



## CIO Flash

# Bond-market turmoil – specific or systemic risks?

October 2, 2015

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### While increasing growth fears played a role, other issues also triggered volatility in Q3

While we believe that some degree of revaluation of both equity and bond markets is justified by a slightly deteriorating macroeconomic outlook, we believe the recent correction was overdone as it was also the result of many – but we believe short-term – issues as mentioned above. Short-term issues include contagion to asset classes which would otherwise be unaffected by events, as due to liquidity issues investors may have to sell what they can. The fact that many asset classes year-to-date (YTD) are in negative territory may also make unusual portfolio realignments more likely. We expect the Q3 reporting season to validate our assumptions of a slight, but not major decline in growth levels, if not, we will have to revisit our targets and recommendations. We still count on DM consumers to support growth. As this is mainly a domestic recovery story, EM issues could slow down, but are not likely to stop DM growth. Remember also that low commodity prices not only have victims, but also beneficiaries within EM.

- **Fixed Income:** While pending Fed tightening over the medium term remains a headwind and ECB QE, with its potential expansion, a tailwind, markets are currently focusing on fundamental issues while also being affected by technical issues such as offer/demand, liquidity and portfolio adjustments. With consensus global growth forecasts further declining, markets are pricing risks higher as they fear default risk may increase. We believe the recent sell-off has however led to valuations that will encourage investors to reassess the asset class. We feel most comfortable with U.S. and Euro IG and believe that certain sectors have been overly punished for single-borrower events. Nonetheless, company selection remains highly important and in the short term high supply will likely reduce the extent of spread tightening. The same applies to Euro HY, where we are nearing entry points, as supply and possible fund outflows could first lead to further price pressure. The asset class has already seen the biggest spread widening recently, mainly driven by companies related to EMs and the metals/mining and telecom/cable sectors. Valuations for better-quality names now seem attractive, while the ECB's QE remains supportive. For EM hard-currency debt, we stay cautious on both sovereign and corporate debt as a Fed hike would increase investors' concern about such debtors' ability to service their debt, especially in light of the EM currency depreciations seen this year. Political risks in countries such as Russia, Turkey, Malaysia and Brazil also encourage investors to avoid this asset class, as do weak commodity prices and the slowdown in China. We believe some of these fears are overdone and also do not take full account of structural improvements in some EMs, leading to favorable risk-return profiles for example for IG sovereign bonds. Overall we stay cautious on the sector, which will likely suffer disproportionately high from any market return to a "risk-off" mode.
- **Equities:** Equities have been under pressure for two months. As they may be more liquid than bonds, portfolio readjustments often happen via equities and respective index futures which helps explain why firms which are included in the major indices on average often suffer more than those which are not. We have already adjusted both our earnings forecasts and multiples to the current environment, but we believe that the equity sell-off is overdone. On a 12-month horizon we see potentially double-digit returns for our preferred regions. Developed markets are preferred over emerging markets.
- **Currencies:** Currencies from commodity-exporting countries have probably seen the worst of their decline. Increasing "risk-off" sentiment in the markets could be beneficial to the funding currencies euro and Japanese yen.

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

Deutsche AWM expectations 2015. Forecasts are based on assumptions, estimates, opinions and hypothetical models or analysis which may prove to be incorrect. No assurance can be given that any forecast or target will be achieved; Deutsche AWM Investment GmbH, CIO Office; Deutsche Bank AG; As of October 2, 2015



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