2023 – The Great Re-Allocation

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Executive Summary

– In 2023, investors are faced with the emergence of a new world order in the investment landscape, characterized by unprecedented challenges that require a more granular and selective approach to asset allocation.
– Three key peaks associated with globalization, inflation, and ESG are driving this shift.
– In this note, we focus on the ETF-minded investor and provide insight on how to capitalize on current market shifts and growth drivers.
– We highlight the potential for global beta to return in fixed income, offering investors a range of options to secure attractive yields and return opportunities that were previously only observed in equities.
– In equities, we provide a new perspective on thematic and factor-based allocations, emphasizing the need for granularity and selectivity in the current market environment.
– Overall, this note aims to provide actionable insights for success in the current market environment, helping ETF investors capitalize on an evolving investment landscape.

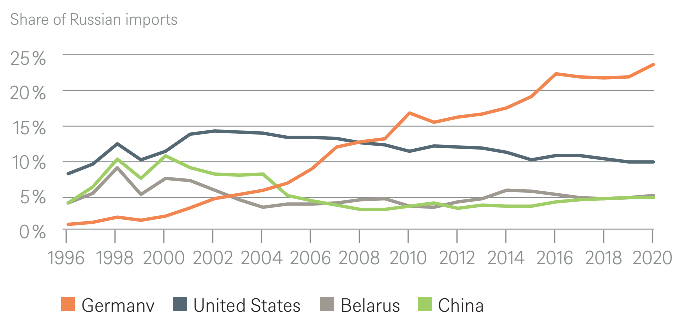
A new world order

Decades of low interest rates, stable growth, low inflation, and limited volatility have contributed to an equilibrium in asset allocation, one most directly characterized by a long-term shift away from low income. While neither a global pandemic nor the onset of war on the European continent disrupted this trend, the knock-on effects of what we coined "ugly inflation" ultimately did. As we enter 2023 investors must confront a new world order, with completely new allocation challenges. In this note we look at "three peaks" that will fundamentally shape market returns and reassess the appropriate passive toolkit against this backdrop.

Peak globalization: From slowbalization to deglobalisation

If the COVID-19 pandemic has not marked the end of the "slowbalisation" era that started after 2008[1], Russia's war in Ukraine certainly has. It has become clear that economic sanctions against a country deeply entangled in global product value chains in effect stopped short of preventing the aggression and had a detrimental impact on the macroeconomic outlook of an entire region. While European leaders are navigating the immediate implications of the collapse of this foreign policy doctrine that has also shaped market sentiment for decades, investors will have to brace for a multi-polar world.

Figure 1: Russian imports by origin: Falling but significant reliance on the west



Source: DWS International GmbH, WITS World Bank 2020.

As the war in Ukraine enters its second year, we see the limits of trade sanctions and the responses from major global economies remain equivocal. In fact, even among Western allies, a politically unified response may come at the cost of more economic fragmentation. The $433bn US Inflation Reduction Act may be a first step towards a widening gap between US and European industries. While the law enables much needed progress on the US green transition[2], subsidies for consumers to buy US assembled electric cars may breach WTO rules and both the European Union and South Korea are considering a challenge. First voices have also called on the EU to pass similar protectionist legislation.[3] This would add to the meagre track record of international organisations including the UN's security council, the World Trade or World Health Organization of preventing the recently increasing global fragmentation. On the European side, the European Union is set to introduce a levy on carbon emissions for carbon-intensive goods produced outside the EU to address carbon leakage. This Carbon Border Adjustment Mechanism will affect non-EU products from carbon-intensive industries such as iron, steel, fertilisers, and energy and eventually producers that are not covered by the EU Emissions Trading Scheme or an equivalent system should bear the same cost.[4]

The ultimate result of such polices may be further de-coupling of global economic cycles. Divergent paths in central bank policy may be a leading indicator of this. While the Fed was able to hike by a total of 4.25% in 2022, the ECB lagged with only 2.5%, which reflects on different regional challenges.

Looking at Emerging Markets, their experience has also been vastly different. The Chinese central bank has loosened its monetary policy amid the absence of a post-lockdown reopening boom, and inflation data in China did not pass 3% in 2022.

[1] See for example the established trade openness index (sum of world exports and imports divided by world GDP) which peaked in 2008.
[2] According to several independent analyses, the law is projected to reduce 2030 U.S. greenhouse gas emissions to 40% below 2005 levels; compared to about 30% without it.
[3] CNBC, Europe shows a united front against Biden's Inflation Reduction Act.
[4] Council of the European Union, Draft regulation of the European Parliament and of the Council establishing a carbon border adjustment mechanism, March 2022.

As the Communist Party started loosening its long-standing Zero-Covid policy, we might see similar demand forces as in other re-opened economies, warranting a more benign outlook for 2023. On the back of this, our CIO View forecasts a double digit returns for Chinese equities. As Europe's Russian oil ban continues to redraw the energy trade map, India is among the beneficiaries. Expected to surpass China in 2023 as the most populous nation, India draws on robust growth, a positive credit cycle and increased capital expenditure. Likewise, the ASEAN region has been an outperformer in 2022, especially Indonesia, helped by higher commodity prices and gradual reopening. Our asset class experts forecast 8.2% return for the Emerging markets in 2023, although investors should anticipate a bumpy ride.

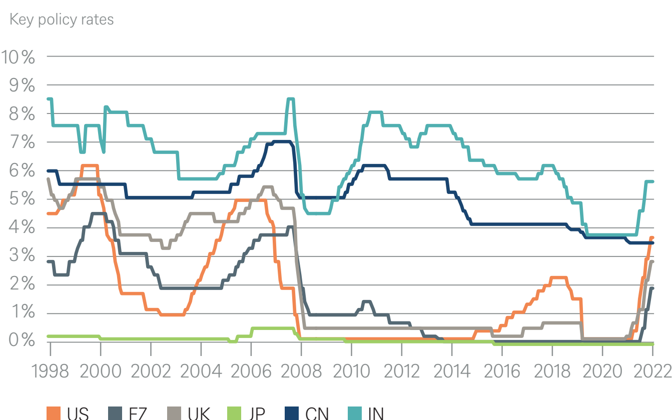
As inflationary concerns begin to dissipate, central banks may start to de-coordinate their actions further. This shift could have significant implications for investors, particularly those with a focus on global, diversified fixed income. In the past, five-year US treasury yields have not correlated strongly with those of other countries. However, more recently, as major central banks had moved to near-zero interest rates and then worked to combat inflation, this relationship has changed. This presents opportunities for those who can effectively navigate these changing conditions. The case of China Government Bonds serves as a reminder how even government bonds can be a main driver of diversification should economic cycles decouple.

Table 1: Rates correlation major economies versus US yields

5Y treasury yield correlations vs US treasuries	EZ	UK	JP	CN	IN
since 2005	17 %	22 %	6 %	-5 %	19 %
last 3Y	68 %	50 %	30 %	20 %	33 %

Source: DWS International GmbH, Bloomberg, as of December 2022. Past performance is not a reliable indicator of future returns

Figure 2: Policy rate paths for major economies



Source: DWS International GmbH, Bloomberg, as of December 2022. Past performance is not a reliable indicator of future returns

Peak inflation: A long way down?

Inflation has been the key indicator to watch, and this might not change much in 2023. In our February 2022 paper on inflation, we distinguished between "good", "bad" and "ugly" inflation. In retrospect, market realities resembled our "ugly" scenario, an alternative risk scenario we sketched out when hopes for "transitory" inflation were still high. Fuelled by the energy crisis and supply chain disruptions, the risk of spiralling inflation expectations called central banks to the scene. They responded strongly, with significant implications for asset valuations, but the last datapoints of 2022 show some early policy successes.

However, taming inflation, which is projected to reach 6.3% in the Eurozone and 3.1% in the US in 2023[5], will be a multi-year challenge due to a range of factors including labour market headwinds, deglobalisation, environmental goals, and limited fiscal discipline.

A demographically-driven tight labour market may help to cushion the impacts of a recession in the short term, but it may put upwards pressure on medium-term inflation. In the coming years, the demographic tidal shift will take full effect and working-age populations will shrink – a shift unlikely to be offset by recoveries in labour force participation or productivity growth.[6]

The previously discussed looming geographic divide also has an inflationary component. Although supply side pressures have eased (see Figure 3), the great reorientation of supply chains is yet to come. And while a comprehensive "on-shoring" is unrealistic, especially for complex supply chains such as semiconductors or battery technologies, the US's "friend-shoring" could become the dominant approach.[7] While desirable, the trend to make supply chains more resilient and to reduce dependencies comes at the cost of efficiency and weakens the supply side. According to a recent OECD study, a shift to a "localised regime" is estimated to decrease global real GDP by more than 5% relative to a post-COVID-19 baseline and makes economies more – not less – vulnerable to shocks. This underscores the gains from international specialisation that have been realised over the past decades.[8]

It is also worth noting that future inflation has a nexus with climate policy. Higher interest rates in the short term may discourage investments in the low carbon transition. Central banks have thus far failed to fully recognize the consequences of this for net-zero goals. Some have even suggested that current inflationary dynamics are largely due to the energy transition, a narrative known as greenflation. While accelerating the energy transition will be crucial for controlling fossilflation (the role that volatile oil and gas prices play on inflation) and contributing to longer-term price stability, it is likely to involve one-off costs that may be high. Isabel Schnabel, a

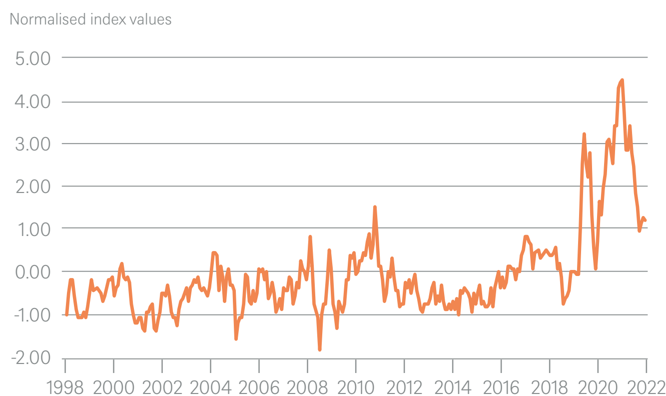
[5] See Eurosystem staff macroeconomic projections and FOMC PCE inflation rate forecast, as of December 2022.

[6] The phenomenon of "lost workers" is a global one. In the US today more than three million fewer Americans participate in the labor force compared to February of 2020. Labor force participation rate is 62.3%, down from 63.3% in February 2020, as of December 2022.

[7] See US Treasury Secretary Janet Yellen on the next steps for Russia sanctions and 'friend-shoring' supply chains.

[8] Here a localized regime is characterized by: (1) tariffs of 25%; (2) subsidies in the agriculture and manufacturing sectors; (3) lowering of import elasticities of firms. See also Shocks, risks and global value chains: insights from the OECD METRO model.

Figure 3: Global Supply Chain Pressure Index



Source: Bloomberg; index is published by the Federal Reserve Bank of New York. Normalized such that a zero indicates the index is at its average value and positive/negative values indicate standard deviations above/below the average value.

member of the executive board of the ECB, has even introduced the concept of climateflation, referring to inflationary pressures resulting from the direct effects of climate change such as droughts leading to higher produce prices.[9] [10] Successful climate transition is key to manage future inflation, as the uncertain costs of man-made natural catastrophes may be more difficult to price into monetary and fiscal policy than the (comparably) short-term inflation caused by the transition to a more sustainable economy. Already today investors have a diverse toolkit to manage their exposure to fossilflation both in equities and fixed income.

Figure 4: The climate-inflation nexus

Fossilflation (1970-2050)	Greenflation (2020-2050)	Climateflation (2010-)
Scarce supply of fossil fuel have an influence of inflation	Strong demand for substitutes to fossil fuels drives innovation but as the share of green fuels increase, this leads to inflation	Natural catastrophes caused by climate change increase the cost of insurance for housing and infrastructure and increases uncertainties around food supply, thereby contributing to inflation

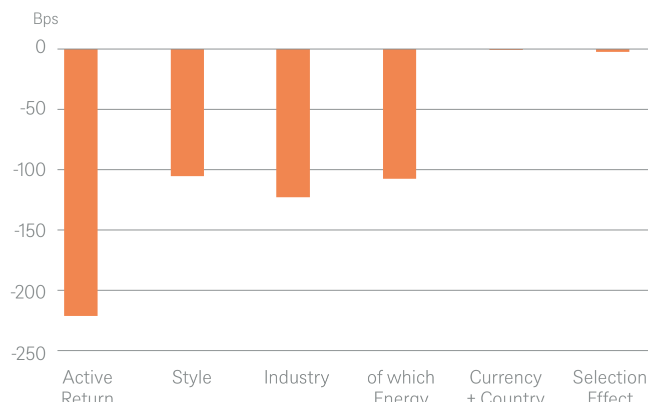
Source: DWS International GmbH

Peak ESG: Visible in the distance?

In a recent analysis of the performance of popular equity ESG strategies we concluded that careful ESG index construction may yield index design results where opportunity costs of an ESG methodology versus a broad index are immaterial.[11] Some might say that the 2022 experience proves that such claims were premature – but we would disagree.

Like many past moments of crisis, the Russia-Ukraine war marked a watershed moment for sector performance. Energy stocks experienced high returns, particularly when oil prices spiked, and aerospace and defence stocks rallied. On a closer look, analysis for High Exclusion ESG indices reveals that the exclusion of fossil-fuel stocks and weapons-related companies explained about half of the recent underperformance (see industry component in Figure 5). We also previously asserted that high-ESG-rated companies have tended to be associated with quality stocks and the lack of exposure to the strongly performing value factor played an important role. The other significant driver relates to controversies exclusions. Such norms-based exclusions result in four of the top ten MSCI World Index constituents to be disqualified. Both these exclusion layers are essential for any credible ESG strategy. ESG indices cannot circumvent these realities, but conscious index design is key to manage wider portfolio effects, for an example via a "smart capping" methodology.

Figure 5: 2022 return attribution MSCI World ESG vs. MSCI World



Source: Bloomberg, return attribution based on ETF holdings, MSCI World ESG refers to an ETF tracking the MSCI World Low Carbon SRI Leaders Index, 31/12/21 to 28/12/22. Based on Bloomberg's MAC3 Global Equity risk model. Past performance is not a reliable indicator of future returns.

The last three years have been a stark reminder of the importance of considering ESG strategies in investment decisions. While idiosyncratic drivers, such as shocks to performance from the pandemic and Russia's war on Ukraine, investors stand to benefit with robust environmental, social, and governance allocations in the face of crisis.[12] With the urgent need to decarbonize the economy, lower-carbon portfolios will be less exposed to the costs of carbon and are likely to show resilience in this aspect as well. Overall, prioritizing sustainability and cultivating strong ties with all stakeholders may also be vital in times of economic uncertainty.

Despite mixed performance recently, ESG investing has reached new heights in public awareness, with an increasing number of individuals and organizations recognizing the importance of considering these factors in their investment decisions. A look at UCITS ETF flows clearly shows that investors continue to have a positive long-term view on ESG assets. In fact, ESG products attracted the bulk of flows in

[9] Forget greenflation, central banks need to tackle fossilflation.
[10] Isabel Schnabel: A new age of energy inflation - climateflation, fossilflation and greenflation (bis.org).
[11] ESG outperformance: Not about one factor, DWS Investment Insights 2021.
[12] See also MSCI Research - Quality in Times of Crisis.

Europe with 64% in 2022[13], bringing total assets in ESG UCITS products to over €250bn. Continued overall momentum also contributed to a new plethora of ESG strategies being launched across asset classes. Investors have a full product suite at their disposal for ESG integration. Especially in fixed income, ESG products have become more comprehensive, for example with the rise of robust sovereign ESG data or Green Bond datasets, that allow for ESG considerations without opportunity costs.[14]

Looking ahead 2023 may be the year of harmonisation. Increasing regulatory oversight on reporting but also a growing asset base tracking regulated benchmarks such as Paris-Aligned or Climate Transition Benchmarks provide investors with more transparency. With respect to reporting, fund managers will be required to publish standardised information on sustainability indicators and how products adhere to regulation. In this space, clarification from the EU or the ESMA on the application of article 8 and article 9 of the Sustainable Finance Disclosure Regulation (SFDR) is expected to standardise further. Yet, we can also expect important changes and additions to regulatory guidance on benchmarks. Changes to the regulatory framework in 2023 could include enhancements to the PAB-CTB regulation regarding forward-looking data on fossil fuels, such as extended exclusion requirements for companies with coal expansion plans. The regulatory focus on decarbonization has also spilled over to existing ESG benchmarks, where decarbonization targets are included in more and more methodologies. Moreover, there seems to be a clear trend to incorporate more and also stricter filters in what were previously more inclusive ESG methodologies as a recent consultation by MSCI on their ESG Screened index range has shown.[15] However the growing active share of ESG indices versus their benchmarks is also reflective of the current polarization around ESG between adopters and sceptics. One may question as to whether this polarisation will make it easy for the many investors who are yet to adopt ESG improvement and climate objectives, raising the question as to whether the adoption of ESG will further grow, especially beyond Europe. In Europe, it is easy to see that while a new apex of ESG investment has been attained in terms of public cognizance, the summit of implementation and integration remains distant.

The great reallocation is already underway

The emergence of these distinct "peaks" within the investment landscape have had and will continue to have a significant impact on financial markets. As such, it is imperative for investors to reevaluate their market perspectives and investment strategies. In particular, a traditional approach to global beta within the equity markets is becoming increasingly challenged and a more granular, selective allocation may prove to be more advantageous. On the other hand, fixed income beta, which had previously been in negative territory, has seen a resurgence in popularity and is now more universally attractive. In this report, we will delve deeper into the implications of this new market regime for passive investors and discuss various strategies that can be adopted to capitalize on these dynamic shifts within the financial markets.

Fixed income: The great comeback of an asset class

The resurgence of fixed income as a viable investment option has been a long time in the making. After a tumultuous first half of 2022 and rapid increases in global interest rates, the fixed income market is poised for a comeback in 2023. As investors increasingly look for opportunities with higher returns and lower risks than in previous years, a reallocation towards fixed income has begun to take place, as evidenced by the over $250bn inflow into fixed income ETFs globally in 2022, the third-strongest year on record.

Figure 6: Fixed income opportunities overview

	Treasuries	IG	HY
USD	– US curve has gotten ahead of itself and may offer interesting entry points to lock in the rate levels for the longer-term – Peaks in longer-term Treasury yields are in sight	– Attractive carry on top as a source of running income – Despite recent spread compressions, current spread levels remain elevated when compared to past decades – Fundamentals remain sound for now	– Spreads have increased but so has the risk of recession – Overall lower rating quality vs. EUR; higher exposure to CCC's may be challenging in times of recession – Inflationary pressures still widespread and may put pressure on fundamentals
EUR	– Euro rates likely to stay in a vulnerable spot during the next months – Risks to the economic outlook are rather to the downside – Moderate recovery of the Euro against the U.S. dollar	– Current spread levels have been tested only on few occasions during the past decade – Sound fundamentals, attractive carry – Underperformed US IG, points to pricing of recession ahead	– Opportunities after repricing of the market, more recession risk is priced – Higher quality vs. US, historically lower default rates

Source: DWS International GmbH, as of December 2022

[13] ETF Book,as of November 2022.
[14] A comparison of otherwise identically constructed ESG and non-ESG index reveals that yield drag is typically in single digit basis point area in Government and IG Corporate Bonds. We note somewhat higher yield drag in high yield, albeit in absolute terms only.
[15] MSCI, Index announcements – Consultation on Potential Enhancements to MSCI ESG Screened Indexes.

Investors do not need to go far

For now, short-term rates proved to be the most popular category, and this is no surprise. The current US hiking cycle is on track to deliver a 500-basis point increase in just one year, compared to the average increase of 300 basis points over 15 months in previous cycles. Also in Europe where short-term rates will edge above 3% the market offers opportunities: steady income generation with low volatility. This provides investors with a good low volatility alternative while they watch developments in 2023.

However, the steep rise in interest rates should also be a reminder for investors to utilize the versatility of ETFs in managing duration in their portfolios. Figure 7 illustrates the monthly flows in UCITS fixed income ETFs, as well as the incremental change in duration exposure. While generally positive flows demonstrate the increasing popularity of ETFs as an investment vehicle, the limited variability in duration management suggest investor hesitancy embrace the full fixed income ETF toolkit.

Moving forward, it may be wise for investors to take advantage of the tools at their disposal, including short-duration and maturity band ETFs, which offer precise control over interest rate risk. These funds are also large and liquid enough to allow for efficient rotation at minimal cost, which will be crucial in the event of a return to steepness in the yield curve.

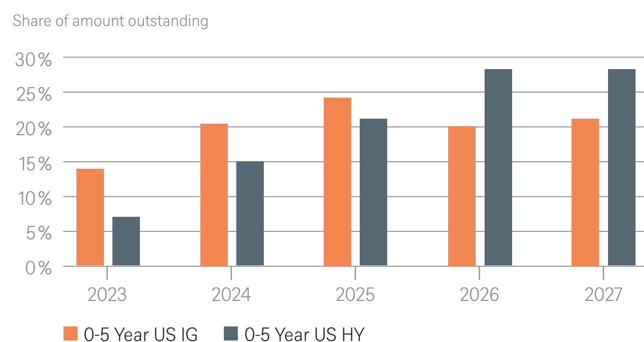
Investment opportunities for those with a strategic perspective can also be found in longer-term interest rates. The yield curve in the United States is approaching its peak, providing an opportunity for investors to secure current rates for extended periods. In the Eurozone, our outlook for interest rates is more uncertain, as economic projections carry downside risks and the ECB maintains a cautious stance on inflation. As global yield curves diverge, a more nuanced approach may be necessary for investors, including the consideration of individual countries' yield curves.

Rates plus spreads equals income

Credit spreads also regained their dynamic in 2022. As we enter 2023 spreads remain significantly wider than in previous years and contribute 50 to 75bps to investment grade yield changes compared to last year. With over 4% yield, Euro corporate bonds are offering levels not seen in over a decade. Under our base case of a moderate recession, this provides opportunities for yield and diversification seeking investors. What's more is that carry will also support the resilience of fixed income, even if credit may come under pressure due to more stagnant economic conditions. Furthermore, downgrades and defaults may be less of an issue than in previous crisis as most issuers have extended their debt maturities and shifted their financing needs into 2024 and beyond.

Figure 8: Corporate bond maturities over the next 5 years

Share of amount outstanding

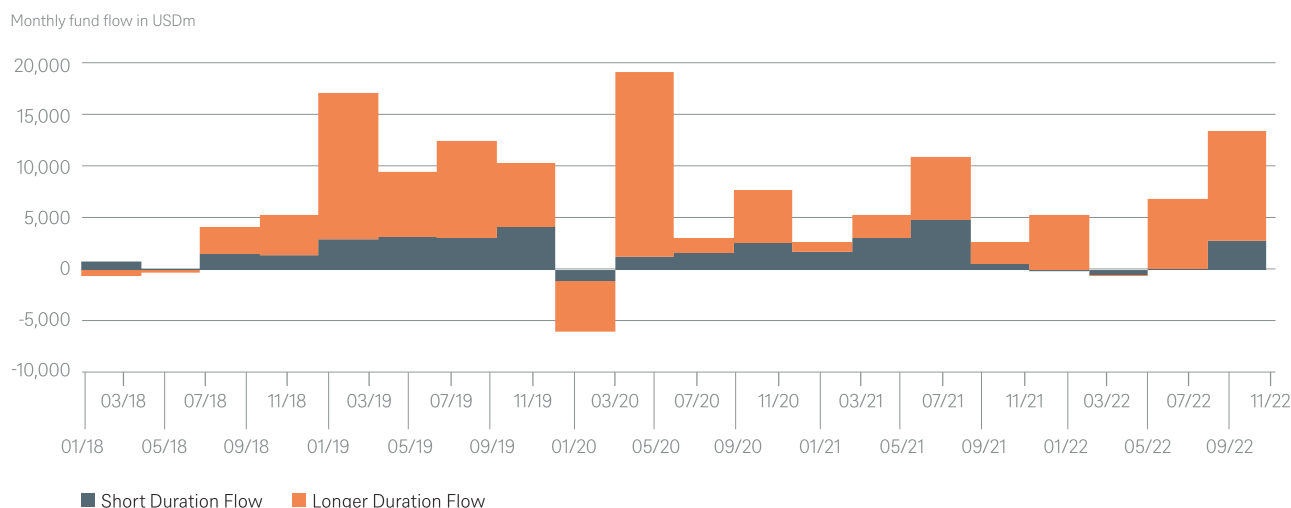


Source: DWS International GmbH, based on ICE BofA 0-5 Year US Corporate Index and ICE BofA 0-5 Year US High Yield Constrained Index, as of December 2022

The same reasoning applies to high yield bonds. With US high yield default rates above 7% in 2020 and 2021, it's possible that the asset class may have already benefited from defaults brought forward by the COVID-19 shock. And while it's difficult to predict the future with certainty, Fitch Ratings

Figure 7: Allocation to short and longer duration UCITS ETFs

Monthly fund flow in USDm



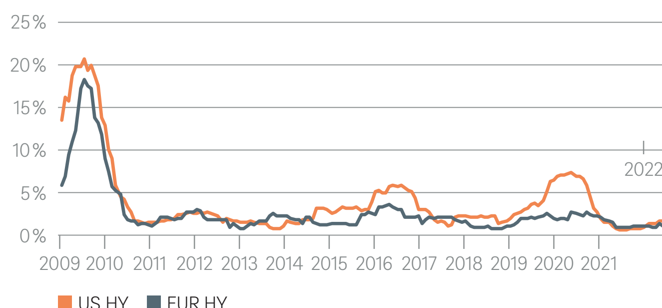
Source: DWS International GmbH, flow data based on fixed income UCITS ETFs with more than EUR200m in AUM, flows are sourced via Bloomberg, shorter duration refers to ETFs with modified duration <3. As of December 2022

[16] Fitch Ratings, 2023 U.S. High Yield Default Forecast.

forecasts the US high yield default rate to remain below historical averages 2.5%-3.5%[16]. More than in investment grade, investors may however want to consider regional differences, European high yield typically features a higher quality issuer base and lower historic default rates as a result. Also, recent spread developments imply that a greater economic slowdown may already be priced in EUR high yield.

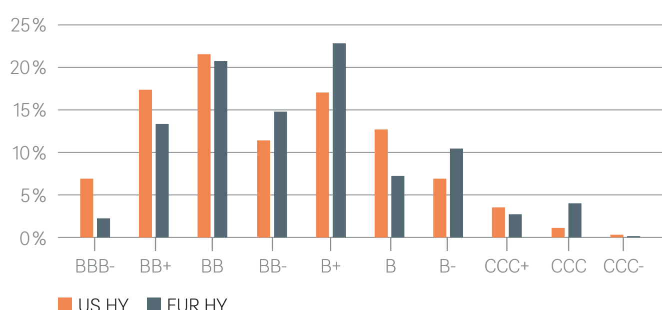
When it comes to implementation, high yield ETFs are a powerful toolkit. Indices in the high yield space show high levels of diversification – a typical liquid US high yield index, for example, features over 800 single bonds from over 300 issuers. This avoids concentration risk and overcomes management concern. At the same time, frequent rebalancing and the enforcement of minimum ratings bounds is key to avoiding exposure to companies drifting towards corporate default. Another particular advantage of ETFs in the high yield segment is their liquidity, which often rivals that of the most actively traded individual bonds and far exceeds that of the average bond in the high yield space. This makes ETFs an attractive "liquid high yield" option and a key reason why they are referred to as a price finding tool.[17]

Figure 9: EUR and USD high yield default rates



Source: Bloomberg, ICE. Trailing-12-Month corporate high yield par default rates (par value of LTM defaulted debt/ par value of debt outstanding). Forecasts are not a reliable indicator of future returns. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.

Figure 10: Rating distribution for EUR and USD high yield



Source: DWS International GmbH, rating distribution for EUR High Yield (iBoxx EUR Liquid High Yield Index) and USD High Yield (Bloomberg US High Yield Very Liquid Index ex 144a). As of January 2023.

The "real" challenge remains

Despite this return to popularity, bond investors are still facing challenges from a real interest rate perspective. As hiking cycles top out, inflation once again becomes the key risk for investor portfolios. Bonds offer fixed nominal payments, but their purchasing power ultimately depends on the evolution of the general price level. A fundamental difference to the equity side, where dividends represent a company's residual income in real terms, which provides some indirect inflation protection. Hence, although appealing, investors should not oversimplify the comparison between earnings and bond yields.[18]

Figure 11: Earnings yields vs fixed income yield

Source: Bloomberg, DWS International GmbH, as of January 2023

To navigate real income, investors may also want to reconsider inflation linked bonds (ILB), despite the bumpy ride this otherwise tame asset class has experienced recently. In 2021 ILBs were among the best performing fixed income category as inflation expectations rose but central banks stuck to a transitory narrative. This was followed by a reversal in 2022 also due to higher duration of ILBs compared to their nominal counterparts.

The upshot of these developments is that for the first time in years investors can achieve positive real yields again – if market implied inflation expectations materialise. This time investors however may find the most merit in ILBs diversification capability: As markets continue to price one of the quickest declines in inflation on record, inflation-linking comes at a reasonable cost. At the same time, the longer duration of ILBs is appealing should inflation dissipate, and rates fall sooner. Irrespective of nominal or real fixed income, however, the cost of remaining on the side-lines have increased significantly and efficient cash allocation is one route to substantially improve returns.

Equities: The great dispersion

The current market environment may offer investors the potential to attain equity-like returns with lower risk by investing in fixed income assets. At the same time, the rate environment has put the key pockets of past equity market growth under pressure. To identify a suitable equity allocation, investors may want to borrow two fixed income principles:

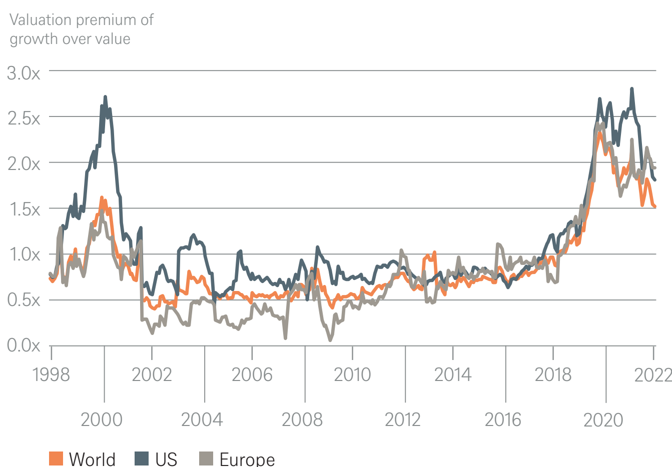
[17] See also ETF Trading in Volatile Times (DWS Investment Insights 2020).
[18] DWS Chart of the Week – How not to interpret corporate bond yield.

Focusing on current income and manage risk by diversifying the portfolio. This inevitably requires more granular market access tools, such as sectors, factors, regions, or themes, to tune the portfolio to drivers of growth and avoid undesirable equity market risks.

Value is back, but so is dividend

Investors already got a taste of this new environment in the first half of 2022 when value stocks outperformed growth stocks. The MSCI World Momentum reveals this shift, with the energy sector experiencing its highest weight in decades and information technology its lowest. Index valuations have also come down to a more modest 14x P/E at the end of December 2022, underlining the factor rotation. Despite these developments, it is worth noting that valuations remain stretched when put into historical perspective and mean-reversion still far away.

Figure 12: Relative valuation growth vs. value



Source: Bloomberg, DWS International GmbH calculations, average valuation premium based on P/E, P/B and P/CF and dividend yield. As of Demceber 2022.

The recent resurgence of value is largely attributable to the recovery of sectors such as energy, materials, and financials. To avoid "value traps" in sectors that may face difficulties in a recessionary economic climate, investors may consider screening for income generation. Investing in dividend paying stocks may prove to be one route to protect portfolios while still adding value factor and sector exposure. The MSCI World High Dividend Index ended the year 2022 nearly flat adding to the track record of many dividend indices in outperforming broad market benchmarks during periods of market volatility and recession. At the core of this lies a comprehensive quality screening that lends itself to a rules-based passive implementation. Key criteria include positive returns on equity, low earnings variability, and manageable debt-to-equity ratios. Investors may also find dividend income attractive to redeploy capital in an era where there are powerful alternatives to equities.

A need for granularity in regional and sectoral allocation

Besides a dedicated factor solution, investors may achieve similar results by careful selection of regional equity markets. It is well established that Europe, Japan and more recently China offer higher dividend yields than the United States. Aided by current valuation discounts compared to the US in Japan (-35%), Europe (-18%), and China (-15%) the return capabilities are even more considerable. In fact, looking at valuations there may be even more need for granularity with Indonesia, Taiwan and South Korea at attractive levels. With strong earnings growth and lower valuations, these markets may offer solid returns for long-term investors, particularly on the back of more stable Chinese growth, or a pivot to a more dovish Fed, which may support currencies and equities alike.

Besides regional dispersion, similar opportunities might emerge from sectoral investing. As witnessed in the past, crisis episodes disrupt business models. Three dominant sectors of the last years – communication services, consumer discretionary, and information technology – have been hit particularly hard. In 2023 the drying up of cash for acquisitions or R&D may continue to pose challenges. Sector rotation remains a crucial strategy for investors looking to navigate these uncertain times. As Figure 14 shows performance dispersion spiked in 2022 and presented a much bigger opportunity to sector rotation than COVID-19 pandemic.

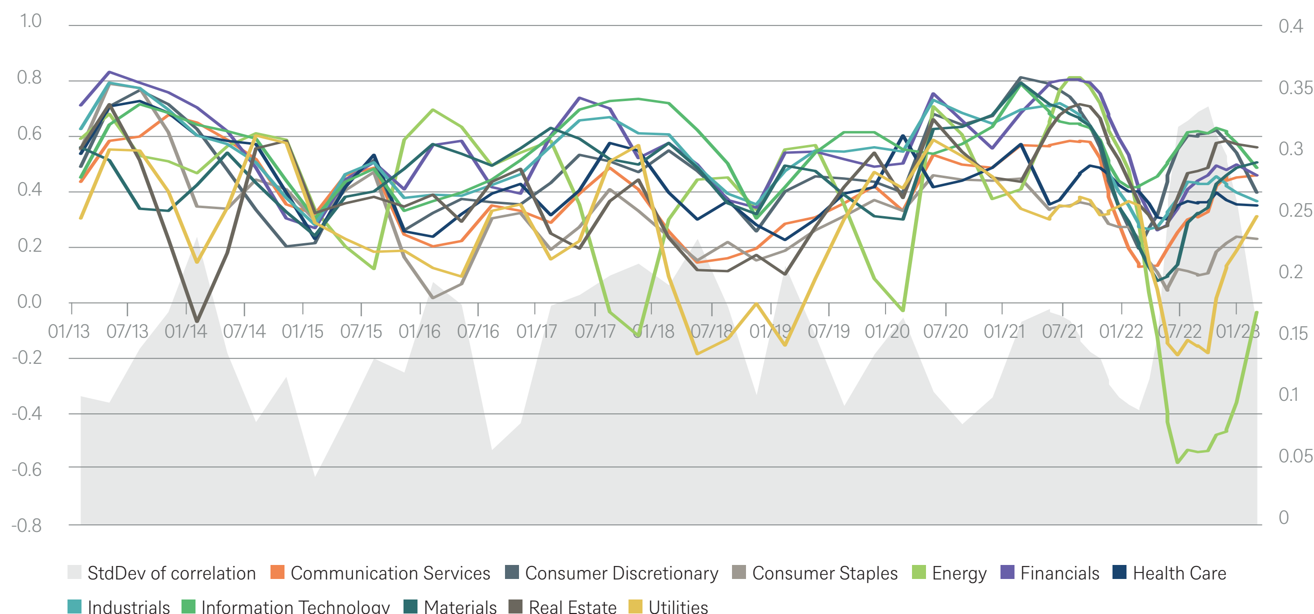
In line with the income orientated perspective, we have suggested previously, investors may want to assess the pricing power within industries to identify sectors that appear more resilient to both economic downturns as well as inflationary environments. The stability of sector index profitability is illustrated in Figure 15 and is one way study this.

Figure 13: Developed and Emerging Market Regional valuation

	World	USA	Europe	Japan	China	India	Indonesia	Taiwan
Fwd P/E	15.0	17.1	11.8	12.0	10.4	21.4	13.4	12.0
Percentile (20Y history)	53%	68%	24%	8%	33%	90%	41%	16%
Percentile (20Y history) 1Y ago	93%	96%	85%	51%	61%	97%	76%	83%
Dividend yield	2.2%	1.7%	3.3%	2.6%	2.2%	1.3%	2.9%	4.7%

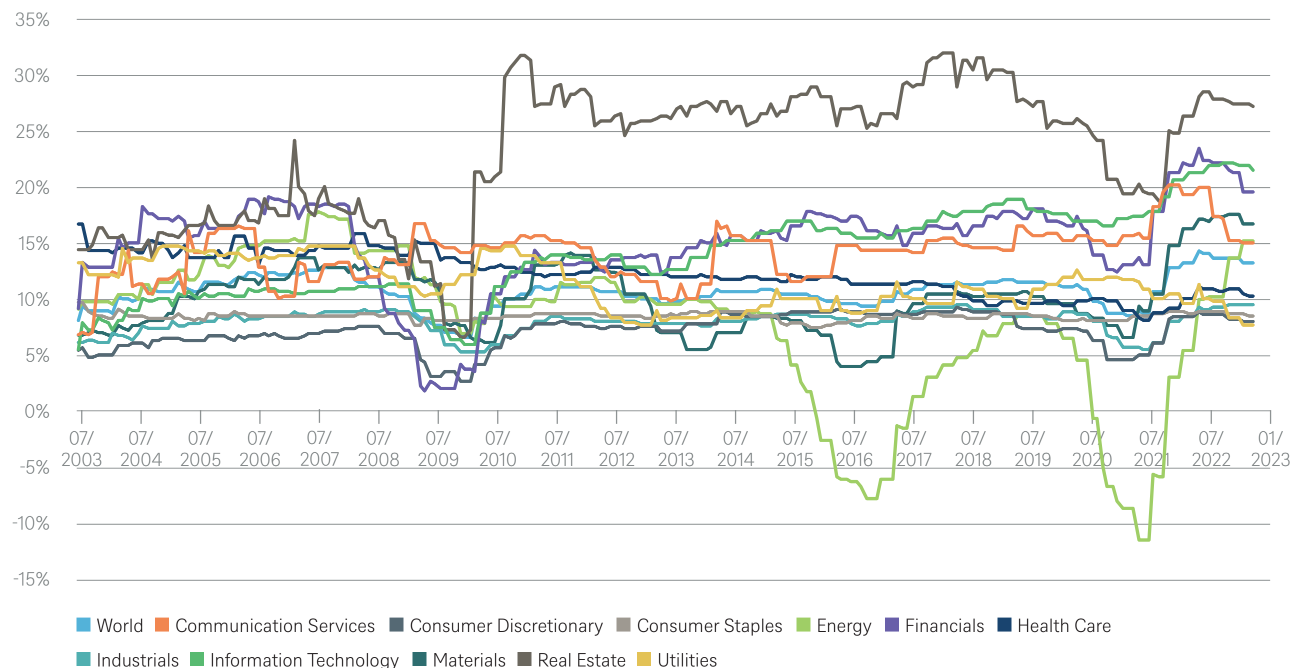
Source: DWS International GmbH, based on single country MSCI indices, as of January 2023

Figure 14: MSCI World sector rolling correlation vs. MSCI World



Source: DWS International GmbH, Bloomberg, based on rolling 1Y correlation of MSCI World sectors indices, versus MSCI World index, based on 20Y history from Jan 2013 to Jan 2023.

Figure 15: Tracking MSCI World sector operating margins



	World	Energy	Materials	Industrials	Consumer Discre-tionary	Consumer Staples	Health Care	Financials	Real Estate	Information Technology	Commu-nication Services	Utilities
Operating Margin (%)	13.8	15.8	17.0	10.3	8.6	8.7	11.0	20.9	27.4	21.8	15.3	9.2
Std. Operating Margin (%)	5.1	23.3	10.8	3.8	5.1	0.9	6.2	16.8	16.5	13.6	8.0	7.6
Operating Margin still above 10Y average	Yes	Yes	Yes	Yes	Yes	No	No	Yes	Yes	Yes	Yes	No

Source: Bloomberg, MSCI, DWS International GmbH calculations, based on monthly data since January 2003. Operating margin is a profitability ratio that measures profit per sales after considering variable costs of production, but before deducting interest expenses or taxes. Hence it reflects on pricing power, direct cost management and overhead cost management. As of January 2023

New routes to finding pockets of growth

With established regional or sectoral growth drivers showing signs of abating, growth-oriented investors may also want to turn to alternatives. A particularly popular approach has been the introduction of thematic investing solutions into client portfolios, to capture cross- or sub-sector themes that demonstrate promise. This investment trend was propelled by the COVID-19 pandemic and saw another strong year in 2022: Over 50 new ETFs launched in Europe and continued investor allocation led to a sizeable overall equity ETF flow share of 7%.

Investment strategies that leverage structural trends and cutting-edge technologies have proven to be particularly attractive to investors. By focusing on stocks that are most closely aligned with a particular theme, investors can gain a more nuanced understanding of a sector and identify opportunities for outperformance. One prime example is the healthcare sector, which has demonstrated strong performance in recent years. However, a closer examination of the underlying drivers reveals that certain key technologies, such as mRNA research, have been particularly impactful. Not only did this technology enable the development of Covid vaccines, but it also has a wide range of potential applications beyond the pandemic and is poised for strong growth in the future. Investors have sought to gain exposure to some of the leaders of research in the field of genomics – the science of sequencing the human genome, editing it, and developing therapies based on genes. If successful, these techniques have the possibility to fundamentally disrupt healthcare. Based on industry forecasts this sub-set of the healthcare sector can enjoy growth that far outpaces the broader sector.

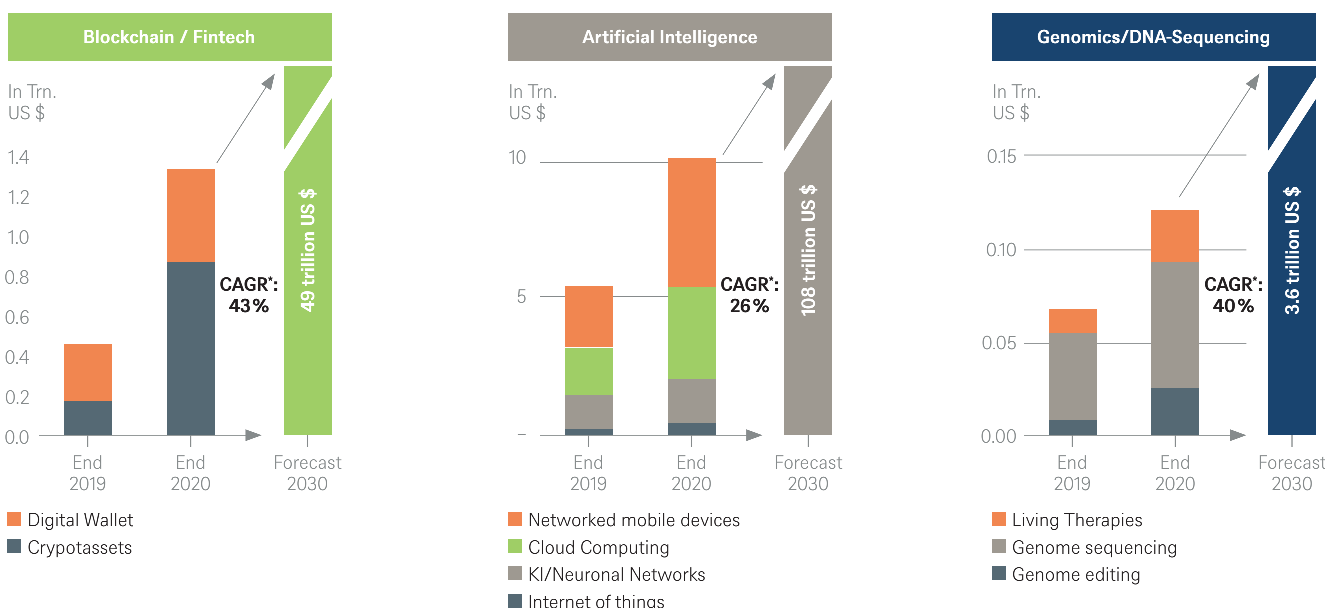
However, while the above example might appear as a mere subsector, the key virtue of thematic investing is the fact that it is not bound by sector classification constraints. Established index solutions in the space of future mobility or artificial intelligence, for example, build diversified and relevance-scored indices across thematic value chains, which nowadays spans multiple sectors.

Implications for passive allocators in 2023: The end of global beta?

Over the last decade, investors were well advised to deviate from the traditional 60/40 approach given low yields in fixed income and generous returns in many equity segments. In 2023, investors should consider returning to the roots. But selection is more than ever key: The disruptive tendencies of deglobalisation are starting to weigh on global beta in equities. As countries move from "off-shoring" to "friend-shoring", growth becomes more localised in specific regions or sectors, rather than globally.

In turn, investors may want to pay more attention to their regional equity allocations to take advantage of relative undervaluation as we see now in Europe compared to the US. From a factor perspective, value but especially dividend show promise. Going forward, a clouded economic outlook, higher interest rates and lingering inflation means that allocation potentials are not as broad and unambiguous as in the past years, but pockets of opportunity also arise in high growth and inflation-beneficiary niches. To tap this dispersion, investors should embrace the passive toolkit in its full extent. The dictum that "a rising tide lifts all boats" no longer applies – granularity and selectivity are paramount in the current market landscape.

Figure 16: Thematic "pockets of growth"



Source: ARK Invest, as of August 2022. * CAGR (Compound Annual Growth Rate) = average annual growth rate. Forecasts are based on assumptions, estimates, opinions and hypothetical models or analyses that may prove to be inaccurate or incorrect

Equally, global beta may well be back in fixed income. After a period of low yields and high correlation with equity, income is back in fixed income and by extension also in the 60/40 portfolio. Investors have some flexibility as they are not required to venture too far to reap yields. Tactically, longer-term Treasury bonds may still present opportunities, particularly in the United States where investors can secure attractive rates. However, it's important to remember that not all investments are created equal, and investors must take into account the impact of sustained high inflation on real yields.

The risk-averse investor may hence consider a broad quality-tilted European equity allocation paired with US treasuries as well as shorter-duration corporate bond exposures across currencies. A satellite allocation to selected themes and emerging market equities can be interesting for those with a more upbeat economic outlook alongside EUR high yield bonds who are relatively attractive given spread levels and offer more robust fundamentals compared to their US counterpart. Regardless of the specific investment strategy, it is crucial for investors to act in 2023, as the opportunity costs are higher than ever, and sitting on the side-lines is not a viable option. Utilizing passive investment tools can be especially beneficial this year, as it allows investors to stay nimble and respond to a market that is likely to remain volatile.

Related Readings

- Deutsche Bank Research (2022). Investing during Stagflation: What happened in the 1970s.
- DWS (2022). CIO View Outlook 2023. DWS Research Institute.
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- ECB (2022). A new age of energy inflation: climateflation, fossilflation and greenflation.
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Authors

Olivier Souliac, Team Lead Product Specialist – Passive
olivier.souliac@dws.com
Lukas Ahnert, Senior Product Specialist – Passive
lukas.ahnert@dws.com
Frederike Bauer, Product Specialists – Passive
frederike.bauer@dws.com

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