Deutsche Bank
Research

Assets that haven't moved yet

#PositiveImpact

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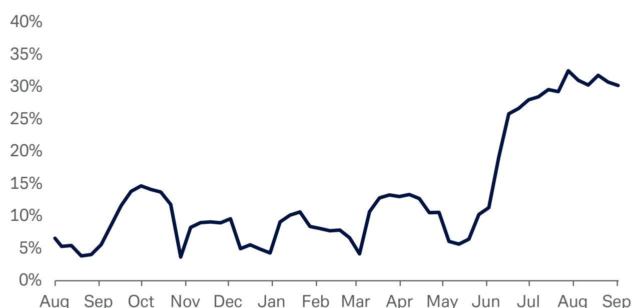
Our big theme coming out of August seems simple enough: Many rate-sensitive assets that fell last year are yet to recover even though a Fed pause has become increasingly likely. To us, investors who sold off these assets last year are nervous about moving back in. We are conscious that the drops last year occurred very quickly. If that speed is mirrored in any post-pause upside, the rally in these assets could be sharp.

For equities more broadly, many investors predict a sell-off in the back end of 2023. Yet, over the last 95 years for which we have data, the S&P 500 has risen 15-20% in the YTD August 11 times. The average return for the rest of the year is 8% and only once has it been negative.

Bear in mind that a lot of investors have missed the rally this year. Hedge funds returned 11% in the 7 months to July, well below the 20% of the S&P 500. We expect some to attempt to catch up by leveraging long equity positions and also buying names that have not rallied this year.

The recent economic developments in China have thrown a light on interdependencies with other parts of the world economy. The following chart shows that in the last two months, European stocks (the Stoxx 600) have moved in an increasingly-similar way to Chinese stocks (CSI 300). Interlinkages are notoriously hard to assess but investors are becoming increasingly aware of the many supply chains connections between Europe and China. Thus, the economic fates of both are connected.

Stoxx 600 and CSI 300, 52w correlation



Source: Deutsche Bank

We are still optimistic about Chinese markets for the rest of the year. Markets and the economy can be less correlated than investors currently price in. Political tensions with the US have eased compared with early 2023. Yet sentiment remains low on recent economic developments. This has the hallmarks of a turning point and with inflation so low, both corporate earnings and reports that bigger stimulus may be in the works could be market catalysts.

In fixed income, many traders are heavily long short-term rates but not the long end of the curve. We see this as sensible on a relative value basis even though we note that commercial hedgers have been buying the long end and history shows they can be early to changing trends. Across the curve, the recent increase in treasury supply has helped keep yields high.

Despite our overall tone of optimism, we remain concerned about certain segments of the market. We are conscious that rate rises in this cycle may take longer to flow through to the real economy than they have in the past. That means we expect a lag in the impact on highly-indebted companies and, particularly, the high-yield debt market. But we see a painful impact as inevitable over the coming 18 months.

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