DWS

Marketing Material

S&P 12-month target 4600: Climb continues on digitally powered EPS growth

David Bianco
Americas Chief Investment Officer

IN A NUTSHELL

_ Raising 2021E S&P EPS to $215, $230 for 2022 excluding a corporate tax hike
_ Record beats, record margins, record quarterly S&P EPS 25% over 2019 levels
_ Above long-term average GDP growth and inflation in 2022, but flat S&P EPS
_ S&P trailing PE target remains 22x, negative real yields support a 20-25 range
_ Digitalization Machines: The envy of governments, perhaps a perceived threat?

Raising 2021E S&P EPS to $215, $230 for 2022 excluding a corporate tax hike

Since the outbreak of the pandemic, S&P earnings per share (EPS) has surprised substantially to the upside. The past 6 quarters of upside surprises versus bottom-up sell-side analyst estimates were among the largest in IBES S&P 500 earnings estimates history. In the first few quarters of 2020, substantial beats posted by S&P firms represented greater S&P EPS resilience against a deep recession than ever seen before. Then in the last few quarters, continued substantial beats represented much higher S&P 500 profitability relative to level of gross domestic product (GDP). For 2Q21, quarterly S&P EPS totaled $54, after beating the analyst bottom-up estimate by 23%. Final 2Q S&P EPS increased 90% y/y, but more importantly it's up 30% from 2Q19.

Record beats, record margins, record quarterly S&P EPS 25% over 2019 levels

The climb in S&P EPS during the record long US economic expansion from 2009-2020 was one for the history books. But then S&P EPS jumped much higher within the first year of this new expansion; in the past, S&P EPS took 2-3 years to recover to prior cycle highs.

What powered this huge profit surge? Stimulus helped, but digitalization dominated

Many point to trillions in quantitative easing and extraordinary fiscal deficits. Some suggest a pandemic, like war, can be profitable. Yet, we think neither inflation, nor government spending, nor pandemic induced spending splurges and shifts, from services to consumer goods, are the main drivers. We point to the increased digitalization of S&P 500 business mix and the accelerated digitization of the economy, both business and consumer sides, during the pandemic. The S&P is now a digital dominated index. Including Technology and Communications sectors, but also Internet Retailing and often overlooked areas like data center real estate investment trusts (REITs), also the more digital nature of Financial services and high tech electric auto.

Above long-term average GDP growth and inflation in 2022, but flat S&P EPS

The S&P is mostly digital with financial services and healthcare the next largest segments. Shifting away from being comprised of Energy, Industrials and other goods manufacturing. The sectors the index is shifting away from remain the most cyclically sensitive, along with Financials. Thus, overall S&P has become more cyclically stable and with greater long-term growth potential. The benefits of this mix shift played out in the recession with a smaller EPS decline than usual and then in the recovery as EPS surged led by digital firms. For 2022, DWS economists expect 4.7% real US GDP growth and 4.5% global growth. Such GDP growth would normally drive 10-15% S&P EPS growth. But owing to higher input costs and wages, flattish commodity prices, a stable dollar, no U.S. Federal Reserve (Fed) hikes, higher regulatory and stakeholder spending, we expect 7% S&P EPS in 2022 before the effect of a corporate tax rate hike and flat with it at $215 again. We expect a 28% corporate tax rate, but without any significant hit from changes in foreign or minimum book profit taxation.

S&P trailing PE target remains 22x, negative real yields support a 20-25 range

Tapering isn't a big risk for equities, as our colleagues say, "Tapering is not a TINA Turner." Because Treasury yields shouldn't surge solely on the Fed's well-advertised tapering of purchases. Also, our fixed income colleagues warn that positive returns are unlikely for quality credit if 10yr Treasury yields rise to 2% in about a year as we expect, perhaps keeping investors stuck in equities. That said, extraordinary deficits, if they continue, pose risk of even higher yields; which could pressure price to earnings ratio (PEs) on both present value and economic risks.

Any S&P upside from 4600? Yes, 5000 within reach for 2022 end, but policy risks

Our 12-month 4600 S&P target is for September end 2022. This is just before the Mid-term Election and many fiscal and monetary policy risks exist this autumn and next. If S&P EPS exceeds expectations again, or if long-term real interest rates persist at -1% or less, as the expansion continues at good pace with fiscal discipline and inflation near target, S&P could reach 5000 or more by 2022 end. If negative real yields persist despite healthy growth and inflation, we'll likely target the higher part of our fair S&P PE range, albeit wide, of 20-25x. But we expect greater volatility over the coming year than the past as policy transitions from rescue to normal as inflation, real yields, taxation, federal spending and regulation are big unknowns, even without delving into the many shifting global issues, in this new cycle.

Digitalization Machines: The envy of governments, perhaps a perceived threat?

Because the S&P 500 is digitally dominated, perhaps its biggest risk is that of government actions to curb the businesses models of the listed, but privately owned digital behemoths. Redirection on reinvestment or curbs on their profits, power and influence or even perhaps the knowledge, choices and empowerment they bring to individuals and enterprises. Whether it be commands and controls in the east or taxes and regulations in the west, governments taking a bigger bite is a risk. This risks exist for Tech and Communications, but we also see such risk at Health Care, but also especially Financials and Energy.

GLOSSARY

The business cycle is the oscillating movement of gross domestic product around its long-term trend during expansions and contraction.

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

The price-to-earnings (P/E) ratio compares a company's current share price to its earnings per share.

Quantitative easing (QE) is an unconventional monetary-policy tool, in which a central bank conducts broad-based asset purchases.

In economics, a real value is adjusted for inflation.

Real Estate Investment Trusts (REITs) are companies, mostly listed, that own and often operate various types of real estate. They are obliged to pay out a minimum of 90% of earnings.

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Tapering is a slow, continuous reduction of the central bank's asset purchases; especially referring to the U.S. Federal Reserve.

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

The U.S. Federal Reserve, often referred to as "the Fed," is the central bank of the United States.

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

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