Deutsche Asset
& Wealth Management

Europe, Middle East & Africa Edition
May 2014

CIO View

Eurozone

Inflation low, deflation no

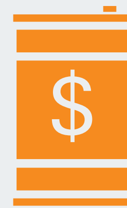
Nine positions

Our key forecasts

Global economic growth outlook for 2014 is unchanged.

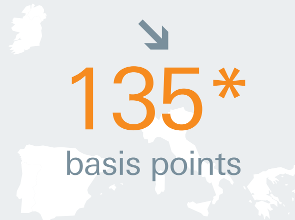
The Eurozone will manage modest growth this year.

Commodity prices will soften. Oil will remain under pressure.



Fair valuations and rising earnings support equities.

Investor interest tightens Eurozone periphery spreads.

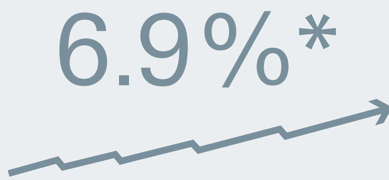


*Spread between periphery government bonds and German Bunds

Concerns about a deflationary crisis in the Eurozone are exaggerated.

EURO STOXX 50 Index moves upward, but it will be a bumpy climb.

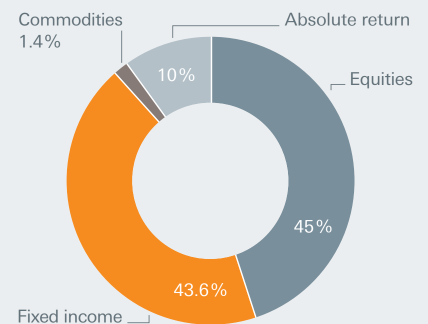
6.9%*



*Expected price potential through March 2015

Emerging markets start to appeal again — but be selective.

Asset allocation of our balanced model portfolio:



Important terms are explained in our glossary at the end of this edition.
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. Source: Deutsche Asset & Wealth Management, as of May 2014.

Letter to investors

The risks for equities are limited

The crisis in Ukraine has global markets on edge—and investors fear that deflation could prove a long-term problem for the Eurozone. What matters most, though, is an objective look at economic and financial data.

Self-interest and fear: These factors are the main driving forces of stock markets. Self-interest, the economist Adam Smith's great motivator, is currently running scared. Right now, fear is the dominant sentiment. In the first months of 2014, the fear that the severe winter in the United States could choke off the economic recovery throttled stock markets. At present, the conflict surrounding the future of Ukraine and fears of deflation in the Eurozone are weighing on markets. Fortunately, though, political markets still have short legs. And in the Eurozone, remember that declining inflation does not necessarily mean deflation (see page 4).

> "The Eurozone is still far from deflation."

The fear that these factors could cause growth to slump is likely to prove unfounded. On the contrary: Leading indicators point to accelerating economic momentum in the Eurozone and in the United States. The U.S. Federal Reserve Board (Fed) is likely to continue its tapering policy and end its bond purchases by fall. At this point, low interest rates could come into focus. If they rise, bond yields should continue to increase. As a result, 2013 and 2014 could go down in history as the end of the 30-plus-year bull market in bonds.

More and more investors are starting to anticipate this and are moving out of bonds and into stocks. This has already caused stock valuations to climb. A look at past valuation ratios, however, reveals one thing: Equities are not overvalued yet. Moreover, higher growth is likely to trigger an increase in corporate earnings. The so-called "smart money" should underweight bonds that offer lower yields at higher risk—and place its bets on stocks.

The old stock market saying "sell in May and go away" could thus prove wrong this year. Indeed, stock markets could be in for a bumpy climb up in light of the expected rise in interest rates. But market dips could be good buying opportunities. In addition, capital flows indicate that the first investors are resetting their sights on emerging markets. We, however, will remain selective and favor emerging markets that demonstrate little dependency on commodity prices and boast strong fundamentals—self-interest still needs to be balanced with a little caution here.

Asoka Wöhrmann,
co-chief investment officer

Focus
Don't worry about deflation

Worries about falling prices in the Eurozone appear exaggerated.

Consumers will be delighted: Prices in the Eurozone are rising only slowly. For economists, however, an inflation rate well below 1% is a concern because it can increase the risk of deflation. Following a meeting of the Governing Council of the European Central Bank (ECB) at the beginning of April 2014, ECB President Mario Draghi stressed that deflation fears in the Eurozone were unfounded. But he also said the bank was prepared to take unconventional measures if needed. According to media, the ECB has modeled the impact of purchasing more than 1 trillion euros of securities. This simulation suggested that such a policy intervention would increase inflation by 0.2 percentage points in the worst-case scenario and by 0.8 percentage points in the best case.

No pressing need for action

At the same time, the ECB has dampened expectations that it will launch a bond-buying program anytime soon. It argues that the decline in inflation is primarily due to a temporary foreign-trade effect, as declining energy prices and a surprisingly strong euro drive down import prices. This is clearly reflected in the GDP deflator adjusted for external effects, which is signaling a price increase of more than 1% in the Eurozone. The deflator has proven to be a much more stable gauge than the consumer price index. Cyclical trends also argue for rising inflation rates. Meanwhile, the latest purchasing managers' index came in at 54, one point above expectations—a reading above 50 indicates economic expansion.

Fragmentation appears to generate concerns

We continue to expect that the Eurozone economy will grow by 0.9% this year. But we are concerned about the differing growth rates occurring within the region. Germany's economy is likely to expand by 1.5% in 2014, France's by 0.5%, Spain's by 1.0% and Italy's by 0.5%. The diverse growth rates are likely to cause a range of price trends. In April 2014, Germany's inflation rate was 1.1% (comparing prices to the same month last year). In France, the rate was 0.7%, in Italy 0.6%, and in Spain 0.3%. Greece reported a decline in prices of 1.5%.

Economic adjustments being made

But negative inflation does not mean that some countries on the periphery are entering a deflationary crisis. First, falling commodity prices produce both a lower inflation rate and a rise in purchasing power. Second, regional differences in inflation rates signal that the process of adjustment needed to deliver an economic recovery is intact. Falling production costs can result in lower inflation in the periphery countries but also greater competitiveness. This, in turn, can fuel growth. With the economic momentum that can be observed at the moment, we expect consumer prices to rise through year-end in all Eurozone countries except for Greece, where deflation should weaken.

Stable inflation expectations

In light of higher growth and increasing economic stability in the Eurozone, the authorities are showing no signs of concern about deflation. The ECB's Governing Council says that "inflation expectations for the euro area over the medium to long term continue to be firmly anchored in line with the Governing Council's aim of maintaining inflation rates below, but close to, 2%." Thus, there appears to be little danger that consumers will cut spending in anticipation of falling prices and choke off growth. We are sticking to our inflation forecast of 1% for the Eurozone this year.

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A short history of the euro

1979
The European Monetary system began, with the aim of establishing fixed exchange rates within agreed currency bands. The system used the ECU as its anchor and remained until the end of 1998.

1990
The Maastricht Treaty that established the Economic and Monetary Union (EMU) was signed by the European Council.

1997
The Stability and Growth Pact was signed. This pact includes provisions calling for members to keep their public debt and budget deficits within certain limits.

1999
The euro was introduced as a currency in nonphysical form. In its first three years of existence, the joint currency was used only as an accounting currency.

2002
The euro went into circulation in physical form and replaced national currencies as legal tender.

2010
High levels of government debt and the financial crisis caused market players to become wary of countries like Greece and Ireland. To address these concerns, the European Financial Stability Facility (EFSF) was created. Its goal was to provide financial support to member countries.

2012
ECB President Mario Draghi stated that the ECB was prepared to do whatever it takes to prevent the breakup of the Eurozone. The euro stabilized and the spread between the yields of sovereign bonds issued by Eurozone members narrowed.

2013
The European Stability Mechanism (ESM) was created to replace the EFSF. The ESM's purpose is to ensure financial stability in the Eurozone.

2014
The ECB announced that it might use quantitative easing to fight deflation. It determined the effectiveness of this approach through modeling.

Long-term inflation expectations in the Eurozone

Source: Bloomberg Finance LP; as of April 2014

Measuring inflation expectations:
The breakeven inflation rate is calculated from the difference between the yields of conventional sovereign bonds and inflation-linked sovereign bonds. This spread reflects the loss of interest the investor incurs for protection against inflation. At the same time, it thus also depicts the inflation expectations of market participants. At 1.75%, the inflation expectation for French five-year sovereign bonds is currently just below the ECB's 2% target.

1.0%
Our inflation forecast for the Eurozone in 2014

The target for the euro

In August 2011, German Finance Minister Wolfgang Schäuble declared: "We hoped—and still hope for that matter—that the euro would gradually lead to a political union. The fact that we have not yet arrived there is one of the reasons for the markets' lack of confidence." With such comments, the German government is indicating that steps leading to a banking and fiscal union will have to be undertaken to stabilize the Eurozone.

0.9%
Our growth forecast for the Eurozone in 2014

The big picture

Interview

Asoka Wöhrmann expects to see ample investment opportunities in financial markets in 2014. But these opportunities will only be for those investors who are willing to take on risk.

"The really smart money will tactically exploit the herd mentality of investors. It will not turn nervous or even panicky."

Download our forecasts: www.deawm.com/CIOView-ourforecasts-APAC

CIO View: You expect the global economy will grow by an impressive 3.7% this year. What role will be played by China's metamorphosis—that is, the country's move to adopt a consumer-based growth model (see CIO View April)?
We expect China's economy will grow by 7.2%. But this hard number really reveals little about the state of this metamorphosis. This is a much more far-reaching process. The news coming out of China in future quarters, no matter whether it is good or not-so-good, will have only a short-term effect on our sentiment—nothing more than that. The key to our global growth forecast is that the U.S. economy continues down the path of self-sustaining growth and expands by 2.8%. I am confident that it will.

And how confident are you about the Eurozone and Japan?
In Europe, we are clearly moving upward. You can see this in just about every piece of data we monitor. I am sticking with our 2014 growth forecast of 0.9%. For Japan, we expect to see a growth rate of at least 1.5%. But this growth will depend on the effect that the country's sales-tax increase ultimately has.

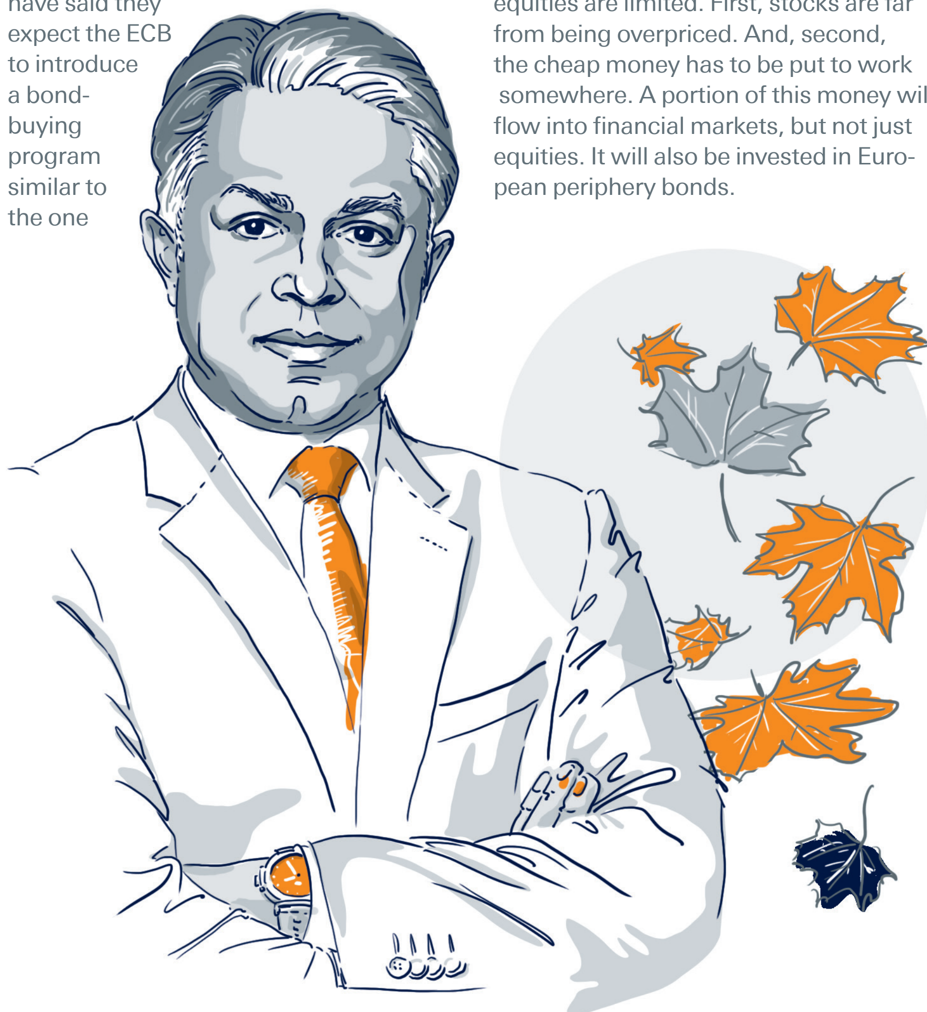
Which Six Sigma event could wreck your forecasts?
That would be the things that economists like to call geopolitical risks—things like a resumption of the East-West conflict, combined with military hostilities and far-reaching sanctions. I can think of one other potential, but very unlikely event as well: A member of the Eurozone could decide to turn its back on the region's stability policies and retrigger the euro crisis.

And how extensively could the strong euro hurt the Eurozone's recovery?
Europe's exporters can live with the current euro to U.S. dollar rate of 1.40. Take German automakers, for instance. They now produce the vehicles for their key sales markets like the United States and China locally. As a result, the exchange rate is not a problem for them. But a significant rise above the level of 1.40 U.S. dollars per euro could feed deflation fears.

How real is the deflation threat?
Based on our calculations, we think that deflation really amounts, once again, to an imagined phenomenon rather than a real one. In 2014, the European inflation rate is very likely to be 1% on average. We are thus a long way from deflation.

What is your ideal scenario for the euro to U.S. dollar exchange rate?
Once tapering ends this year, the Fed will begin to raise interest rates in 2015. This will represent the beginning of a new era for many investors, particularly young people who have never experienced a period of rising rates in their lives. The yield curve in the United States should change in the process, and the euro to U.S. dollar rate should head back in the direction of 1.30.

How will the ECB respond if the euro grows significantly stronger?
One point is already clear: Conventional monetary policy has reached the end of the road in the Eurozone with a benchmark rate of 0.25%. Some economists have said they expect the ECB to introduce a bond-buying program similar to the one employed by the Fed. I do not think this is likely or desirable. We think such a policy would be likely only if the euro climbed well above 1.50 U.S. dollars or we really did experience deflation.



How is the smart money—those major investors with quick access to information—positioning itself right now?
The really smart money will tactically exploit the herd mentality of investors. It will not turn nervous or even panicky. This year will be the year of mini panics—this will be the case because a very large number of market players have been too certain that everything was just great. The smart money will not earn anything this year without taking on some risk. But I think that the downside risks for equities are limited. First, stocks are far from being overpriced. And, second, the cheap money has to be put to work somewhere. A portion of this money will flow into financial markets, but not just equities. It will also be invested in European periphery bonds.

To what extent do emerging markets now again offer acceptable investment opportunities for investors ready to tolerate higher levels of risk?
There are clear opportunities here. But I urge investors to be selective. You can look in India and China, or in Asia in general, but also in Brazil and Turkey. By the time that the United States begins talking about the first interest-rate increases, emerging markets may be jolted once again. This could cause the last nervous money to pull out of the market. Once worries about the growth rate in China subside and people begin to understand that China's approach will ultimately produce qualitatively better growth, the time to invest will have arrived.

And when could this happen?
Possibly by this fall, when the initial rate increases in the United States have been priced in.

Waiting for fall

Autumn for the Northern Hemisphere officially begins on September 22. Asoka Wöhrmann thinks investors, much like the population in general, will then prepare for the coming winter by starting to price in the first U.S. interest-rate increases. The last nervous money may then finally pull out of the emerging economies' financial markets—and clear the way for their sustainable recovery.

Investment traffic lights

Our tactical and strategic view

Equities	1 to 3 months	up to March 2015
Regions		
United States	orange (circled)	↗
Europe	green	↗
Eurozone	green (circled)	↗
Germany	orange	↗
Japan	orange	↗
Asia ex-Japan	orange	↗
Emerging markets	orange (circled)	→
Sectors		
Consumer staples	red	
Health care	orange (circled)	
Telecommunications	red	
Utilities	red	
Consumer discretionary	green	
Energy	orange	
Financials	green	
Industrials	orange	
Information technology	green (circled)	
Materials	orange	
Style		
Small and mid-cap	green	

The tactical view (one to three months)
Equity indices:
- positive view
- neutral view
- negative view

Fixed income and exchange rates:
- The fixed-income sector or exchange rate is expected to perform well
- We expect to see a sideways trend
- We anticipate a decline in prices in the fixed-income sector or in the exchange rate

Previous traffic lights are shown in the small graphs to the right as well as on the next page.
A circled traffic light indicates that there is a commentary on the topic.

The strategic view up to March 2015
Equity indices and exchange rates: The arrows signal whether we expect to see an upward trend (↗), a sideways trend (→) or a downward trend (↘) for the particular equity index or exchange rate.
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 sovereigns for each respective region. ↗ 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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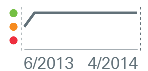
United States

U.S. equities are fairly valued by historical standards. Through March 2015, corporate profits should produce high single-digit percentage gains. Our outlook is neutral for the short term, but positive for the long term.

Eurozone



Leading indicators are signaling an acceleration of growth in the Eurozone. This is a positive sign for corporate profits. When it comes to profitability, Europe's companies continue to lag behind their U.S. peers. They have some catching up to do.

Emerging markets

Since mid-March, the MSCI Emerging Markets Index has significantly outperformed the MSCI World Index. As a result, this is not an especially favorable time to enter the market. Investors with long time horizons should focus on countries with high growth potential and low current-account deficits.

Fixed income	1 to 3 months	up to March 2015
Rates		
U.S. Treasuries (2-year)	● orange	↗ orange
U.S. Treasuries (10-year)	◉ orange	↗ orange
U.K. Gilts (10-year)	● orange	↗ orange
Eurozone periphery	◉ green	↘ green
German Bunds (2-year)	● orange	↗ orange
German Bunds (10-year)	◉ red	↗ orange
Japan government bonds (2-year)	● orange	↗ orange
Japan government bonds (10-year)	● orange	↗ orange
Corporates		
U.S. investment grade	● orange	↘ orange
U.S. high yield	● orange	↗ orange
Eurozone investment grade	◉ green	↘ green
Eurozone high yield	● orange	↗ orange
Asia credit	● orange	→ orange
Emerging-market credit	● orange	↘ green
Securitized/specialties		
Covered bonds	● green	↘ green
U.S. municipal bonds	● orange	→ orange
U.S. mortgage-backed securities	● red	↗ red
Currencies		
EUR vs. USD	● red	↘ orange
USD vs. JPY	◉ orange	↗ green
EUR vs. GBP	● orange	↘ orange
EUR vs. JPY	● orange	↗ green
GBP vs. USD	● red	↘ orange
Emerging markets		
Emerging-market sovereign	● orange	↗ orange
Alternatives		
Infrastructure	● green	↗ green
Commodities	● orange	→ orange
Real estate	● green	↗ green

Health care

This industry is characterized by high cash flows, strong pricing power and an ever-expanding pipeline of new medications. The sector is in very good shape, but the subsequent valuations lead us to a neutral weighting.

Information technology

We stay overweight for the MSCI World Information Technology Index as we expect growth of global technology spending to continue, as indicated by recent surveys. Cloud-based software should drive growth. The average valuation of the shares in this sector is also moderate.

U.S. Treasuries (10-year)

Stable growth and continued tapering by the Fed suggest a long-term rise in interest rates in the United States. As a result, we view U.S. Treasuries as a price risk. Over the next one to three months, we expect a sideways trend in the asset class.

Eurozone periphery

The growing stability of economies in the Eurozone's periphery has already resulted in a sharp reduction of spreads between these countries' sovereign bonds and German Bunds. This spread-narrowing trend should continue.

German Bunds (10-year)

As the year began, Bunds profited from market uncertainty. The stabilization we're seeing at the moment is creating a counter-trend. At current levels, Bunds are overpriced. We are taking short positions.

EUR Investment Grade

The ECB's statement that it might launch a bond-buying program if deflation and recession set in will underpin bonds in the Eurozone. Demand is particularly strong for solid corporate bonds. The shortage of these investments is giving them momentum.

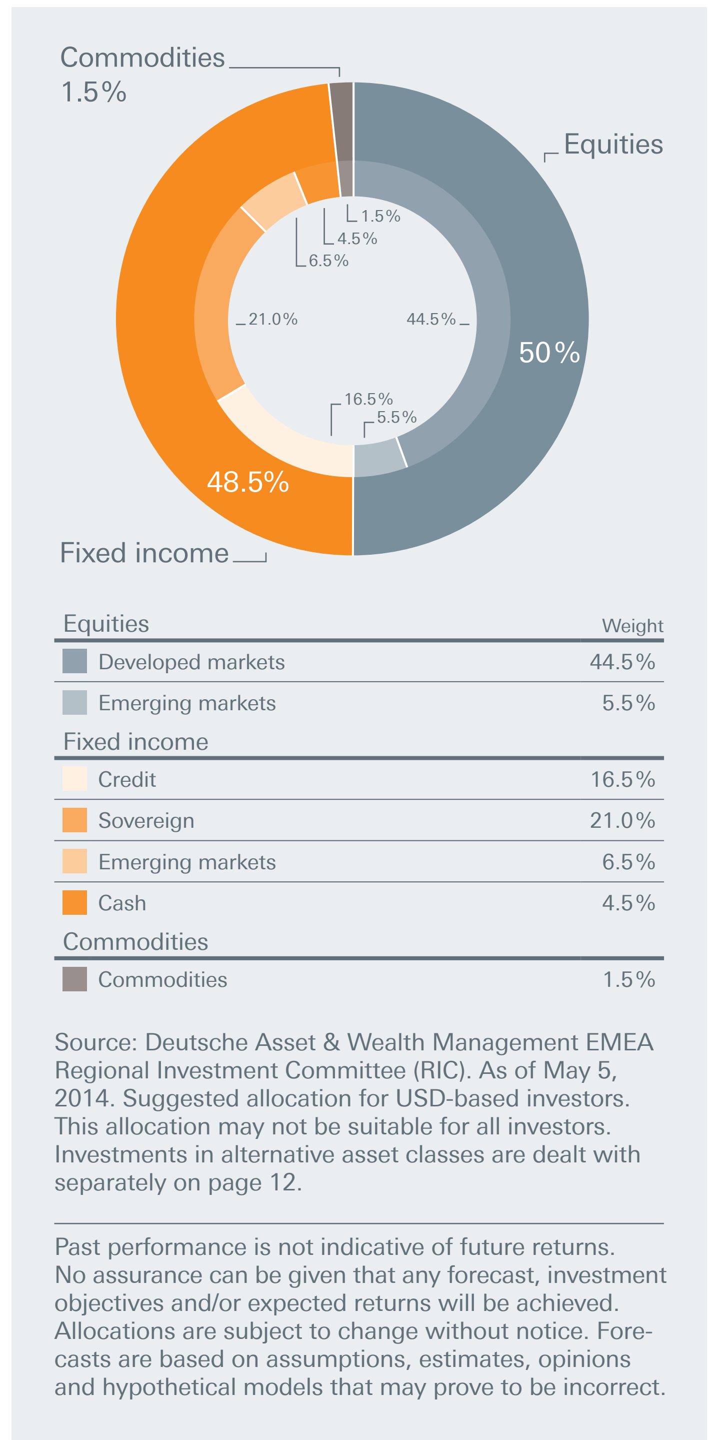
USD vs. JPY

The robust U.S. jobs numbers should give the U.S. dollar a lift. In Japan, improved retail sales and the rise in industrial production are likely to help bolster the yen. In the coming months, we expect the U.S. dollar to Japanese yen exchange rate to trend sideways.

Europe, Middle East, Africa

Portfolio

How we allocate assets



Equities	Weight
Developed markets	44.5%
Emerging markets	5.5%
Fixed income	
Credit	16.5%
Sovereign	21.0%
Emerging markets	6.5%
Cash	4.5%
Commodities	
Commodities	1.5%

Source: Deutsche Asset & Wealth Management EMEA Regional Investment Committee (RIC). As of May 5, 2014. Suggested allocation for USD-based investors. This allocation may not be suitable for all investors. Investments in alternative asset classes are dealt with separately on page 12.

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Our core portfolio allocation

With our core portfolio, we cover assets such as equities, fixed income and commodities. The chart shows how we would currently design a balanced portfolio.

Fixed income: waiting for U.S. yields to move up

U.S. Treasury yields will eventually move higher as the Fed continues to normalize monetary policy—but April proved to be a bumpy month, and so could May. German Bund yields will follow the United States upward while opportunities still exist in the Eurozone periphery. As regards credit, investment grade, and high yield look less appealing than a few months ago and we maintain a small underweight here. However, emerging-market debt (hard currency and local) may offer some opportunities.

Equities: look for gains later in the year

There could be some setbacks over the next few months, due to seasonal and other factors. With developed-market valuations looking stretched, we also need more evidence of sustained corporate earnings growth to conclusively pull prices higher. But strengthening global growth will add support later in the year. Emerging-market equities' valuations have not reached distressed levels, but still below historic average. But some opportunities will start to present themselves for investors who are prepared to be selective.

Commodities: fundamental headwinds

Commodities' gains so far this year do not look likely to be sustained. With regard to oil, Russia/Ukraine and other concerns have recently helped keep WTI prices above 100 U.S. dollars per barrel. But the fundamentals still point to downward pressure: global oil production is still growing faster than demand. Gold's appeal also seems likely to fade as we return to a more normal monetary policy environment and the U.S. dollar strengthens.

Stéphane Junod is the multi-asset group chief investment officer for Europe, Middle East and Africa (EMEA).

Long or short, Stéphane Junod?

Six market views from our regional chief investment officer

CIO View: The U.S. economy—still improving?

LONG The advance reading on first-quarter 2014 U.S. GDP was disappointing, but the U.S. consumer remains confident and job growth seems likely to accelerate. Fiscal drag looks set to fade and the "wealth effect" from increasing asset price appreciation and healthier household balance sheets should help as well. Further impetus will come from catch-up capital expenditure by corporates.

Positive on U.S. equities?

LONG At a fundamental level, we remain positive on U.S. and other developed-market equities. We believe they will be supported by accelerating global growth, stronger corporate earnings and accommodative monetary policy. But in the short term, this might be a good time to tread a little cautiously. Seasonal and geopolitical factors could pose some short-term headwinds.

U.S. cyclicals over defensives?

LONG We still expect the U.S. economy to accelerate, and cyclicals are still trading below their 15-year average relative to defensives. Cyclical stocks' earnings are also expected to grow faster than defensives in 2014 and 2015.

Is further ECB monetary policy easing imminent?

SHORT We do not expect any new monetary policy initiatives soon—the ECB is likely to want to wait to see April and May inflation data. This is a complex issue, and the options—cutting the repo rate again; instituting negative deposit rates; extending additional cheap funding to banks; purchasing corporate bonds; Fed-style purchases of government bonds—all have negatives as well as positives. But were the markets to try and push the euro to U.S. dollar exchange rate beyond 1.40 in coming weeks, we would expect a strong verbal response from the ECB.

Have emerging markets turned a corner?

SHORT Some emerging markets have performed well recently. But they remain vulnerable to future interest-rate increases in the United States, with Chinese economic concerns and some politically related issues also casting a shadow. This keeps us cautious on emerging markets in general, although we see some value in emerging-market debt (hard and local currency) and in equities, if you are selective. Within emerging-market equities, we still prefer Asia.

U.S. dollar—still expecting strength?

LONG Gravitational forces can't be resisted forever: Relatively strong U.S. economic growth and tighter Fed policy (compared with that pursued by the ECB and Bank of Japan) are likely to result in a stronger U.S. dollar later this year.

LONG represents a positive answer
SHORT represents a negative answer

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Europe, Middle East, Africa

Absolute-return portfolio

Our absolute-return portfolio covers non-traditional liquid and illiquid assets. For most investors, this will represent a relatively small share of their total investments.

Liquid alternatives

The first quarter has been encouraging for both equity long/short and event-driven strategies. An improving stock-picking environment has been supportive for the former, while a fertile period of corporate activity has supported the latter. In contrast, improving global growth and low yields have continued to make life tough for trend followers.

Private equity

Private equity continues to recover from its post-crisis slump. Returns in the first quarter have been strong, with appreciation in unrealized values and healthy cash returns from exiting portfolio companies. Capital deployment is gathering momentum and the number of deals should continue to rise. Fundraising remains strong as investors seek to deploy capital in asset classes with higher return potential.

Infrastructure

Capacity use of infrastructure is rising due to global GDP growth and governments' limited ability to provide additional capital expenditure. This supports higher income from the asset class. One risk is that, if growth is accompanied by big rises in real rates, our research shows this could be a headwind for infrastructure. But we would expect infrastructure to serve as a hedge against inflation should prices start to rise unexpectedly.

Real estate

Higher demand for commercial real estate, combined with limited new building, is driving rental growth in markets such as the United States, Germany, the United Kingdom, Australia and Japan. Property yields are still above average relative to sovereign yields. When this occurred historically, real estate produced strong returns.

Liquid alternatives	Private equity
Investments that offer exposure to hedge-fund strategies and claim higher liquidity than their underlying components.	Investments in private firms or public company buyouts. Not quoted on a public exchange and with a long time horizon.
Infrastructure	**Real estate**
Long-term defensive investment in infrastructure assets that may offer low correlation to traditional asset classes.	Direct or indirect investment in commercial real estate with the aim of delivering rental income and/or capital gains.

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Long or short, Mark G. Roberts?

The head of real estate strategy and research reviews commercial property markets

CIO View: Real estate fundamentals — are they improving?

LONG Global growth is translating into healthier fundamentals. With rising employment and limited new construction, vacancy rates are falling and rent growth is turning from negative to positive in many markets.

Investor demand — picking up?

LONG The volume of commercial property bought and sold last year rose by 20%. But global transaction volume is still only 60% of what it was at the peak in 2007. While prices have risen in many regions, we are at an early stage in the cycle and fundamentals are recovering. Risks remain — especially the potential for higher rates, slower growth in China and geopolitical instability. Diversification is crucial.

Returns — how will property perform?

LONG We expect annual returns to average between 7% and 9% globally over the next five years. By region, we forecast 9% to 11% in Emerging Asia, close to 9% in southern Europe, about 7.5% in North America and from 4.5% to 5.5% in developed Europe. German-speaking countries are at the lower end of the latter range.

The United States — positive outlook?

LONG Economic activity is gaining momentum, initial yields from real estate are wide relative to sovereigns and well above average, occupier demand is increasing and new construction is low. Net operating income should grow at a faster pace over the next few years. However, tapering is the biggest risk to valuations. Thus, investors might want to consider underweighting assets with long-term leases that don't allow rents to reset, and overweighting shorter duration leases to capture higher rents and minimize capital market risks.

Asia Pacific — where are the opportunities?

LONG We are "long" (i.e., a positive view) for logistics markets in countries like South Korea, Australia and Japan. Logistics infrastructure is being upgraded to serve global trade, China's expanding middle class and e-commerce growth. But "short" caution is warranted for Hong Kong offices. While the long-term outlook is favorable, slower growth in China is a shorter-term headwind.

Risk appetite — how are investors positioning?

LONG Investors are increasing their risk tolerance in the search for yield. They're looking to expand their portfolios beyond the established centers of New York, London and Tokyo. Some emerging locations for international investors include southern Europe and outer London office markets.

Home bias — is it best to stay local?

SHORT International property investing typically offers diversification and in some cases potentially higher returns. However, our analysis shows the costs of currency hedging and taxes can undermine risk-adjusted returns. It depends which currency investors are hedging against. For example, until U.S. rates rise, U.S. investors seeking currency-hedged core returns in Australia may find it tough to outperform opportunities nearer home. Conversely, Chinese, German and Australian investors are better positioned to invest in the United States, Southern Europe and parts of Asia.

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.

High-conviction ideas

Selected investment ideas to complement wealth management clients' portfolios

U.S. cyclicals vs. defensives

Idea initiated
November 26, 2013

Performance

Reference measure
Morgan Stanley Cyclical Index vs. S&P 500 Consumer Staples Index*

Investment horizon
3–12 months

Performance since initiation

Historically, cyclical sectors usually outperform during periods of accelerating GDP growth. Although P/E ratios have risen recently, U.S. cyclical sectors generally still appear attractively valued at present. Cyclical sectors also appear less leveraged — in terms of the ratio of debt to earnings — than defensive stocks. Some cyclicals could benefit from an increase in capital expenditure, and pent-up demand in the United States after the cold winter.

Opportunities in cloud computing

Idea initiated
November 26, 2013

Performance

Reference measure
n/a

Investment horizon
3–12+ months

Performance since initiation: no reference index

The ever-increasing volume of data available on the cloud will increase the demand for analytical software that helps businesses make better data-driven decisions. The cloud also creates a naturally efficient environment for using security software. Overall, software spending may increase at the expense of services spending. Infrastructure-level software and emerging areas (such as software-defined networking) may also take bites out of the hardware budget.

European small- and mid-cap stocks

Idea initiated
September 24, 2013

Performance

Reference measure
Equal-weighted portfolio of STOXX Europe Mid 200 Index and STOXX Europe Small 200 Index vs. cash**

Investment horizon
3–12 months

Performance since initiation

European small- and mid-cap stocks have significantly higher sales exposure to the European market than European large-cap stocks, enabling them to benefit more from European economic recovery. As a result, their earnings growth is expected to be higher than large caps. They also tend to be skewed toward cyclical sectors such as industrials and consumer discretionary, which are likely to gain from the expected economic upturn in particular.

Convertibles

Idea initiated
September 24, 2013

Performance

Reference measure
Barclays U.S. Convertibles Index vs. cash**

Investment horizon
3–12+ months

Performance since initiation

Convertibles have performed well since this idea was initiated, helped by their strong correlation with the equities market. Despite these gains, we still believe that convertibles could be an attractive component of a client's fixed-income exposure. Historically, convertibles also tend to outperform high yield in an environment of accelerating growth and low default rates. They may also provide a way to hedge against a rising-rate environment.

Global industrials

Idea initiated

September 24, 2013

Performance

Reference measure
MSCI World Industrials Index vs. cash**

Investment horizon
3–12 months

Performance since initiation

Developed-market industrials look set to continue to benefit from stronger global economic growth, with pent-up investment demand and the need for capital expenditure maintenance and investment aimed at reducing production costs. Catch-up potential exists in both the United States and Europe. Healthy balance sheets, with net debt to equity falling to cyclical lows, provide another tailwind for capital expenditure, which is still very low in historical terms.

Japanese real estate investment trusts (J-REITs)

Idea initiated

August 27, 2013

Performance

Reference measure
Tokyo Stock Exchange REIT Index vs. cash**

Investment horizon
3–12 months

Performance since initiation

During 2014, deregulation of the labor market (part of the third arrow of Abenomics) may help to boost rental housing markets further. At the same time, we expect further growth in housing investment by high-net-worth individuals keen to minimize tax liabilities ahead of the scheduled inheritance-tax increase. Although short-term weakness is possible, J-REITs' earnings are trending firm and the J-REIT index outperformed the TOPIX index in April.

Divergent trends in Asian economic policy

Idea initiated

May 21, 2013

Performance

Reference measure
Bloomberg JP Morgan Asia Dollar Index vs. JPY/USD spot*

Investment horizon
3–12 months

Performance since initiation

We continue to think that the yen is on a multi-year weakening trend—encouraged by Bank of Japan balance-sheet expansion, a weak current-account position and big outbound foreign direct investment. Although the renminbi has been weakened recently by Chinese economic concerns, our view is still that it will appreciate over the longer term, as will the Korean won and a number of other Asian currencies.

High-conviction ideas key
indicates gain
indicates loss

* Relative-return idea, based on the relative performance of the two measures in U.S. dollars. Stated performance is from given entry date to May 1, 2014.

** Total-return idea where performance is measured by the gain/loss in the performance measure in U.S. dollars. Stated performance is from given entry date to May 1, 2014.

High-conviction ideas may not be suitable for all investors.

Source: Deutsche Asset & Wealth Management Multi-Asset Group. As of May 1, 2014.

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.

Glossary

Here we explain central terms from CIO View

Abenomics refers to the growth-oriented economic policies advocated by Japan's prime minister Shinzō Abe.

The Barclays U.S. Convertibles Index tracks the performance of U.S. convertible bonds.

The Bloomberg JP Morgan Asia Dollar Index tracks the performance of emerging Asia's most actively traded currency pairs valued against the U.S. dollar.

The breakeven rate of an inflation-linked bond represents the average inflation rate that must be exceeded over the remaining life of the bond for an investor to make more of a profit than buying an equivalent conventional bond.

A capital expenditure (capex) is money used by a company to acquire or upgrade physical assets such as property, buildings or equipment.

Carry is a strategy in which an investor sells a certain currency with a relatively low interest rate and buys another, higher-yielding currency.

Correlation is a measure of how closely two variables move together over time. A 1.0 equals perfect correlation. A –1.0 equals total negative correlation.

The European Currency Unit (ECU), defined by a basket of European Community member states, was used as the unit of account of the European Community until 1998, when it was replaced by the euro.

The European Monetary System (EMS) was established in 1979 to prevent large fluctuations among currencies of the European Community's member states. Exchange rates with the ECU were defined and it was agreed to keep their rates within bands of initially +/– 2.25% to the ECU, while Italy was allowed +/– 6%. The central banks committed to cooperation in case of interventions.

Gross domestic product (GDP) is the value of all goods and services produced by a country's economy.

A long position involves buying a security with the expectation that the asset will rise in value.

The Morgan Stanley Cyclical Index tracks the performance of economically sensitive industries' stocks within the U.S. economy.

The MSCI Emerging Markets Index tracks the performance of stocks in select emerging markets.

The MSCI World Index tracks the performance of stocks in select developed markets around the world, including the United States.

The MSCI World Industrials Index tracks the performance of mid- and large-cap industrial stocks in 23 developed countries around the world.

Periphery countries (sometimes referred to as just the periphery) are those that are less developed than the core countries of a specific region.

Price-to-earnings ratio (P/E) ratio divides a company's current share price by its per-share earnings.

Quantitative easing is the introduction of new money into the money supply by a central bank.

The S&P 500 Consumer Staples Index tracks the performance of S&P 500 Index consumer staples companies.

The S&P 500 Index tracks the performance of 500 leading U.S. stocks and is widely considered representative of the U.S. equity market.

Shorting is borrowing then selling a security with the expectation that the security will fall in value. The security can then be purchased and the borrower repaid at a lower price.

Spread refers to the excess yield various bond sectors offer over financial instruments with similar maturities. When spreads widen, yield differences increase among bonds in the two sectors being compared. When spreads narrow, the opposite is true.

The STOXX Europe Mid 200 Index tracks the performance of mid-cap European companies.

The STOXX Europe Small 200 Index tracks the performance of small-cap European companies.

The Tokyo Stock Exchange REIT Index tracks the performance of all real estate investment trusts listed on the Tokyo Stock Exchange (J-REITs).

The Tokyo Stock Price Index (TOPIX) tracks the performance of Japanese stocks.

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 corporate bonds is on yields, not trends in bond prices.
— For corporates and securitized/specialties bonds, the arrows depict the respective option-adjusted spread.
— For bonds not denominated in euros, the illustration depicts the spread in comparison with U.S. Treasuries. For bonds denominated in euros, the illustration depicts the spread in comparison with German Bunds.
— For EM sovereign bonds, the illustration depicts the spread in comparison with U.S. Treasuries.
— Both spread and yield trends influence the bond value. Investors who aim to profit only from spread trends must hedge against changing interest rates.

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