growth and a strong macroeconomic environment are expected to drive them on. At a sectoral level, we are positive on financials and information technology.

The first quarter of 2018 was notable for a long-overdue pick-up in volatility. Investors had been anticipating this for the best part of last year, with it finally triggered by a market correction in February. This downturn temporarily reversed an exceptionally long ascent of global equity indices that had defied expectations for a long time. Indeed, since 2009, the performance of the S&P 500 index has far outstripped U.S. real Gross Domestic Product (GDP) growth.

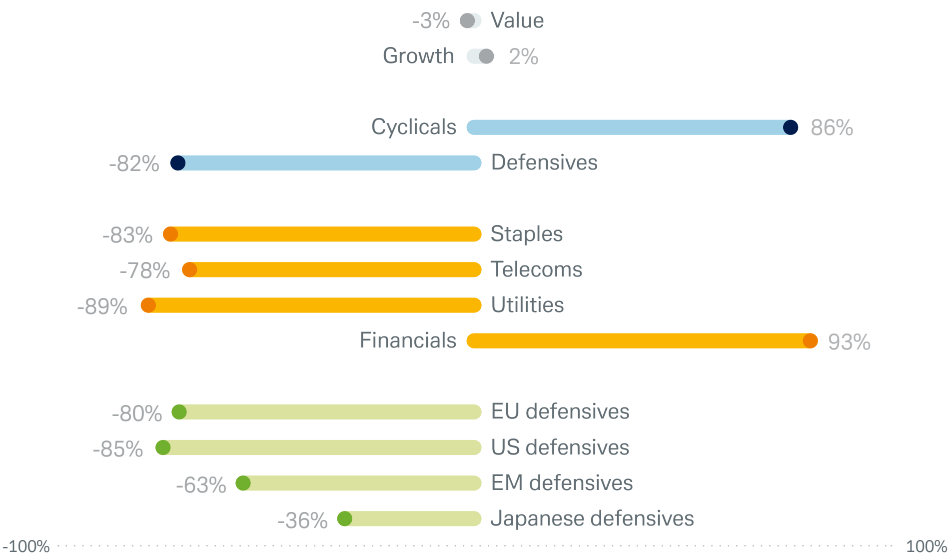
However, we believe that the bull market in equities, currently in its ninth consecutive year, is not over. Equities have of course been propped up by ultra-accommodative monetary policy in place since 2008, which is being gradually tightened. But there are other positive factors too, including the exceptional performance of the technology sector, and rising corporate earnings across most industries, in particular cyclical sectors. An improving global growth environment, strong business sentiment and solid corporate earnings are still underpinning equities across developed and emerging markets in early 2018, much as they did in 2017.

For these reasons we regard the recent sell-off as the result of a technical, overdue reaction to normalizing volatility and real interest rate levels in the U.S. and not as the start of a sustained downturn. In fact, even though U.S. equity valuations are high in historical terms, they are not excessive in comparison with bond yields. U.S. tax reform, already visible in upgraded earnings per share forecasts, should boost capital expenditure throughout the year. We are in a long economic cycle with still benign inflation, likely to remain below the level of nominal GDP growth.

Rate rises and U.S. equities

We are not overly concerned about the impact of the expected rise in nominal interest rates, so long as the Fed does not get behind the curve on rate rises. (One warning sign of this could be an inversion of the U.S. yield curve, i.e. as long as 2-year rates don't exceed 10-year rates). Higher bond yields per se do not pose a threat to equities, even when they exceed dividend yields, a scenario which is not particularly uncommon. In fact, history suggests that higher real rates can mean higher equity price/earnings multiples, up to a point. (At a global level, however, it is notable that different equity sectors have different correlations with interest rates, as shown in Figure 5.) We are expecting the next 5% U.S. equity move to be upwards and keep a long-term constructive view, expecting normal total returns over the next 12 months.

Figure 5:
Equity sectors' correlation with interest rate changes
Source: DWS, FactSet, Deutsche Bank Wealth Management. Data as of March 9, 2018. Based on a 3-year correlation of relative performance vs. MSCI AC World to 10Y U.S. Treasury yields.



Strong European fundamentals

We stick to a similar view for European equities. Strong fundamentals across the Eurozone as well as continued earnings growth allow the recent market correction to be considered as a buying opportunity, in spite of recent euro strength. German equities, in particular, appear to be attractively valued, as German exports are at record highs, monetary policy in the Eurozone remains expansive and corporate earnings are on the rise. On the other hand, German firms would be exposed to further U.S. dollar weakness and to potential trade restrictions.

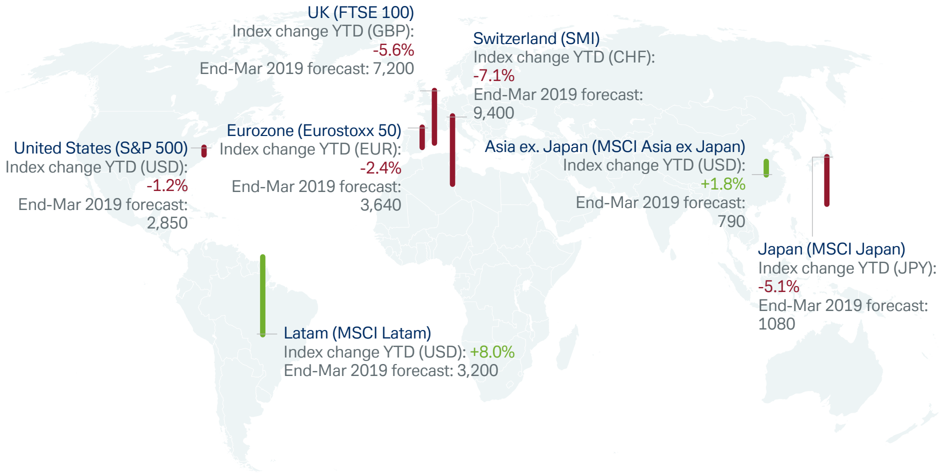


Figure 6:
Equity market forecasts and year-to-date index change by region
Source: Bloomberg Finance L.P., Deutsche Bank Wealth Management. Data and forecasts are as of April 11, 2018. All returns are YTD.

Japanese normalisation?

In Japan, the return on equity is finally catching up with global peers, prompting talk of a normalisation of the Japanese equity market. Japanese price/earnings ratios, long well above global averages, are belatedly falling in line with global multiples. Lately, in spite of a higher Yen, we have seen a raft of positive revisions of earnings per share. Macroeconomic fundamentals are solid, however trade friction represents a potential risk. The labor market is very tight, boosting consumer confidence and consumption, while monetary policy is likely to remain accommodative, especially after the reappointment of Bank of Japan Governor Kuroda.

The case for Asia ex-Japan

Asia ex-Japan remains a favourite equity market of ours. Macroeconomic fundamentals are strong and export growth is buoyant. An interesting development is for intra-Asian trade to make for a growing share of Asian countries' exports, which should reduce the region's direct dependency on developed markets, a particularly positive aspect considering the threat of protectionist measures stemming from the U.S. While Asian emerging markets have long benefited from a strong technology industry, we expect Asian earnings per share growth in 2018 to be less dependent on technology and generally more broad-based, making for a more diversified and hence more stable economic foundation. Earnings growth in the region is expected to be encouraging in 2018 at +20% for the MSCI EM index after 27% in 2017. However, geopolitical tensions and a stronger U.S. dollar could hurt local currencies.

Asian earnings per share growth in 2018 should be less dependent on technology

Sector inspector

At a sectoral level, we have a positive view on financials and information technology. Financials should benefit from a turning U.S. rate cycle, tax reform, rising dividends and share buybacks and good cost discipline. For the moment, however, the low yield environment is still impacting margins and investment income outside the U.S. and regulation casts a shadow. Information technology should continue to benefit from the growth potential of innovation and disruption, as well as solid balance sheets and strong free cash flow generation. We are neutral on consumer discretionary, consumer staples, energy, health care, industrials and materials. We are negative on telecommunications and utilities.

Instant Insights: Equities

- The recent sell-off is not the start of a sustained downturn.
- Strong economic fundamentals and earnings growth give scope for gains.
- Risks include trade friction and U.S. dollar moves.

Fixed income and foreign exchange

Slowly up the bumpy track

The path ahead will not be smooth: Fed rate rises are certain and the ECB will start to shift its language around policy normalization. Recent spread widening has started to make corporate credit valuations more attractive, if not cheap. Reasons to expect future U.S. dollar strengthening outweigh sources of weakness.

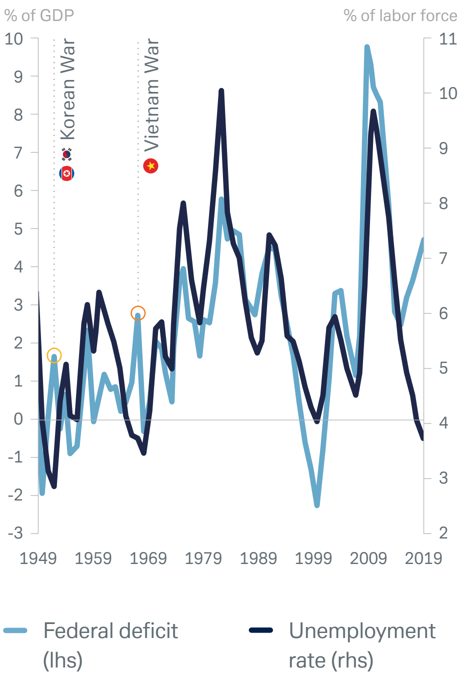


Figure 7:
U.S. budget deficit breaks link with the economic cycle
Source: U.S. Bureau of Economic Analysis, U.S. Treasury, DWS, Deutsche Bank Wealth Management. Data as of March 2018.

Anchoring rate expectations for 2019 is particularly important for the ECB

U.S.: Rates rising, watch the budget deficit

As widely expected, the Fed went ahead and raised rates at its March 2018 meeting and we expect two further increases this year. So the process of "normalization" is expected to continue, at a steady but not panicked pace. In advance of the Fed's decision, we had already seen a significant increase in Treasury bill supply, pushing front-end rates higher. In fact, 3-month LIBOR rose in early March to its highest level since 2008, before the Lehman bankruptcy, and higher front-end yields have also drawn down Fed Repo balances to their lowest levels since the program began in 2013. The picture for the rest of the year is more of the same: higher bill supply (+$400bn for the year) is likely to push up yields and also start to "crowd out" corporate financing rates.

What could disrupt the expected restrained upward rise in U.S. yields? (We forecast U.S. Treasury yields at 3.25% in March 2019, not far above current levels.) One area of concern is the U.S. budget deficit. The deficit is forecast to reach 5.5% in FY2019 and the debt/GDP ratio is expected to reach 97% - very unusual at this point in the economic cycle. (Figure 7 illustrates this, using the unemployment rate as a proxy indicator.) It is possible that Republican fears of losing the U.S. mid-term elections lead to a major infrastructure package, pushing up the deficit even further. One rule of thumb is that every one percentage point rise in the deficit adds 10bps to 10-year rates. Increased issuance by U.S. corporates ahead of September 2018 could also create "crowding out" effects, further disrupting bond markets.

Eurozone: Deeds will eventually follow words

For the Eurozone, it's still a question of words not deeds. Slightly more hawkish talk is being encouraged by good economic data. The ECB has already committed itself to an exit from quantitative easing (QE) and we expect an announcement in June about tapering in September and a program end in December 2018. However communication will be an ongoing issue. What seems likely is that the ECB will start to move the language away from QE and towards interest rates in an attempt to support the recovery in inflation. Anchoring rate expectations for 2019 is particularly important if volatility is to be avoided. The key focus here will be on "sequencing" – reassurance that rate rises will not happen until we are well past the end of QE. The ECB's continued emphasis on its reinvestment policy is also intended to hold down expectations around rate rises. We don't expect a first hike in the ECB's deposit rate until spring 2019, narrowing the deposit-refinancing rate spread.

In Japan, the reappointment of Mr. Kuroda as Bank of Japan (BoJ) governor (along with new, dovish deputies) means that the current monetary policy is likely to continue into next year. This will include continued fine tuning of the market through changing monthly purchasing amounts and unlimited purchasing offers at fixed rates. The BoJ has opted to keep the JPY80 trillion monthly purchase targets, even though actual purchases have recently been well below this. This should allow it to maintain a large degree of flexibility. However, note that core inflation is climbing (from low rates) and unexpected sharp Japanese yen strengthening (or rapid rises in rates elsewhere) could force the BoJ into action earlier than expected.

Corporate credit

On corporate credit, recent spread widening has made valuations more attractive – but not cheap. However, with the underlying fundamentals still sound, temporary periods of weakness could provide buying opportunities – but (as February demonstrated) remember that markets can turn quickly, with liquidity very thin. Some volatility also looks likely, particularly in the inherently more risk-sensitive U.S. investment grade market. We still think that spreads in both U.S. and European markets will reach post-global financial crisis lows during the course of this year.

The U.S. high yield default rate is expected to be 2.3% in 2018, with the EUR rate beneath this. Coverage and call protection around new issues has materially worsened, however, and we would be cautious around new issues where the issuer may seek to boost shareholder value at the expense of bondholders, or where structures or covenants allow for the issuance of priming debt.

Emerging markets debt has weathered global uncertainty better than would have been expected a few years ago and, despite its current popularity, still various opportunities. Economic indicators will help, as could higher commodity prices. But supply is a potential issue, for example in China.

Instant Insights: Fixed Income and FX

- U.S. rate rises should be restrained, but budget dangers remain.
- Emerging market debt will continue to offer opportunities.
- USD appreciation is expected later this year.

Past performance is not indicative of future returns. Forecasts are not a reliable indicator of future performance. Readers should refer to disclosures and risk warnings at the end of this document. Produced in April 2018.

The U.S. dollar: its time will come - again

The U.S. dollar has remained obstinately weak this year, despite a strong U.S. economy increasing the likelihood of sustained policy tightening. So what really is driving the currency? Stepping back, it's possible to identify six perceived factors that should strengthen the U.S. dollar and seven that could weaken it (Figure 8). Perceptions may not equate with reality, however. Looking down the perceived reasons for a weaker U.S. dollar, history suggests that the U.S. "twin deficits" are only harmful for the U.S. dollar when they become really bad (as in 1980-85). The synchronized global growth argument sounds a convincing way of explaining U.S. dollar weakness against emerging markets, as they tend to be highly leveraged to the global growth cycle; it doesn't explain U.S. dollar underperformance against lower-yielding developed market currencies. We don't have strong evidence of reserve managers or China selling off U.S. assets. Forward curves are not suggesting that the market is discounting a peak in Fed rates. All in all, the reasons for a weak U.S. dollar seem overstated: we expect an appreciation of the currency later this year, with EUR/USD at 1.15 in March 2019.

Figure 8:
Positive and negative U.S. dollar drivers
Source: DWS, Deutsche Bank Wealth Management. Data as of March 2018.

Reasons for a stronger U.S. dollar	Reasons for a weaker U.S. dollar
Already strong U.S. economy	U.S. "twin deficits" (budget and current account)
Tax reforms push up growth further	Synchronized global growth should lead to policy convergence
Carry (3% is priced into 1 year forward)	Reserve managers diversify out of U.S. dollar
Current market positioning	China selling U.S. Treasuries
1-year market technicals limit euro gains	Fed could be close to end of policy cycle
Other central banks' growing unease with weak U.S. dollar policy	Trump "risk premium" and trade war concerns
	U.S. actively pursues weaker dollar policy

Alternatives

Hedge funds

Some hedge fund strategies appear increasingly well placed to benefit from the current market environment.

We would favor Discretionary Macro, CTA, Equity Long/ Short and Event Driven strategies.

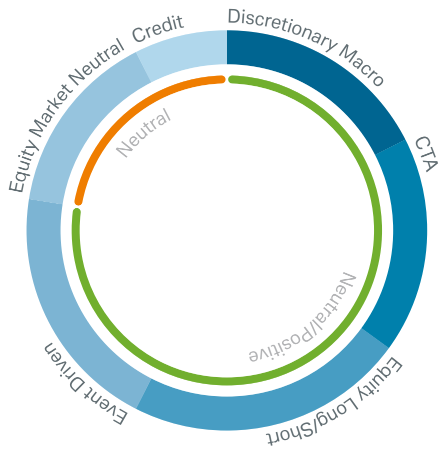
Instant Insights: Hedge funds

- Hedge fund strategy must be based around the broader market context.
- A better stock picking environment will help multiple strategies.
- Distressed strategies will suffer from a lack of opportunities.

Our hedge funds outlook is based first and foremost on the broader market context. We expect equities to deliver positive returns once again over the next 12 months. We are however in a late phase of the economic cycle that, while still benefiting from solid macroeconomic fundamentals, is already showing higher volatility than last year. Interest rates and bond yields are also on the up, just when corporate earnings and the incentives for capital repatriation into the U.S. boost mergers and acquisitions.

Discretionary Macro strategies should be able capitalize on policy divergence in the major developed economies. Equity Long/Short strategies seem well placed to benefit from current and expected market conditions, with gains possible through effective stock-picking and sector selection. CTA strategies should gain from the emergence of clearer market trends in fixed income, currency and commodity markets as well as in equities. Event Driven strategies, meanwhile, are set to reap the rewards of announced deals as soon as capital repatriation into the U.S. starts in earnest. Equity Market Neutral strategies should also benefit from a more conducive environment for stock-picking, and any increase in realized market volatility.
As the hunt for alternative sources of yield continues, Credit strategies are set to benefit, but will be affected by the evolution of interest rates and falling credit spreads. Finally, Distressed strategies keep suffering from an extended lack of opportunities as bankruptcies are low, both because of the favorable economic context and because ultra-low interest rates in many developed markets allow many near-insolvent companies to stay afloat.

Figure 9:
Hedge fund allocations within the overall illiquids allocation
Source: DWS, Deutsche Bank Wealth Management. Data as of March 26, 2018.



Discretionary Macro	17.5%
CTA	17.5%
Equity Long/Short	22.5%
Event Driven	20.0%
Equity Market Neutral	15.0%
Credit	7.5%

Figure 10:
Hedge fund strategy views summarized
Source: DWS, Deutsche Bank Wealth Management. Data as of March 21, 2018.

Equity Long/ Short NEUTRAL / POSITIVE	We expect mid-single-digit returns for equity markets in 2018, primarily driven by cyclical sectors. In addition, to that we expect managers to generate alpha through stock and sector picking. However, given the late cycle and valuations above the historical average, we suggest overweighting quality-driven equity long/short strategies in the medium term to reflect what we believe is a quality bias in the current equity rally.
Equity Market Neutral NEUTRAL	This strategy benefits from a constructive environment for stock-picking, with high dispersion in sector performance and pro-cyclical as well as technology sectors outperforming. We expect the US tax reform to be a major source of alpha for stock pickers: while at a macro level the reform has supported the broad equity market, its effect on individual companies will become more apparent in the coming months. On the other hand, realized equity volatility continues to be at multi-year lows and we don't see a catalyst for the situation to change.
Discretionary Macro NEUTRAL / POSITIVE	We think that one of the key events in 2018 will be the expected policy divergence between the USA and the rest of the world, as the Fed will deliver a projected three 0.25% rate increases in 2018, with a possible fourth hike in the first quarter of 2019, while markets in the Eurozone and Japan are still relying on monetary stimuli and will be sensitive to how carefully quantitative easing is scaled back. In our view, divergence and possible policy mistakes could generate trends in currencies and fixed income markets that macro managers should be able capitalize on.
CTA NEUTRAL / POSITIVE	This strategy has so far profited from the upward trend in equities and is positioned to continue benefiting from that. We expect some trends in fixed income and currencies to materialize from the previously mentioned macro policy divergence; we also expect commodity markets to present an improving opportunity set for trend following, as inflation expectations come back into the economic discourse. We have seen some initial signs of volatility in commodities as strong global growth momentum lifted industrial metals prices. CTA strategies have also profited from a rally in copper futures driven by the brightening prospects of electric vehicles: copper demand for electric cars is estimated to rise nine-fold in the next 10 years.
Credit strategies NEUTRAL	On the back of globally synchronized growth, commercial demand for capital continues to increase. While margins remain very attractive in non-sponsor lower middle market lending, this is not the case for sponsor-linked middle market direct lending. We are very cautious of unsecured consumer debt consolidation and unstructured sub-prime auto and therefore remain focused on scrutinizing quality and the structure of how private debt is being deployed.
Event Driven / Multi-Strategy NEUTRAL / POSITIVE	Changes in market structure trends and an increased expression of corporate strategy supporting both special situations and merger arbitrage have led us to lift our rating from neutral to neutral positive. We expect the favorable economic backdrop to keep supporting the overall market direction and potential beta contribution for special situations investors. We also expect above-average single stock and industry dispersion to persist.
Distressed NEUTRAL / NEGATIVE	We remain uninspired by this strategy. However, with historic debt issuance, rising leverage and softening covenants, the next distressed cycle may be bountiful. Default rates are 1.9% in the U.S., 1.2% in Europe and 1.4% globally, vs. an average of 3.7% since 1986. Therefore we see a limited opportunity set because there is no compensation for being early in distressed debt.

Deutsche Bank Wealth Management

Macroeconomic forecasts

	DB WM 2018 Forecast	DB WM 2019 Forecast
GDP growth (%)		
U.S.*	2.6	2.5
Eurozone (of which)	2.3	1.9
Germany	2.3	1.8
France	2.3	2.0
Italy	1.3	1.1
UK	1.5	1.6
Japan	1.5	1.0
China	6.5	6.3
India	7.5	8.0
Russia	2.0	1.8
Brazil	2.2	2.5
World	3.9	3.9
Consumer price inflation (%)		
U.S.*	1.9	2.0
Eurozone	1.5	1.7
UK	2.7	2.1
Japan	1.0	1.4
China	2.0	2.2
Current account balance (% of GDP)		
U.S.	–2.8	–3.0
Eurozone	3.0	2.9
UK	–4.0	–4.0
Japan	3.8	3.8
China	1.5	1.2
Fiscal balance (% of GDP)		
U.S.	–4.1	–4.7
Eurozone	–0.9	–0.8
UK	–2.5	–2.7
Japan	–4.0	–3.8
China	–3.5	–3.2

Please see risk warnings for more information. Forecasts are based on assumptions, estimates, opinions and hypothetical models or analysis which may prove to be incorrect. No assurance can be given that any forecast or target will be achieved. Past performance is not indicative of future returns.
* For the U.S., GDP measure is calendar year but inflation measure is Core PCE Dec to Dec %. Forecast for U.S. Headline PCE (Dec/Dec) is 2.0% in 2018 and 2.0% in 2019. U.S. GDP Q4/Q4 growth is 2.6% in 2018 and 2.4% in 2019.
Source: Deutsche Bank Wealth Management. As of March 22, 2018.

Deutsche Bank Wealth Management

Asset class forecasts

	Official rate	End-Mar 2019F
Benchmark interest rates		
U.S.	Fed fund rates	2.25-2.50%
Eurozone	Refi rate	0%
UK	Repo rate	1.0%
Japan	Overnight call rate	0%
FX		
EUR vs USD	EUR/USD	1.15
USD vs JPY	USD/JPY	112
EUR vs JPY	EUR/JPY	129
EUR vs GBP	EUR/GBP	0.90
GBP vs USD	GBP/USD	1.28
USD vs CNY	USD/CNY	6.5

	Market Index	End-Mar 2019F
Equities		
U.S.	S&P 500	2,850
Germany	DAX	13,500
Eurozone	Eurostoxx 50	3,640
Europe	Stoxx 600	390
Japan	MSCI Japan	1,080
Switzerland	SMI	9,100
UK	FTSE 100	7,200
Emerging Markets	MSCI EM	1,280
Asia ex Japan	MSCI Asia ex Japan	790
Latam	MSCI Latam	3,200
Commodities		
Gold	Gold spot	1,290
Oil	WTI spot	60
Fixed Income		
U.S.		
UST 2yr	U.S. 2yr yield	2.80%
UST 10yr	U.S. 10yr yield	3.25%
UST 30yr	U.S. 30yr yield	3.45%
U.S. IG CORP	BarCap U.S. Credit	80bp
U.S. HY	Barclays U.S. HY	350bp
Europe		
Schatz 2yr	GER 2y yield	–0.10%
Bund 10yr	GER 10y yield	1.00%
Bund 30yr	GER 30y yield	1.60%
Gilt 10yr	UK 10y yield	1.75%
EUR IG Corp	iBoxx Eur Corp all	75bp
EUR HY	ML Eur Non-Fin HY Constr. Index	260bp
Asia Pacific		
JGB 2yr	JPN 2y yield	–0.10%
JGB 10yr	JPN 10y yield	0.10%
Asia Credit	JACI Index	225bp
Global		
EM Sovereign	EMBIG Div	285bp
EM Credit	CEMBI	270bp

F = Forecasts. Please see risk warnings for more information. Forecasts are based on assumptions, estimates, opinions and hypothetical models or analysis which may prove to be incorrect. No assurance can be given that any forecast or target will be achieved. Past performance is not indicative of future returns.
Source: Deutsche Bank Wealth Management. As of March 22, 2018.

Glossary

Alpha refers the gain in the price of a security relative to moves in the relevant overall market index.

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

Convertibles are bonds that can be converted into equity in the issuer company.

Correlation is a statistical measure of how two securities (or other variables) move in relation to each other.

Credit strategies seek to exploit opportunities within different credit types from the same issuer, or between credit of similar quality from different issuers.

Cyclical stocks are affected by the business cycle, typically including goods and services the purchase of which is discretionary.

Crowding out refers to the displacement of one form of economic activity by another.

Discretionary macro strategies attempt to gain from macroeconomic, policy or political changes.

Distressed strategies look at securities from entities experiencing bankruptcy or other types of corporate distress.

The Energy Information Administration (EIA) is part of the U.S. Department of Energy and an agency of the U.S. Federal Statistical System.

Equity long/short strategies take long positions in securities that are expected to strengthen, and short positions in those that are expected to weaken.

Equity market neutral strategies aim to gain from opportunities within a particular market sector, geography or other categorisation.

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

Event-driven hedge fund strategies seek to gain from specific corporate events (e.g. mergers)

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

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.

Hawkish, in the context of monetary policy, is an apparent desire to raise interest rates or otherwise tighten policy.

Hybrids include bonds that have a range of conditions attached (including the possible suspension of future interest payments) and which are low-ranked for insolvency purposes.

LIBOR or London Interbank Offered Rate is a benchmark rate that some of the world's leading banks charge each other for short-term loans, and serves as the first step to calculating interest rates on various loans throughout the world.

Long positions in an asset suggest a market belief that its price will increase.

Millennials is a term used to refer to people born in the 1980s and 1990s, although this definition can vary.

The North American Free Trade Agreement (NAFTA) came into force in 1994 and covers the U.S., Mexico and Canada.

The Phillips Curve describes an inverse relationship between rates of unemployment and rises in prices or wages.

Quantitative easing (QE) is an unconventional monetary policy tool, in which a central bank conducts broad-based asset purchases.

Repo rates are paid on agreements whereby a borrower sells securities to a lender but agrees to repurchase (repo) them in future. They can be used by central banks to influence the level of deposits with them, with an impact on overall interest rates.

The Trans Pacific Partnership (TPP) is a planned trade agreement between 12 Pacific Rim countries.

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

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm's stock price in relation to its earnings.

Volatility is the degree of variation in a trading-price series over time.

The World Trade Organization (WTO) is an intergovernmental organization, founded in 1995, that provides a framework for trade agreements.

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