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Equity-market perspectives

Who's afraid of Janet Yellen's first move?

No subject has been discussed more widely within the financial markets during the past twelve months than a possible rate hike by the Fed. The Fed and its expansionary monetary policy have strongly supported the equity-market boom which started in 2009. Would a shift in the policy stance by Fed chair Janet Yellen, by contrast, not automatically weigh on equities?

History shows that the S&P 500 Index has initially reacted with increased volatility in the months around a shift in monetary policy but reported price gains in the months that follow. So no reason to worry?

A more differentiated view with a clear distinction between the drivers of price gains – earnings growth and equity-market valuation – seems appropriate. In the past, corporate-earnings growth rates have often exceeded 15% in the year following the first rate hike since many industrial sectors had just emerged from recession. But the second driver – valuation – has often partially offset this. Valuation measures such as the price-to-earnings (P/E) ratio have usually fallen during this period, due to market participants' concerns that the central bank might impede economic activity with its anti-inflationary rate hikes. Despite this countervailing trend, equity investors have, in sum, tended to record price gains in the six to twelve months following the first Fed hike due to strong earnings growth.

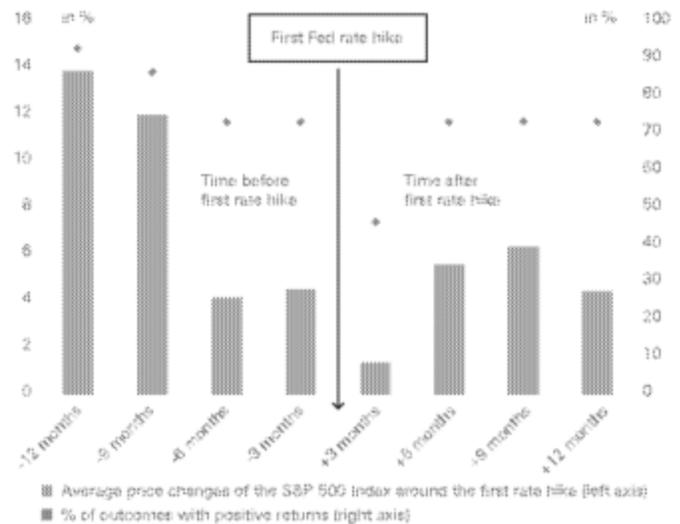
Will history repeat itself? 2015 is somewhat different since the U.S. recovery is no longer in its initial phase. Equity investors should therefore instead be prepared for one-digit yearly growth rates in the S&P 500 Index for the rest of this economic cycle. Most of the valuation measures have already exceeded their historic average values. A slight decline of P/E ratios therefore seems plausible for the years to come.

Due to diverging central-bank policies, equities outside the United States should be less negatively affected during this

cycle than in the past. Even if the Fed starts tightening this year, the central banks of Europe, Japan and China will continue to expand liquidity. Equities remain an attractive investment choice in this environment.

All in all, we are not afraid of Ms. Yellen's decision. Price adjustments may rather be seen as buying opportunities.

S&P 500 Index: reactions to first rate hike



In over 70% of all incidents, the U.S. equity market advanced by an average of 6% in the 6-12 months after the first Fed hike.

Source: FactSet Research Systems Inc., Deutsche Asset & Wealth Management Investment GmbH. Average calculations on the basis of 15 episodes of first rate hikes by the Fed 1959-2004, using the discount rate up to 1971 and the Federal funds rate from 1971 onwards.

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