Deutsche
Asset Management

CIO | VIEW

Europe, Middle East & Africa Edition
June 2016

The productivity puzzle

Why finding a solution
is so difficult

Marketing Material. This report is for Deutsche Bank clients only, not the broader voting public in the U.K. Deutsche Bank does not intend to promote a particular outcome to the referendum on the U.K.'s membership of the European Union. Readers should vote in the referendum as they personally see fit.

Nine positions

Our key forecasts

Global economy hampered by low productivity growth.

Eurozone recovery is gradually gaining steam.

U.S. Federal Reserve (Fed) to lift rates only gradually.

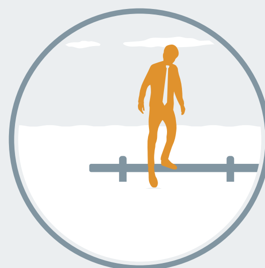
U.S. dollar set to appreciate again versus the euro later in 2016.

Stronger focus on high-yield bonds.

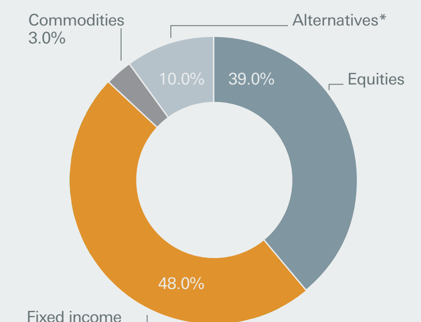
Earnings forecasts have been revised down since the start of 2016.

Developed-market equities offer moderate upside potential.

We are approaching the entry point for emerging markets.



Asset allocation of our balanced model portfolio:



* Alternatives are not suitable for all clients.

Important terms are explained in our glossary.
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Source: Deutsche Asset Management Investment GmbH, as of 05/20/16

Letter to investors

Actively passive

If investors want to achieve adequate returns in an environment where yield expectations are low, they need to beat the market. At the expense of others.

Neutral, neutral, equal weight, hold. This is certainly not what clients expect to hear when they ask for a description of their asset manager's investment style. And, at first sight, our investment traffic lights do not appear to bear out our claim of being an active fund manager. It might seem to observers as if we had simply asked the markets to determine our tactical asset allocation. However, nothing could be further from the truth. We have consciously decided on taking a neutral stance from a top-down perspective in many market segments before summer. But there still is considerable activity below the surface – and thus opportunities – which cannot be captured adequately by the "traffic-light" signals. Allow me to explain.

> "If you want performance in 2016, playing the index may no longer be enough."

Our strategic price targets for almost all asset classes are near the current price levels. At the same time, the major economies are still growing at a rate near their potential, as they have been doing during this long, but not very dynamic upswing. In this environment, nearly every new piece of economic data can be interpreted as a turn to the upside or to the downside. The markets are lacking a clear direction, not least because the Fed might for the first time in years start to slow the expansion and could raise its key rate further during the remainder of the year if the upswing continues. The uncertainty is increased further by breaks in longer-term trends, which are difficult to assess. For example, are traditional leading indicators, which focus heavily on industry and conventional money and rate markets, still reliable? Why is the potential rate of growth in many industrial countries so low? How can the central banks return to a normalization path in view of record debt levels?

Despite these questions and uncertainties we are still an active market participant. However, we would focus mainly on individual sectors and securities and in an opportunistic way. In view of the advanced state of the investment cycle and the current valuations, the analysis of individual assets is necessarily the main source of alpha – and that is quite in line with our DNA. In fact, companies which release disappointing quarterly data these days often register two-digit falls in their share price, whereas successful firms trade at highs. Aggregate returns have become smaller. If you want to generate the same returns as before, we believe you need to be better than your peers. And we are confident that we are. Not least because we do not follow over-hyped stories – as evidenced by our skepticism about the alleged revival of the emerging markets. We hope that you will enjoy reading one of the last printed monthly issues of our CIO View. In the future, the print version will be published only at quarterly intervals. At the same time, we will update our website more often in order to inform you more quickly about the markets and our positions.

Stefan Kreuzkamp,
Chief Investment Officer

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Focus

The mystery of low productivity growth

The longer-term prospects for global economic growth look increasingly dim. Or so a growing number of observers think. Are the growth skeptics right?

In his science-fiction classic "Foundation", Isaac Asimov imagines a new science able to accurately predict the future of human societies – even whole galaxies. The books have been a source of inspiration to generations of economists, including several Nobel Laureates. In terms of forecast reliability, however, they very much remain science fiction.

Take recent debates on productivity, defined in economics as the amount of output produced with a given amount of inputs. As Josh Feinman, our Chief U.S. Economist, acknowledges in a recent note on the topic, "Understanding productivity trends – let alone forecasting them – is notoriously difficult."[1]

What is clear is that U.S. labor-productivity growth has averaged just 0.5% during the past five years. Much of the rest of the developed world has experienced a similar slowdown. This puts a speed limit on how much wages can grow, without triggering inflation or hurting corporate profits. More broadly, productivity is the key driver of how fast gross domestic product (GDP) per capita can grow in the longer term.

Potential growth in GDP partly depends on the size and skills of the working-age population. A second factor is the machinery workers have access to. However, there is a limit as to how much good spending capital on new machines can do. The first plow, say, may do wonders to a farmer's labor productivity – how much he can produce per hour. A second plow, though, would have much less of an impact. The higher the spending on new equipment today, moreover, the costlier it will be to replace, when it eventually becomes obsolete. This leaves a third factor: improvements in output for a given amount of labor and capital due, for example, to technical and organizational innovations. This is called total factor productivity (TFP) – and usually is estimated by looking at what is leftover, when all other factors have been accounted for.

Back to the future?

Economists are still trying to disentangle the various components of the recent productivity slowdown. After the financial crisis of 2007-08, cyclical factors no doubt contributed. Some also point to measurement problems. It is hard to see, however, why these problems should have been so much worse in recent years. Moreover, productivity already stalled well before the Great Recession.

This suggests more deeply rooted reasons. According to growth skeptics, the productivity boost from communication and information-technology (IT) advances in the late 1990s was a mere blip. Factors such as aging populations, rising inequality and increasingly concentrated industries may also have made economies less dynamic. Most prominently, the economist Robert Gordon argues that recent innovations compare unfavorable to previous breakthroughs. Would you really choose the ability to access social media through your smartphone over indoor plumbing, say?

Then again, previous technological revolutions took a while for their full impact to be felt. Air conditioning only became wide-spread almost 100 years after electrification. Similarly, many IT innovations may simply be too recent to have had much of an impact yet. Cloud computing, which allows companies to scale up their data storage and processing needs with fewer upfront costs, has only been commercially available since 2006.

Meanwhile, the real impact from social media on productivity and GDP may lie in the data users inadvertently leave behind, not the (mostly free) services themselves. Such real-time data could be invaluable, not least for many services where productivity has traditionally been lagging. In asset management, for example, the implications of big data look profound, as our colleagues at Deutsche Bank Markets Research point out in a recent report.[2]

In short, both sides in the current productivity debate are heavily relying on their intuition. Hari Seldon, the fictional mathematician at the center of Asimov's books, would have approved: "Intuition is the art, peculiar to the human mind, of working out the correct answer from data that is, in itself, incomplete or even, perhaps, misleading." This may be part of the reasons why predicting the future for now remains as hazardous as ever.

[1] Joshua Feinman, "A closer look: Productivity blues", April 2016, DeAWM Distributors, Inc.
[2] Gaurav Rohal et al.,"Big Data in Investment Management", 17 February 2016, Deutsche Bank Securities Inc.

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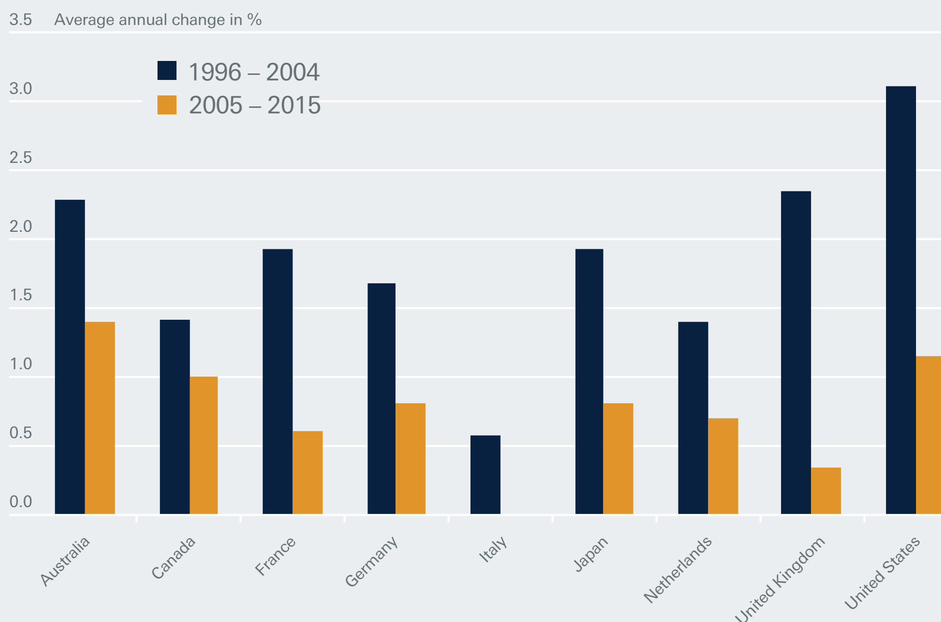
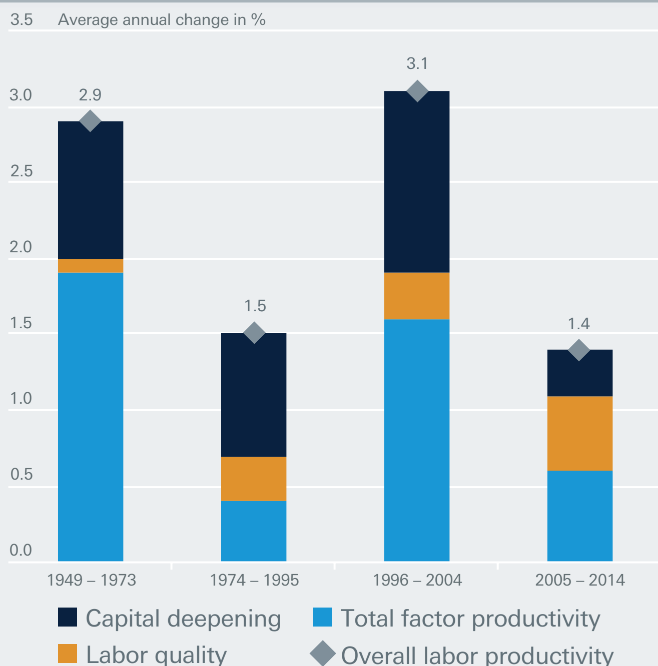
The productivity slowdown is widespread



Over the past decade, labor-productivity growth has fallen markedly in many advanced economies. This may partly reflect the continuing shift from manufacturing, where productivity growth has historically been higher, to lower productivity service sectors. The financial crisis of 2007-08 no doubt also played a role, by dragging down investment, for example.

Sources: Conference Board, Bureau of Labor Statistics, Deutsche Asset Management Investment GmbH; as of 04/2016

Contributors to U.S. productivity



Sources: Bureau of Labor Statistics, Deutsche Asset Management Investment GmbH; as of 04/2016

Among the contributors to U.S. labor productivity in the nonfarm business sector, labor quality (how skilled the U.S. workforce is) appears to have improved in recent years. Due to sluggish business investment, there has been less capital deepening (i.e. the capital employed per worker). Most significantly, total factor productivity (TFP) has slowed down, though not quite as much as from 1974 to 1995.

U.S. labor-productivity growth

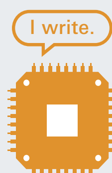
In recent years, average annual labor-productivity growth in the United States has been far below historical norms.

0.5%* (2011 – 2015)

* Source: U.S. Bureau of Labor Statistics; as of 04/2016

"The most exciting phrase to hear in science, the one that heralds the most discoveries, is not 'Eureka!' ('I found it!') but 'That's funny...'"

Attributed to Isaac Asimov (1920 – 1992), professor of biochemistry and science-fiction writer.



Electronic writing assignments

By 2018, the information-technology research and advisory company Gartner expects one fifth of business content to be authored by machines.

20%* (2018)

* Forecast by Gartner, Inc.; as of 10/06/15

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Interview

The big picture

Short-term concerns overstated, long-term concerns understated

"The Fed has a significantly wider scope for action than the ECB and BOJ."

Mr Kreuzkamp, in the face of lower growth expectations, business consultants, international organizations and even usually optimistic brokers are warning that capital markets may run out of steam. Is this an overreaction?
I share the view that we will have to live with lower growth rates over the medium term, particularly in the developed economies. The reasons are aging societies and dwindling productivity growth. As to capital markets: Yes, things are getting more difficult but in my view the stock markets of most industrialized countries are not yet overpriced. For example, Europe's valuation is close to the long-term average. But it is, of course, not very helpful that earnings estimates are being continuously revised down.

You are forecasting 2016 global GDP growth at 3.2 percent. This is only slightly above the value which used to herald a recession. Are we threatened by recession?
I do not think so. Growth is sluggish but, at the same time, the recovery continues. Cyclically speaking, we have reached autumn. But winter, i.e. recession, should neither come this nor next year. It is, however, quite possible that sustained slow growth will continue to spoil not only investor sentiment but also corporate investment plans.

In mid-February, sentiment was in the dumps: within a couple of days the MSCI World Index lost 13 percent, although it then recovered quickly. Can fundamental data change so fast as to warrant such extreme price fluctuations?
No, but perception can change very quickly. The accumulation of negative events – Chinese weakness, severely strained oil and high-yield markets, deflationary concerns and political warning signals – combined with stock markets' weak start to 2016 contributed to a downward spiral, with sentiment dominated by negative scenarios. At the same time, many funds' risk budgets were quickly exhausted, removing possible buyers from the market. We did not exit the market then because this reaction was, in our eyes, overdone. The U.S. labor market continued to please, while the European recuperated, the Chinese government went out of its way to counter economic deceleration, and it was hard to imagine that commodity prices would continue their rapid drop.

So would you say that worries about China are dead and buried with the announcement of a first-quarter growth rate of 6.7%?
No, not at all. Of course, these figures did calm the markets, together with the fact that the yuan has not continued to depreciate versus the U.S. dollar and

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capital outflows have slowed down. But this has only been a short-term positive shift, not a long-term all-clear. Our 2016 growth forecast of 6.0% places us among the more cautious market participants anyway. But growth in itself is not the real problem – rather the way it is achieved. At the moment, Chinese debt is growing at double the pace of GDP. And nobody can tell at what point the Chinese government will find it difficult to retain control. The implications for global financial markets would be grave and are one of the reasons why we take an increasingly critical look at the financial sector, not only in China.

Further reasons for the spring rally are a more prudent Federal Reserve (Fed), the weaker U.S. dollar, stabilizing commodity prices, and emerging markets. This is the order in which the recovery has taken place – with the Fed as the source of all market changes. Will the rally curb its scope for action?

In my opinion, the Fed has quite a lot of leeway, in both directions. We still expect two interest-rate hikes by end of March 2017. In the face of the Fed's dual mandate – sustained price stability and high employment – it will have to make a move this year. The United States is approaching full employment, and oil should no longer fuel deflation but rather inflation even if prices only remain flat. The Fed is even a little late in raising rates, according to the Taylor rule. However, the Fed also has to consider other factors with direct or indirect repercussions on the domestic economy, as it has made clear in its most recent statements, which regularly refer to the international financial markets. So it is fully aware of the disruptive effect of rate hikes and a stronger U.S. dollar, particularly on emerging markets. Furthermore, the Fed is keeping an eye on the current state of the U.S. stock market and how it is reacting to relevant news.

How much leeway do the European Central Bank (ECB) and the Bank of Japan (BOJ) have?

Much less. Both have not even taken the first step towards normalization but persevere with unconventional measures – presumably feeling even less at ease than a couple of months ago since stepping deeper into the negative interest-rate zone has proven to be of little help. Their currencies have not weakened while their banks' business models are being challenged. And what other policies could the ECB unveil, should growth slump again? Conversely, what could it do, were inflation expectations to rise abruptly again? With this in mind, we should be happy about the current situation in Europe, with improvements being only minor and gradual.

Stefan Kreuzkamp,
Chief Investment Officer

Equity markets more nervous than the economy

The good news: There are still more positive than negative signals for the world economy. The recovery is driven by the services sector, as the strong U.S. labor market confirms. The bad news: The capital markets have not priced in much else. The reconciled news: The market continues to offer reasonable opportunities to active investors.

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Investment traffic lights

Our tactical and strategic view

Equities*	1 to 3 months	up to March 2017
Regions		
United States	◉ (orange)	→ (orange)
Europe	● (orange)	↗ (green)
Eurozone	● (orange)	↗ (green)
Germany	● (orange)	↗ (green)
Switzerland	◉ (orange)	↗ (green)
United Kingdom	◉ (orange)	↘ (red)
Japan	● (green)	↗ (green)
Emerging markets	● (orange)	→ (orange)
Asia ex Japan	● (orange)	→ (orange)
Latin America	● (red)	↘ (red)
Sectors		
Consumer staples	● (red)	
Healthcare	◉ (orange)	
Telecommunications	● (orange)	
Utilities	● (orange)	
Consumer discretionary	● (green)	
Energy	● (orange)	
Financials	● (orange)	
Industrials	● (orange)	
Information technology	● (orange)	
Materials	● (orange)	
Style		
Small and mid cap	● (orange)	

*as of 05/19/16
**as of 05/24/16
Source: Deutsche Asset Management Investment GmbH
[1] Spread over German Bunds
[2] These traffic-light indicators are only meaningful for existing private-equity portfolios

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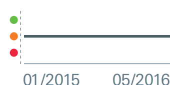
Fixed income**	1 to 3 months	up to March 2017
Rates		
U.S. Treasuries (2-year)	● (orange)	↗ (red)
U.S. Treasuries (10-year)	● (orange)	↗ (red)
U.S. Treasuries (30-year)	● (orange)	→ (orange)
U.K. Gilts (10-year)	● (orange)	↗ (red)
Italy (10-year)	● (orange)	↘ (green)
Spain (10-year)	● (green)	↘ (green)
German Bunds (2-year)	● (orange)	→ (orange)
German Bunds (10-year)	● (orange)	→ (orange)
Japanese government bonds (2-year)	● (red)	→ (orange)
Japanese government bonds (10-year)	◉ (red)	→ (orange)
Corporates		
U.S. investment grade	● (orange)	→ (orange)
U.S. high yield	● (orange)	↗ (red)
EUR investment grade[1]	◉ (green)	↘ (green)
EUR high yield[1]	● (orange)	→ (orange)
Asia credit	● (orange)	↗ (red)
Emerging-market credit	● (orange)	↗ (red)
Securitized / specialties		
Covered bonds[1]	◉ (green)	↘ (green)
U.S. municipal bonds	● (orange)	→ (orange)
U.S. mortgage-backed securities	● (orange)	→ (orange)
Currencies		
EUR vs. USD	◉ (orange)	↘ (red)
USD vs. JPY	● (orange)	↗ (green)
EUR vs. GBP	● (orange)	↘ (red)
GBP vs. USD	● (orange)	↗ (green)
USD vs. CNY	● (orange)	↗ (green)
Emerging markets		
Emerging-market sovereigns	● (orange)	↗ (red)

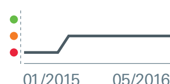
Alternatives*	1 to 3 months	up to March 2017
Infrastructure	● (green)	↗ (green)
Commodities	● (orange)	↗ (green)
Real estate (listed)	● (green)	↗ (green)
Real estate (non-listed)	● (green)	↗ (green)
Hedge funds	● (green)	↗ (green)
Private equity[2]	● (orange)	→ (orange)

United States (equities)



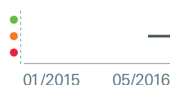
We leave U.S. equities at neutral. We expect earnings to improve in the course of the year and swing back to showing year-on-year gains in the second half of 2016. This positive dynamic, however, risks being jeopardized by the Fed, were it to pursue a rate-hike cycle on the back of stronger macro data.

United Kingdom (equities)



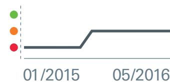
U.K. equities also remain neutral. Just like other European equities they are under the spell of the Brexit referendum on June 23rd. A Brexit could raise uncertainty, which could probably prove burdensome overall. However, we view bigger companies with a global reach as being less affected than smaller firms focusing on the domestic U.K. market.

Switzerland (equities)



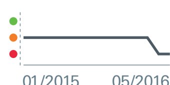
Switzerland could prove to be a more stable alternative to the rest of Europe in case of a Brexit and ahead of the referendum as its foreign trade should be less affected. The Swiss franc might appreciate in case of a Brexit, but Swiss companies have learned how to deal with a strong currency. In a global context, however, Swiss equities stay neutral.

Healthcare (equities)



While we keep the healthcare sector on neutral, we see pockets of opportunities. The relative valuation of biotechnology companies, for example, has become cheaper after almost one year of underperformance compared to the broader sector. Other examples include U.S. companies with a strong focus on their home market, making them less vulnerable to exchange-rate movements.

Japanese government bonds (10-year)

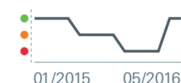


We remain skeptical on Japanese sovereign bonds (JGBs) and expect few triggers to emerge from the next Bank of Japan (BOJ) meeting in mid-June. It seems more likely that the central bank will press the government to deliver new fiscal programs, the size of which could surprise markets. Furthermore, we see declining JGB demand from Japanese investors, who increasingly look abroad for investment opportunities.

EUR Investment Grade

We stick to our positive view on euro investment-grade bonds. Although prices have been under pressure in May as a result of high supply, the ongoing economic stabilization, continuing low default rates as well as the start of the European Central Bank's (ECB's) corporate-bond buying program should well support this asset class.

Covered bonds



The covered-bonds market remains heavily influenced by the ECB as well. We have moved from neutral to positive here as we expect little new bond issuance in the coming months. Issuers are instead using the ECB's generous TLTRO facilities, which indirectly takes pressure off the secondary market.

EUR vs. USD

We believe the period of weakness of the U.S. dollar versus the euro has come to an end. In view of better macro data, increasing inflation and a relatively benign global risk environment, several Fed members have hinted at the need for further rate hikes this year. At the same time, an expansive ECB monetary policy and risks stemming from the Brexit referendum are weighing on the euro.

The tactical view (one to three months)
Equity indices, fixed income and exchange rates:
- ● positive view
- ● neutral view
- ● negative view

The traffic lights' history is shown in the small graphs.
◉ A circled traffic light indicates a supplementary comment.
The strategic view up to March 2017
Equity indices, exchange rates and alternative investments:
The arrows signal whether we expect to see an upward trend (↗), a sideways trend (→) or a downward trend (↘) for the particular equity index, exchange rate or alternative asset class.
Fixed income: For sovereign bonds, ↗ denotes rising yields, → unchanged yields and ↘ falling yields. For corporates, securitized /specialties and emerging-market bonds, the arrows depict the option-adjusted spread over U.S. Treasuries, if not stated differently. ↗ depicts an expected widening of the spread, → a sideways spread trend and ↘ a spread reduction.
The arrows' colors illustrate the return opportunities for long-only investors.
↘↗ positive return potential for long-only investors
→ limited return opportunity as well as downside risk
↘↗ high downside risk for long-only investors

Further explanations can be found in the glossary.

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Joe Benevento and
Joern Wasmund,
Global Co-Heads of
Fixed Income/Cash

Fixed-income market perspectives

Emerging-market bonds: even optimists need to be selective.

Despite an often difficult economic and political backdrop – particularly in Brazil – Latin America has been the best performing market this year. Accompanying Brazil's probably not sustainable performance has been Argentina's return to the capital markets, with a large and oversubscribed new issue following an agreement with investors in its old bonds earlier this year. This is an encouraging restructuring story.

Latin America's recent successes remind us of two things. First, that markets like to look forward – and that if they think a positive solution is possible for an underlying problem (e.g. the Brazilian leadership), then they are prepared to overlook the intervening uncertainty. Second, that historical issues (e.g. Argentinean debt) can be resolved, often years after the original event.

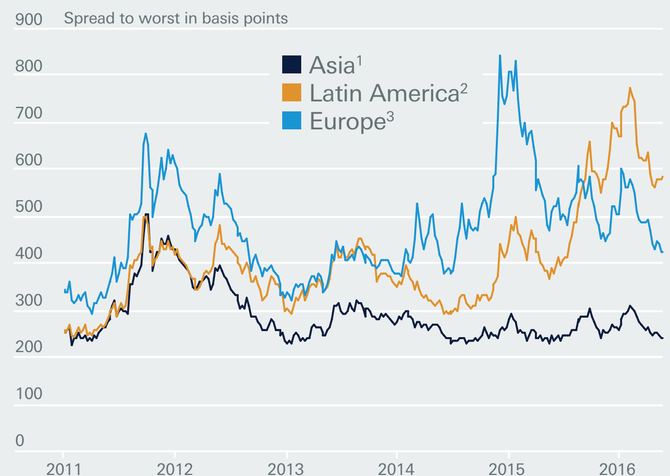
But these are specific issues. Is it possible to identify some broader, universal factors that have given emerging-market fixed income a helping hand? The answer is yes, if you are an optimist. In aggregate, it has gained from a positive mix of higher oil prices, a weaker U.S. dollar (until recently), reduced concerns over China and the associated recovery of other commodity prices. But to what extent is improved sentiment underpinned by fundamentals?

The most obvious point is that China's problems are not resolved: many concerns (e.g. about credit bubbles and loan defaults) remain. Moreover, governance issues remain in many emerging-market economies – recent experiences in Mozambique and South Africa serve to remind us of what can happen here. Mozambique's "tuna-bond" saga demonstrates to what extent emerging-market borrowing can be tangled up with government financing, and that clarity is difficult to get.

A second point is that many of the correlations between emerging-market performance and fundamentals are more complex than they might appear. The one exception to this is their relationship with the U.S. dollar: history suggests that reverses in emerging markets are usually accompanied by a stronger U.S. currency (with an exception in 2014). Our long-term forecast is for U.S.-dollar appreciation and this would likely be overall negative for emerging markets. The impending Fed rate hike is not likely to help either.

So while this is a generally positive environment, setbacks are still possible. We would favor being selective – and on the basis of facts rather than hopes.

Emerging-market spreads fall back



Spreads over U.S. Treasuries have fallen in all regions in 2016, helped by a variety of factors. But renewed U.S.-dollar strength and China concerns could weigh on this heterogeneous asset class.

[1] J.P. Morgan Corporate Emerging Markets Bond Index (CEMBI) Asia
[2] J.P. Morgan CEMBI Latin America
[3] J.P. Morgan CEMBI Europe
Source: J.P. Morgan Securities LLC; as of 05/27/16

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 can 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. Deutsche Asset Management Investment GmbH; as of 05/27/16

Henning Gebhardt,
Global Head of Equities

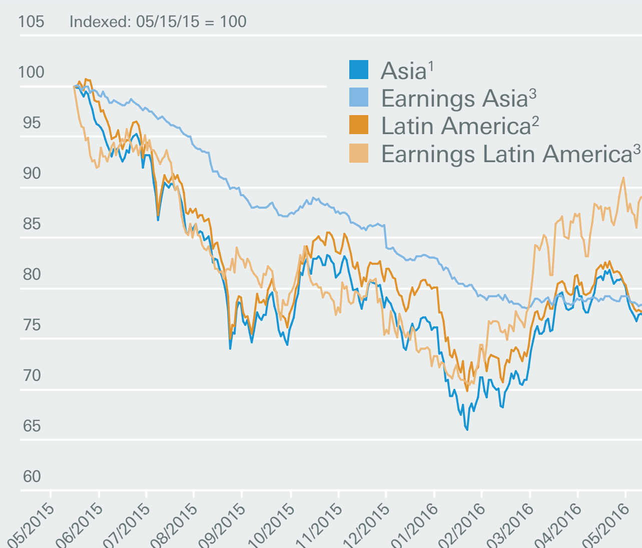
Equity-market perspectives

Emerging markets – this spring's commodity swallow does not make a summer.

Emerging-markets (EM) equities staged a spectacular comeback this spring. Still, investors need not be afraid that they might be late to the party: the periods of EM outperformance (or underperformance) over the developed markets tend to be quite long. The most recent downswing (in relative terms) took place between 1994 and 1998. Afterwards, the emerging markets boomed for twelve long years, before the current downtrend (as measured in U.S. dollars) got underway towards the end of 2010. Unsurprisingly, many investors were itching to invest and thought that the ideal moment to do so had come by end-2015. After all, things could hardly get any worse, could they? And the situation did indeed improve in the spring. The U.S. dollar depreciated against other major currencies, the Fed became more cautious again after its first rate hike, and commodity prices recovered. In turn, EM exchange rates stabilized. Institutional investors, who had been overweight Europe and Japan at the expense of the emerging markets, quickly adjusted their positions. Prices rose by almost 25% from their low in mid-February.

We, too, changed our stance on the emerging markets to neutral in March, as their risk-return profile improved in comparison to sluggish developed markets. Their valuation discount versus U.S. equities, as measured by the price-earnings ratio, amounts to about 35%. While diversification remains key in the emerging markets, Asia and Brazil jointly make up three quarters of the total market capitalization. Asia remains our favorite EM region – and not just because the Asian emerging markets, being net commodity importers, should benefit from low commodity prices in the medium term and favorable demographic trends in the long run. In addition, the Indian government continues its reform efforts, Beijing has stabilized the Chinese economy for now and South Korean exporters could benefit from Japanese yen appreciation. In Latin America, short-term dynamics appear attractive. Here, earnings expectations for 2016 have improved since mid-February, whereas they have only stabilized for Asia. The possibility of a political turnaround in Brazil is fuelling investor speculation. Still, we believe the current degree of optimism is excessive, as the country is faced with major economic-policy challenges. Overall, we think it is too early to expect a sustained upswing of EM equities. Still, they should have passed their trough, and we believe moderate investments in EM equities offer good diversification opportunities away from the developed markets.

Latin America – strong recovery after significant decline



The MSCI EM Latin America Index, where Brazilian companies make up half the market capitalization, has showed the biggest price movement this year, not least due to favorable earnings revisions.

[1] MSCI AC Asia ex Japan Index
[2] MSCI EM Latin America Index
[3] 2016 consensus earnings estimates
Source: FactSet Research Systems Inc.; as of 05/16/16.

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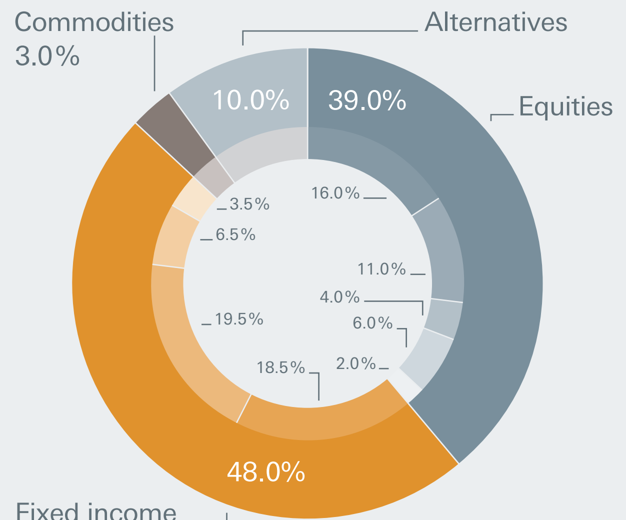
Europe, Middle East & Africa



Portfolio

Our asset-class allocation in a balanced portfolio[1]

Traditional asset classes

Within the core part of our balanced portfolio, we cover traditional liquid assets such as equities, fixed income and commodities. The chart shows how we would currently design a balanced portfolio, including alternative asset classes.[2]

Equities

Recent increases have already taken developed-market indices close to – or in some cases past – our 12-month strategic targets. Valuations appear to be at high levels, particularly in the United States, and this has added to fears about future volatility. Currency movements are likely to play a significant role in determining the direction of individual equity indices as well as investor returns across markets: any further policy initiatives by the Bank of Japan (BOJ) could, for example, have a positive effect on Japanese equities. Emerging-market equities may now find the going tougher as we approach a Fed rate rise. Within this sub-asset class we would favor Asia over Latin America.

Fixed income

Yields on core government bonds are likely to remain very low, despite signs of continued economic recovery in the Eurozone and some domestic pressures on the Fed to raise rates. In euro investment-grade credit, strong technicals and promised European Central Bank (ECB) action may drive spreads tighter in the near term. U.S. investment-grade credit should also gain from the latter factor, but in a less predictable way. The backdrop for euro high yield remains favorable, but U.S. high yield is likely to remain overshadowed by default concerns. Emerging-market hard-currency debt has done well recently, but we would suggest staying selective here.

Commodities

Commodity prices have picked up on the back of a continuing recovery in oil prices and assistance (until recently) from a weaker U.S. dollar. Whilst we expect a further rise in oil prices on a 12-month horizon we are skeptical as to whether the overall commodities rally can be maintained in the medium term as it is not clear how many of them are really in short supply. In regard to oil, we expect prices will be supported over the long term by a gradual reduction in U.S. production and a gradual increase in global demand.

[1] This portfolio may not be suitable for all investors.
[2] Alternative investments are dealt with separately in the next chapter. Alternatives are not suitable for all clients.

Equities	suggested weight
Developed markets	31.0%
United States	16.0%
Europe	11.0%
Japan	4.0%
Emerging markets	8.0%
Asia ex Japan	6.0%
Latin America	2.0%
Fixed income	
Credit	18.5%
Sovereigns	19.5%
Emerging markets	6.5%
Cash	3.5%
Commodities	
Commodities	3.0%
Alternatives	
Alternatives	10.0%

Sources: Regional Investment Committee (RIC), Deutsche Asset Management Investment GmbH, Deutsche Bank (Suisse) SA, as of 05/25/16. Suggested allocation for USD-based investors. This allocation may not be suitable for all investors.

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Long or short, Stéphane Junod?

Six market views from our regional Chief Investment Officer for Wealth Management in Europe, the Middle East and Africa (EMEA)

Will the Fed really want to raise rates further?

LONG The global environment remains very uncertain and the Fed will be keen not to upset the applecart. For example, it will be well aware of the possible impact of higher U.S. interest rates on those emerging markets with large amounts of U.S.-dollar-denominated debt. But the Fed has good domestic reasons to act: the U.S. labor market still looks in good shape, U.S. inflation (on multiple measures) is rising and wages may also trend higher. So the Fed still looks likely to raise rates during the next few months, most likely in July.

Will the BOJ refrain from further intervention?

SHORT In Japan (as in Europe) there are concerns about the declining impact of successive waves of quantitative easing (QE) on the real economy. Markets are certainly reacting increasingly unpredictably to new policy announcements. This can be seen most obviously in the currency markets. But the BOJ still seems likely to intervene further, possibly using a range of measures, although an important question (again, as in Europe) is to what extent this can be complemented by fiscal measures.

Are you staying cautious on U.S. equities?

LONG U.S. first-quarter (Q1) GDP was weak, as expected. The focus now moves to Q2 and here the macroeconomic data so far has been mixed, although retail sales have beaten expectations. Equity markets remain concerned about weak earnings in Q1 2016 and the downward revisions in earnings for 2016 and 2017. Moreover we would describe current high levels of valuation as "pricing in perfection". History suggests that May-September tends to be both the weakest period of the year in terms of returns – and also a period when disruptive events are frequent. So while further gains are possible, there remain plenty of reasons to be cautious.

Is it time to venture into emerging-market equities?

SHORT Emerging markets in aggregate have done well recently but the fundamentals are still uncertain and some individual economies are struggling. Renewed U.S.-dollar strength could be a further problem – this has a particularly marked negative correlation with Latin American equities. Moreover, the market has revised down emerging markets' earnings expectations over the last six months and further declines here are possible.

Do you still need a selective approach in the search for yield?

LONG The likely reduction in U.S. issuance (due to a falling budget deficit) will be one additional factor likely to help keep the lid on rates. So the search for yield from other fixed-income sources will continue – but you do need to be selective. In regard to U.S. high yield, it is not yet clear whether the high level of spreads is fully pricing in expected higher default rates; we would tend to prefer European high yield. We are cautious on emerging-market debt, given volatile currencies and a deteriorating fiscal situation in many countries.

Can the oil market find a balance?

LONG Oil-price moves can often be short-term in nature, affected by rapid shifts of market sentiment due to individual pieces of news. Recently there have been various studies suggesting that the global supply-demand imbalance appears to have narrowed and this has pushed oil prices up. We are still cautious about oil over the medium term, noting that there are no signs of an agreement to limit OPEC production and that oil inventories are still high. Further periods of volatility therefore look likely. But, with demand slowly increasing, eventually a balance should be found.

LONG represents a positive answer
SHORT represents a negative answer

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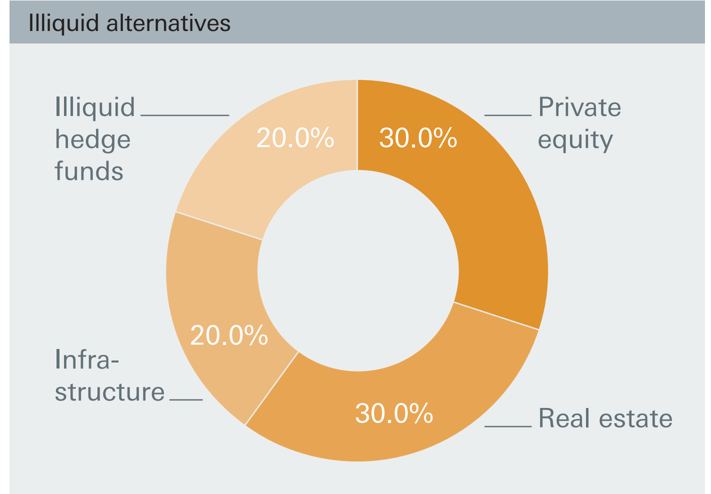
Alternatives

Our view of non-traditional asset classes

Alternatives portfolios

Due to their distinct characteristics, we take a differentiated look at selected liquid and illiquid alternative investments.[1]

Illiquid alternatives

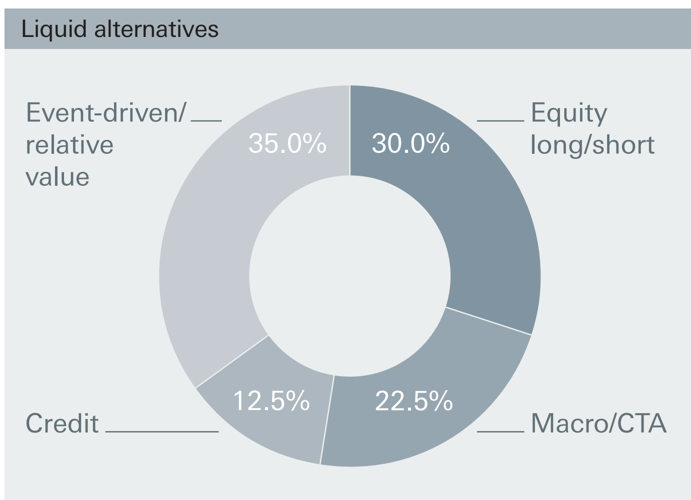


Liquid alternatives

Discretionary macro and CTAs

We think that both discretionary global macro and systematic/commodity trading advisor (CTA) strategies can bring to a portfolio a useful, idiosyncratic and diversifying risk-return profile. As equity markets have rebounded, the correlation of these types of strategies to the MSCI World Index has remained firmly negative, which suggests they could prove to be an effective source of diversification, should equity-market sentiment deteriorate again. In regard to global macro strategies, those focused on inter-asset-class relationships and geographic dispersion look particularly interesting. Commodities, equity indices, bonds and credit indices all offer distinct sets of opportunities. The United States, Europe and emerging markets have been exhibiting different patterns since the indiscriminate sell-off at the beginning of the year. CTAs could well profit from any renewed weakness in equity markets, while also capitalizing on another wave of flight to quality through long positions in U.S. Treasuries.

Liquid alternatives



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Illiquid alternatives[2]

Private equity

Total capital raised followed the usual seasonal slowdown in the first quarter of 2016, dropping back to $66 billion. However, the proportion attributable to buyouts rose to its highest in any first quarter of this decade, with $39 billion aggregate capital raised. Dry powder remains high with $775 billion in capital available as of March. This is contributing to stubbornly high valuations, with private-equity acquisition multiples remaining above the 10-year average for all deal sizes in Europe and for medium and large deal sizes in the United States. Fundraising is expected to remain generally healthy in Europe for the remainder of the year, despite political risks, but private-equity deals in the U.K. have fallen to levels not seen since 2008.

Infrastructure

Investor demand is still healthy for unlisted infrastructure, helping valuations for the asset class to remain broadly above their long-term average. Deal flows have continued to grow in the first quarter of 2016 with 224 deals completed. Asia's share rose to 37% of the global reported deal value. However, the inherent commodity exposure of many sectors in the region still presents risks, as could China. Economic fundamentals are also a headwind for unlisted infrastructure in the United States, though pockets of opportunities remain. Utilities can provide long-term, stable cash flows, that when coupled with fair valuations make this sector look interesting amidst continued global uncertainty.

Sources: Deutsche Asset Management Investment GmbH, Deutsche Bank AG Filiale London, as of 05/20/16
This allocation may not be suitable for all investors. In our balanced model portfolio, we currently allocate 10% to alternative investments (see "Portfolio").
[1] These portfolios may not be suitable for all investors.
[2] Not available in discretionary portfolios. Hedge funds and other investments classified as non-mainstream pooled investments are not considered as suitable investments for retail clients in the United Kingdom. Illiquid investments may be difficult to acquire or dispose of. The product's ability to respond to market conditions may be impaired and investors may experience adverse price movements on liquidation.

Long or short, Tim Gascoigne?

The Head of Liquid Alternatives – Hedge Funds shares his outlook.

Can discretionary macro outperform during 2016?
LONG We think it can. Monetary-policy divergence became more accentuated during the first quarter (Q1) of 2016 between the United States and the Eurozone, with implications for interest-rate trends and foreign-exchange trading in particular. While strategies based around U.S.-dollar strengthening have not delivered results year to date, repositioning and risk management by significant global investors so far has thrown up a number of interesting relative-value opportunities in this area.

Can CTAs deliver results in the current environment?
LONG We currently prefer shorter-term approaches over the longer-term strategies here. Both short- and long-term CTAs in aggregate performed well overall during the first six weeks of 2016 against a background of elevated asset-class volatility and well-defined trends in fixed-income and commodity markets. Equity-market volatility subsided towards the end of Q1 but continued repositioning by market participants due to prolonged uncertainty still supports the performance of certain shorter-term funds based on behavioral finance.

Does distressed debt offer compelling opportunities?
SHORT Not yet. But it may do so soon. For example, pricing in certain segments of the collateralized-loan-obligation (CLO) market reflects deteriorating fundamentals despite a significant overall tightening in spreads since mid-February. This is because default rates are increasing in the U.S. within the energy and metals & mining sectors in particular. However, the situation here could well get worse over the coming months before it gets better – hence we suggest caution in order to find the correct entry point before making any investments.

Will equity-market-neutral strategies' performance pick up?
LONG Coming into 2016, investors were positive on equity-market-neutral strategies, which tend to perform well during periods when stock correlations are low and there is increased volatility. However, these strategies have underperformed year to date because of the broad, undifferentiated sell-off in global equities earlier in the year, which led to a rotation out of growth and momentum stocks – the investment styles which have consistently outperformed for the past five years. However, we see these market dynamics as likely to be temporary and expect an improvement in the performance of these strategies.

Should a balanced portfolio stay defensive for the coming quarters?
LONG Our suggested liquid-alternatives portfolio for the remainder of 2016 reflects our view that this is a period which will continue to witness the persistence of elevated equity-market volatility. In particular, this should be because the market needs to rationalize the reality of rising discount rates in the United States within a zero-earnings-growth environment. We thus maintain a defensive-looking balanced portfolio with an emphasis on equity-market neutral, discretionary macro and CTAs. Within those types of strategy that can struggle during periods of higher volatility we maintain a focus on low-net-exposure approaches in both equity and credit asset classes.

LONG represents a positive answer
SHORT represents a negative answer

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Offers and sales of alternative investments are subject to regulatory requirements and such investments may be available only to investors who are "Qualified Purchasers" as defined by the U.S. Investment Company Act of 1940 and "Accredited Investors" as defined in Regulation D of the 1933 Securities Act. Alternative investments may be speculative and involve significant risks including illiquidity, heightened potential for loss and lack of transparency.

Glossary

Here we explain central terms from the CIO View.

Alpha is a measure of the active return on an investment. An investment's alpha is the excess return relative to the beta-adjusted market return.

In relation to currencies, appreciation refers to a gain of value against another currency over time.

Asset allocation is the apportioning of a portfolio's assets to individual asset classes such as equities, fixed income and cash in line with an investor's goals, risk tolerance and investment horizon.

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

Behavioral biases refer to irrational or flawed mental habits (such as extrapolating from the most recent observations), which can often hurt investment performance.

Behavioral finance is a sub-field of economic science, which studies the effects of psychological, social, cognitive and emotional factors on financial decisions, as well as the consequences for financial markets.

Big data is a term for extremely large data sets that may be analysed computationally to reveal patterns, trends and associations, especially relating to human behavior and interactions.

Bretton Woods in the U.S. State of New Hampshire was the site of an international conference in 1944, which established a system of largely stable currency exchange rates between leading Western nations, an arrangment that lasted until 1973.

Brexit is a combination of the words "Britain" and "Exit" and describes the possible exit of the United Kingdom from the European Union.

A bubble is characterized by prices surging higher than warranted by fundamentals, followed by a drastic drop in prices as a massive selloff occurs.

Bunds are issued by Germany's federal government, most frequently with a maturity of 10 years, and are the German equivalent of U.S. Treasury bonds.

A buyout is the purchase of a company's shares in which the acquiring party gains controlling interest of the targeted firm.

A company's cash flow is comprised of its inflows and outflows which arise from financing, operational or investing activities.

The CBOE SPX Volatility Index (VIX) is a leading measure of market expectations of near-term volatility conveyed by S&P 500 Index (SPX) option prices.

Cloud computing is a model for enabling ubiquitous network access to a shared pool of configurable computing resources by providing users and enterprises with various capabilities to store and process their data in third-party data centers.

Collateralized loan obligations (CLOs) are securities backed by a pool of debt, such as low-rated corporate loans.

A commodity trading advisor (CTA) is an individual or organization providing advice and services related to trading in futures contracts, commodity options and/or swaps.

Contrarian investing is an investment strategy that is characterized by positioning oneself in the opposite direction of prevailing sentiment.

Core government bonds are debt securities issued by especially credit-worthy governments both within the Eurozone and in other developed markets.

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

Default is the failure to meet the legal obligations of a loan, for example when a corporation or government fails to pay a bond which has reached maturity. A national or sovereign default is the failure or refusal of a government to repay its national debt.

The default rate refers to the proportion of borrowers who cannot service their loans.

Deflation is a sustained decrease in the general price level of goods and services.

Devaluation is the forced reduction of the value of a currency against other currencies.

The discount rate is the interest rate charged to commercial banks and other depository institutions for loans received from the country's central bank's discount window.

Discretionary macro strategy is the most flexible global macro trading strategy deploying directional positions at the asset-class level to exploit macroeconomic, policy or political changes.

Distressed debt may not be repaid in full due to the emitter's financial conditions.

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

A dividend is a distribution of a portion of a company's earnings to its shareholders.

Dry powder, in a private-equity context, refers to cash or other very liquid reserves that can easily be deployed for investment.

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 standards to be a developed market.

Equity-market-neutral investing strategies are hedge-fund strategies that seek to exploit differences in stock prices by balancing long and short positions in stocks within the same sector, industry, market capitalization, country etc. as to avoid market-risk exposure.

The Euro Stoxx 50 Index tracks the performance of blue-chip stocks in the Eurozone.

The Euro Stoxx Select Dividend 30 Index tracks high-dividend-yielding companies across 12 Eurozone countries.

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

The European Union (EU) is a unique economic and political partnership between 28 European countries covering much of the continent, which developed from the European Economic Community (EEC), created in 1958 by six countries.

The Eurozone, also called the euro area, is a monetary union of 19 of the 28 European Union (EU) member states which have adopted the euro as their common currency.

The Federal Reserve System or Fed, which serves as the U.S. central bank, was established in 1913, consisting of the Federal Reserve Board with seven members headquartered in Washington, D.C., and twelve Reserve Banks located in major cities throughout the United States.

Free cash flow (FCF) is a measure of financial performance calculated as operating cash flow minus capital expenditures. It shows how much cash a company is able to generate after deducting the money required to maintain or expand its asset base.

The FTSE EPRA/NAREIT Developed REITs Germany Index measures the performance of listed German real estate companies and investment trusts.

The Group of Twenty or G20 is an international forum of the governments and centra- bank governors from 19 individual countries – Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom and the United States – along with the European Union (EU), founded in 1999 with the aim of promoting international financial stability.

The Great Recession refers to the prolonged economic downturn in much of the world after the financial crisis of 2007-08.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Hard-currency bonds (debt) are bonds (debt) issued by legal entities in a hard currency such as the U.S. dollar, euro or Swiss franc.

High yield (HY) is often used as a shorthand for high-yield bonds.

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

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

The J.P. Morgan Corporate Emerging Markets Bond Index (CEMBI) Asia is a liquid corporate emerging markets benchmark that tracks U.S.-denominated corporate bonds issued by entities in Asian emerging markets.

The J.P. Morgan CEMBI Europe is a liquid corporate emerging markets benchmark that tracks U.S.-denominated corporate bonds issued by entities in Eurpean emerging markets.

The J.P. Morgan CEMBI Latin America is a liquid corporate emerging markets benchmark that tracks U.S.-denominated corporate bonds issued by entities in Latin American emerging markets.

JGBs or Japanese Government Bonds are issued by the government of Japan and are, due to their high levels of credit and liquidity, very much like U.S. savings bonds.

Labor productivity measures the amount of goods and services which can be produced by using one unit of labor.

The Louvre Accord was an 1987 agreement between leading Western nations, which aimed to stabilize the international currency markets.

Market capitalization, in the context of an individual firm, is the number of shares issued multiplied by the value of the shares.

Mortgage is a debt instrument, secured by the collateral of specified real-estate property, that the borrower is obliged to pay back with a predetermined set of payments.

The MSCI AC Asia ex Japan Index captures large- and mid-cap representation across 2 of 3 developed-market countries (excluding Japan) and 8 emerging-market countries in Asia.

The MSCI AC World Index captures large- and mid-cap companies across 23 developed- and 23 emerging-market countries.

The MSCI Emerging Markets (EM) Latin America Index captures large- and mid-cap representation across five emerging-market countries in Latin America.

The MSCI Japan Index is designed to measure the performance of the large- and mid-cap segments of the Japanese market.

The MSCI World Index captures large and mid-cap representation across 23 developed-market countries.

A multiple is a ratio that is used to measure aspects of a company's well-being by setting various of the company's metrics against each other and thereby building indicative ratios.

NAREIT Index is a REIT-focused index that spans the commercial real-estate industry.

The Organization of the Petroleum Exporting Countries (OPEC) is an international organization with the mandate to "coordinate and unify the petroleum policies" of its meanwhile 12 members.

An owner's equivalent rent is the amount of rent that would have to be paid if a homeowner instead had to rent an equivalent property.

The Plaza Accord was a 1985 agreement between leading Western nations, which aimed to ensure an orderly decline in value of the U.S. dollar, and was followed by the Louvre Accord in 1987.

Potential growth of gross domestic product (GDP) is defined as the rate of output growth that an economy can produce at a constant inflation rate. Although an economy can temporarily produce more than its potential level of output, that comes at the cost of rising inflation.

The price-to-book (P/B) ratio or multiple is used to compare a stock's market value to its book value. It is calculated by dividing the current closing price of the stock by the latest quarter's book value per share.

The price-to-earnings (P/E) ratio or multiple measures a company's current share price relative to its per-share earnings.

For private-equity acquisition multiple see "multiple".

Productivity measures how much economic output is produced for a given level of inputs (such as capital and labor).

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

A Real Estate Investment Trust (REIT) is a company that owns, and in most cases, operates income-producing real estate. REITs sell like a stock on the major exchanges and invest in real estate directly, either through properties or mortgages.

The S&P 500 Biotechnology Index captures the companies listed in the S&P 500 Index from the biotechnology sector.

The S&P 500 Health Care Index captures the companies listed in the S&P 500 Index from the health care sector.

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

Spread to worst is the difference between the yield of a sovereign bond and the yield to worst of a callable bond with the same maturity.

The ECB's targeted longer-term refinancing operations (TLTROs), announced in June 2014, are designed to enhance the functioning of the monetary-policy transmission mechanism by supporting bank lending to the real economy.

The Taylor Rule, developed by the economist John Taylor, determines how a central bank should set short-term interest rates, in response to observed divergences of actual from target inflation and actual from potential output.

Total factor productivity (TFP) measures changes in output for a given amount of labor and capital due, for example, to technical and organizational innovations.

Treasuries are fixed-interest U.S. government-debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

The "Tuna-Bond" Saga refers to the ongoing efforts of Mozambique to restructure some $850m in state-backed loan financing. Since the initial loan was granted in 2013, the proceeds have mostly been used to buy a tuna fishery fleet, as well as patrol boats to defend the tuna fishers from pirate attacks. Unfortunately, costs for security equipment have proven much higher than initially thought, undermining the economics of the project.

Underperformance refers to an investment performing comparatively less well than others.

An unlisted business is not listed (traded) on a stock exchange but can have multiple shareholders.

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 of a trading-price series over time.

The wealth effect is the change in spending that accompanies a change in perceived wealth.

The Japanese yen (JPY) is the official currency of Japan.

Yield is the income return on an investment referring to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

Yield to worst is computed by using the lower of either the yield to maturity or the yield to call on every possible call date for a bond.

Investment traffic lights (pages 8–9): comments regarding our tactical and strategic view

Tactical view:

- The focus of our tactical view for fixed income is on trends in bond prices, not yields.

Strategic view:

- The focus of our strategic view for sovereign bonds is on yields, not trends in bond prices.
- For corporates and securitized/specialties bonds, the arrows depict the respective option-adjusted spread.
- Both spread and yield trends influence the bond value. Investors who aim to profit only from spread trends must

Risk warning

Investments are subject to investment risk, including market fluctuations, regulatory change, possible delays in repayment and loss of income and principal invested. The value of investments can fall as well as rise and you might not get back the amount originally invested at any point in time.

Investments in Foreign Countries - Such investments may be in countries that prove to be politically or economically unstable. Furthermore, in the case of investments in foreign securities or other assets, any fluctuations in currency exchange rates will affect the value of the investments and any restrictions imposed to prevent capital flight may make it difficult or impossible to exchange or repatriate foreign currency.

Foreign Exchange/Currency - Such transactions involve multiple risks, including currency risk and settlement risk. Economic or financial instability, lack of timely or reliable financial information or unfavorable political or legal developments may substantially and permanently alter the conditions, terms, marketability or price of a foreign currency. Profits and losses in transactions in foreign exchange will also be affected by fluctuations in currency where there is a need to convert the product's denomination(s) to another currency. Time zone differences may cause several hours to elapse between a payment being made in one currency and an offsetting payment in another currency. Relevant movements in currencies during the settlement period may seriously erode potential profits or significantly increase any losses.
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