DWS

Market update | Liquid real assets

As of January 31, 2024

Macroeconomic indicators

Broad themes

_ Global equity markets started the new year by handing back some of December's gains, and after some recovery, sold off again as central bank figures pushed back on rate cuts starting in spring. However, after some encouraging economic data and (mostly) solid earnings results from the tech and financial sectors, markets surged ahead, regaining the lost ground and ending January with mild gains. The recovery was all the more impressive given that 10-year sovereign yields were largely rising over the same period, though they did ease into the month's end. Aside from increasing oil prices (and shipping costs), investors also shrugged off the rising tensions in the Middle East that seemed to spread by the day during January.

_ All Real Assets classes underperformed the broader equity markets in January, with only Commodities and TIPS rising for the month, with the former led by gains in Livestock and Energy. Global Real Estate securities and Global Infrastructure securities suffered losses, with downward movements in stocks from the Asia Pacific region weighing on both. Natural Resource Equities were the overall laggards, dragged down by losses in Metals & Mining names and Agriculture equities.

_ The U.S. Federal Reserve (Fed), European Central Bank (ECB), and Bank of England (BOE) all opted to hold policy rates steady in January (the BOE meeting was technically Feb 1) and all pushed back on rate cuts occurring in the spring, with the summer showing likely potential if inflation continues to slow. The pace of economic growth continues to vary by region, with China's economy growing by 5.2% in 4Q 23 (though there are clearly issues in their property markets), the U.S. posting better-than-expected growth at 3.3%, and the euro zone registering as flat. Inflation showed mixed signals during the month, with the Consumer Price Index (CPI) in the U.S. and the UK coming in hotter than expected during December, and while the euro zone was in line with expectations, China is suffering at the opposite end of the spectrum with a case of deflation.

_ In geopolitical events, the U.S. avoided a government shutdown with another short-term spending bill but barely kicked the can down the road as the bill provided funding only until March 1. Elsewhere, the situation in the Middle East continues to escalate, with Yemen-based Houthi rebels attacking merchant vessels in the Red Sea on an almost daily basis, while the U.S. has started retaliatory and preemptive strikes on the Houthi. There was also a situation where Iran and Pakistan were lobbing missiles into one another's territory to strike at militants, with each side condemning the other's actions. Late in the month, conditions escalated further as an Iran-backed militant group launched a drone attack on a U.S. military base in Jordan, which resulted in three American casualties. U.S. President Biden has vowed a meaningful retaliatory response but is also looking to avoid direct confrontation with Iran, which also appears wary of a widening conflict.

_ Turning to other macro indicators we track, volatility (per the VIX) remains generally subdued but rose slightly during the month to end at 14.35. Inflation breakevens ended the month a bit higher, with the 5-year at 2.26% (up 11 bps) and the 10-year at 2.25% (up 7 bps). Movements in credit spreads were minimal in January, with only a 1 bps increase for BBB, though high yield spreads widened a bit, increasing by 15 bps. The U.S. dollar strengthened (per the DXY) as expectations for rate cuts from the Fed were pushed back, with the greenback climbing 1.9% from the start of the year to end the month at 103.3. Gold declined for the month on the stronger dollar and new Fed expectations, ending the month at ~$2,040/oz. Finally, Crude Oil prices jumped on the escalating situation in the Middle East and closed out the month at ~$76/bbl.

_ As we continue into 2024, we remain optimistic that a soft landing could be achieved in the U.S., but investor optimism on the timing of Fed rate cuts remains too rosy. Europe has narrowly avoided a recession to date but could see growth contract this year, especially given the situations in the Middle East and Ukraine. We continue to opt for an allocation to Liquid Real Assets, which can help with portfolio diversification through low correlations to other asset classes while offering attractive long-term return potential and the ability to perform well conceivably through a variety of economic conditions.

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_ **For real assets classes:**
  _ Global Real Estate securities declined in January and unperformed the broader equity market. All regions ended the month with losses, with the sharpest decline seen in the Asia ex Japan region. Losses were also sharp in Europe, while Canada, Japan, and Australia held up the best. In the U.S., Data Centers saw robust gains driven by AI-fueled leasing, while Hotels saw just minor losses. The balance of sectors also finished in the red, with losses steepest in Self Storage and Healthcare, with the Hospital segment of Healthcare particularly hard hit. In the Asia Pacific region, Hong Kong stocks dropped the most, followed by Singapore property stocks. Japan Developers ended the month with slight gains, while Japan REITs had losses. In Europe, losses were greatest in the Office and Nordics segments, while Retail and Residential held up better. UK property stocks generally outperformed Continental Europe, though UK Large Cap REITs underperformed Other UK names by a small margin. Names in Australia had losses but generally outperformed the global index.
  _ Global Infrastructure securities saw losses in January and lagged broader equity market returns. All regions ended the month lower, with the Asia Pacific region selling off the most, while Europe's losses were shallow and with the Americas in the middle. In the Asia Pacific region, Australia infrastructure stocks declined the most, followed by Asia ex Japan names, while Japan names held up somewhat better, though airport names were hard hit. In the Americas, MLPs and Waste had meaningful gains, while Rail rose slightly. Oil Storage & Transportation (OSTs) names in Canada were essentially flat while Americas OST declined. Americas Communication names and Latin America Airports slumped the most, while Americas Utilities fell less. Lastly, in Europe, Transport was the only sector to end the month with positive returns. Europe Communications fell the most within the region while Europe Utilities and UK Infrastructure stocks saw more muted losses.
  _ Commodities posted slight gains in January, while Natural Resource Equities was the worst performing asset class within Real Assets; both underperformed broader equities. On the physical side, Livestock was the top performing segment, with Lean Hogs moving higher after a report showed lower breeding inventory in the final quarter of 2024. Energy also caught a bid higher, with all Energy commodities (aside from Natural Gas) moving higher in the wake of conflict in the Red Sea. Agriculture was down overall, but the Softs led the Grains with Sugar, Cocoa, Cotton, and Coffee higher for the month, while Soybeans, Corn, and Wheat were down. Both Industrial and Precious Metals priced lower overall, with only Copper prices rising, while Palladium and Platinum fell the most. Within the equities, Energy producers had only minor losses, with Emerging Oil & Gas making a move higher while Developed Oil & Gas dipped slightly. Metals & Mining names fell more following in the footsteps of their underlying commodities. The Agriculture sector was also an underperformer, dragged down by losses in Agriculture Products, while Chemicals and Paper & Forestry declined to a lesser extent.

Global real estate

Broad themes

The outlook for commercial real estate has stabilized as no further Fed hikes are expected and as the yield on the 10-year US Treasury has come down. Additionally, the outlook for fundamental growth looks more favorable in the back half of 2024. Private market appraised values have further to fall, but we are closer to equilibrium with spot prices, which are stabilizing due to the move in rates. Transaction volumes should start to recover in 2024 as the bid-ask spread narrows even as capital costs are still elevated. Bank lending remains tight, but public REITs retain access to the capital markets, with unsecured debt proving to be a competitive advantage. Fundamentals are largely moderating but should see improvement as expense pressures ease, supply deliveries shrink, and revenue comps ease. Decelerating growth near-term leads us to a moderately defensive tilt, with the end of the Fed tightening cycle and an improving earnings outlook serving as compelling catalysts.

Sector-level themes

_ **Net Lease** – acquisition volumes are weak due to higher cost of capital, but earnings outlook for 2024 gradually improving

_ **Industrial** – remain neutral given continued healthy demand, but decelerating market rent growth

_ **Healthcare** – favor occupancy upside in skilled nursing & senior housing; less optimism on hospitals & medical office

_ **Retail / Malls** – concerns on consumers have yet to lead to weaker demand as leasing in malls and retail remains robust

_ **Data Centers** – optimistic on better pricing power and power limits curtailing supply; AI euphoria fueling next growth cycle

_ **Hotels** – cautious given the economic backdrop and difficult comps, but favor select names with exposure to group bookings

_ **Self Storage** – comps ease in early 2024 and lower rates should stimulate housing related demand later in 2024

_ **Residential** – apartment fundamentals slowing amidst supply pressure; SFRs and MH screen best with little new supply

_ **Office** – negative absorption and market rent growth combined with restrictive capital markets offset attractive valuations

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Global infrastructure

Broad themes

We remain focused on relative valuations and companies that can maintain and grow cash flows as we assess opportunities within the space. Volatility will likely continue; however, recent softening in inflation data and slower economic growth seem to be affecting central banks' tightening efforts, which could be a signal that peak interest rates have already occurred for the foreseeable future. Infrastructure should benefit given its inflation passthrough traits and necessity-based assets, and a lower cost of capital in the form of lower long-duration bonds would also be a positive. We expect performance dispersion to continue, affording active managers alpha opportunities.

Sector-level themes

- **Communications** – Sound fundamentals continue to support U.S. towers given their stable cash flows. In the U.S. and Europe, organic growth is expected to maintain its current pace, and we could see an increase in leasing activity later in the year. Recent strong stock performance has been supported by lower interest rates. Names within this space could continue to benefit if long-duration bond yields moderate further in the near-to-intermediate term.
- **Midstream Energy** – We expect volatility to continue, and we remain cautious on natural gas, but expect the negative rate of change to moderate into 2024. We are more constructive on crude oil-exposed names but are watching if slowing demand could weigh on the sector. Company balance sheets remain strong, which should buoy the sector if fundamentals weaken, as valuations are currently undemanding.
- **Transports** – Fundamentals remain mixed. Toll road traffic has recovered, and we expect modest growth going forward. European and Mexican airports are seeing strong demand for leisure travel, leading to traffic levels exceeding 2019 levels. U.S. Rail freight volumes have likely bottomed, however broader economic growth is needed to manifest a strong catalyst.
- **Utilities** – U.S. regulated utilities fundamentals are improving, and multiples should benefit in a slowing macro environment especially with abating interest rates. In Europe, we favor electric grid and renewable generators over gas utilities. In the U.K., regulatory risks remain in the water sector, but we see the electric names as attractive. Utilities should continue to benefit from capex spending due to favorable policies on renewable energy projects and EV charging stations.

Natural resource equities

Broad themes

Themes include the scope of China's economic stimulus and carry through to commodities demand, developed market economies' growth trajectory given restrictive monetary policy, and dearth of capacity due to low capex levels. This space is also impacted by geopolitical developments including the Ukraine-Russia conflict and Middle East tensions. Repercussions are generally positive for upstream, ex-Russian producers of materials in short supply and negative for downstream consumers.

Sector-level themes

- **Base Metals producers** – The keys are the extent to which Chinese stimulus boosts demand along with the scope of supply losses. We remain somewhat pessimistic on China's property markets (and therefore steel, zinc, and other construction materials), but pockets of strength elsewhere (e.g. EVs, infrastructure, manufacturing), have us more constructive on copper. Meanwhile, various supply-side concerns present a bullish upside risk for metals prices.
- **Precious Metals and mining companies** – Nominal and real rates have retreated with slowing inflation and more dovish central bank speak. Meanwhile, the geopolitical backdrop continues to intensify - a bullish backdrop for safe-haven demand. Gold's relatively high premium in Shanghai evidences strong physical demand from China, and we expect resilient strategic global demand. Platinum & Palladium demand should remain sensitive to changes in industrial/manufacturing activity.
- **Paper & Forestry** – Supply chain constraints have eased, and cost inputs are easing on the margin. Destocking headwinds have abated in areas, but an uncertain demand outlook with growing capacity keeps a ceiling on upstream and downstream prices for now. Lumber prices have firmed up a bit seasonally, but new home construction activity will ultimately depend on how rates and affordability evolve with fiscal and monetary policy.
- **Energy companies** – Oil prices have remained volatile within a broad trading range. Upside risks include geopolitical developments and conflicts that have caused fear, shipping disruptions, and marginal impacts to export infrastructure. However, prices could remain capped or retrace barring escalation, given spare capacity, seasonality, discord in OPEC+, or any negotiated ceasefires. Natural gas prices should remain a function of local weather developments, subject to tail risks.

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Commodities

Sector-level themes

Energy

_ The oil complex reversed its downward trend to start the new year, while most distillate products climbed in January as well. Crude oil rose as attacks on oil freighters in the Red Sea and attacks on U.S. bases in the region reflected the escalation of the Houthi and other Iran-sponsored groups stepping up attacks on both civilian and military targets to further pressure the U.S. to influence Israel's policies. This has led to more shipments being routed around the African Continent, resulting in delayed shipments and higher costs. In a surprise move, Saudi Arabia decided to halt its plan to increase oil production capacity by one million barrels per day by 2027, and while this won't immediately impact short-term supplies, it has sparked speculation about future oil demand and raised questions about global oil balances in the long run.

_ In contrast to Crude Oil, U.S. Natural Gas prices corrected sharply with warmer than typical weather moving in and expected for the next few weeks (following a brief cold spell in the middle of the month) in the U.S. and the rest of the Northern Hemisphere. Additionally, the EU is expected to end the winter with storage levels at 54%, much higher than the typical 30-40% seen before the Ukraine-Russia conflict, and LNG remains well supplied despite the conflict in the Middle East.

_ **Our View:** Near-term geopolitical risks remain a key driver of Crude Oil prices. Although the longer-term outlook for balances remains uncertain due to the timing of OPEC+ cuts, geopolitical risks to supplies should keep crude prices elevated. We continue to favor crude over products on the margin, although freight dynamics, weather, and the timing of new refinery startups in Nigeria and Mexico will likely dictate relative performance. We expect that Natural Gas prices in the US will remain tethered to weather updates in the near term.

Metals

_ **Industrial Metals** posted minor losses in January. Economic headwinds for China continue to put pressure across the base metal complex, although this was somewhat reversed by market optimism on potential new fiscal measures in addition to the reserve rate requirement cut announced by the Chinese central government. Copper was the standout for the month, catching a slight bid higher primarily due to a collapse in refining margins, which signals an abrupt tightening of the Copper concentrate market. Aluminum was an underperformer in the complex as new industry data showed declines in new orders during December, though prices bounced higher on the bullish stimulus news out of China and the announcement of a newly idled smelter in Missouri. Iron ore was flat for the month even as China steel production and inventory levels are recovering, as this restocking is consistent with historical seasonality ahead of the Chinese New Year holiday.

_ **Precious Metals** were lower to start the year. Gold prices glided down for the month as expectations for a March rate cut by the Fed have been reduced and as the U.S. dollar strengthened, while ETF holdings of physical Gold continue to be abysmal, making new lows on a multi-year basis. Palladium and Platinum saw steeper losses for the month on the same interest rate and Fed concerns, but also as the market expects lower production volumes from Russian producers in 2024. Silver also declined for the month but could see another short squeeze (as was seen last December) as inventories continue to decline, with a structural market deficit expected for a fourth consecutive year.

_ **Our view:** We remain bullish on Copper, where we think the market has underappreciated the substantiality of unrelenting supply challenges, but after recent gains in Aluminum and Zinc, we are more neutral on the broader Industrial Metals complex. We do not see a meaningful recovery in base metals absent a significant recovery in China's property sector. We expect the price of Gold to stabilize near current levels ($2,000 to $2,100/oz) before moving higher later in the year.

Agriculture

_ **Agriculture** commodities saw mixed results to start the new year. Livestock was bid higher with prices rising for both Lean Hogs and Live Cattle. Generally, the softs outperformed grains in January. Sugar and Cocoa were the top performers, with Sugar supply concerns across southeast Asian countries containing to be a tail wind and Cocoa rising with poor weather and crop disease in West Africa. On the other hand, the Soybean complex remains weak mainly due to a relatively low U.S. 2024 planting estimate and weak China soybean import demand. Corn and Wheat prices also declined for the month with more favorable weather set to cross South America.

_ **Our view:** On the crop side, we continue to see relatively attractive risk-reward in Sugar, Wheat, and Cotton, with our bullish view underpinned by tight global supply-demand equations. We remain bearish on the Soybean complex due to the improved supply outlook (mainly in Argentina) and weaker global demand (China). Looking ahead, we expect the weather to drive price volatility in the grain markets, especially with recent drought concerns in Brazil and its potential impact on safrinha Corn production.

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