Marketing Material

2021 S&P 500 EPS LIKELY THE SAME AS 2019: SHOULD THE P/E BE HIGHER?

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IN A NUTSHELL

_ We raise our S&P 500 EPS estimates on better-than-expected pandemic resilience.
_ We think a trailing 20 P/E is fair value on normalized S&P 500 EPS.
_ We remain, however, tactically cautious.

WE RAISE OUR S&P 500 EPS ESTIMATES ON BETTER-THAN-EXPECTED PANDEMIC RESILIENCE

Given better-than-expected earnings delivered by most S&P 500 companies in the second quarter, as its virtual and essential sectors and most of its other largest firms operated well to meet customer demand – demand that was dented, but not crushed thanks to government aid – we raise our 2020, 2021, 2022 S&P 500 earnings-per-share (EPS) estimates from 110 dollars, 150 dollars, 170 dollars, to 130 dollars, 165 dollars, 175 dollars. We now think the S&P 500 recovers its 2019 EPS of 164 dollars in 2021. This assumes that no national or state level lockdowns reoccur in the United States and that monthly Covid-19 hospitalizations and deaths this winter do not reach levels suffered this spring.

We think Covid-19 infections stay a material risk into the first quarter of 2021 and choices by individuals and private organizations will keep demand depressed for long distance travel, events, hotels, restaurants, small retailers, etc. Many large office buildings and schools are adopting hybrid or partial occupancy plans and local restrictions likely reoccur to control outbreaks. A full year of such preventions likely weighs on the jobs recovery, small businesses, big cities, landlords, banks and interest rates. We think more federal aid is needed to support households, small business, state and local governments. The economy still faces big challenges, but the S&P 500 demonstrated better resilience to all of this than we expected.

2020E S&P 500 EPS TO 130 DOLLARS: 15 DOLLARS BOOST AT TECH, COMMUNICATIONS, A LARGE CONSUMER-DISCRETIONARY RETAILER AND HEALTH CARE

S&P 500 second quarter EPS is finalizing at about 27 dollars or down 33% year-over-year with revenue down 11% year-over-year. The young and healthy sectors of tech, communications, health care, staples and utilities held aggregate EPS and sales flat year-over-year. But the old and vulnerable sectors of energy, materials, industrials, consumer discretionary, financials and real estate investment trusts (REITs) had EPS down 70% with sales down 25% year-over-year. Tech and communications acted like defensives, but REITs like cyclicals.

We raise 2020E (estimated) S&P 500 EPS to 130 dollars from 110 dollars; 12 dollars from the second quarter being 27 dollars vs. our 15 dollars estimate. Our 2020E S&P 500 EPS by quarter is now: 33+27+34+36= 130 dollars, which aligns with bottom-up estimates. Of this 20 dollars EPS hike, nearly 15 dollars is from tech, communications, health care plus a large consumer-discretionary retailer. The remainder is mostly the rest of consumer discretionary and industrials as the second-quarter losses at manufacturers were less than feared; financials plus energy is unchanged. We also raise 2021E S&P 500 EPS from 150 dollars to 165 dollars, almost entirely at tech, health care and consumer discretionary especially the large consumer-discretionary retailer in 2019, young and healthy sectors were nearly 55% of S&P 500 EPS, up from 45% to 50% in 2012-2014. In our

2020E & 2021E S&P 500 EPS, they are about 70% and 60%, respectively. The accelerated shift toward virtual businesses and young and healthy sectors boosted S&P 500 resilience to this pandemic.

WE THINK A TRAILING 20 P/E IS FAIR VALUE ON NORMALIZED S&P 500 EPS

Our approach to fair valuing the S&P 500 is based on our estimates of: 1) normal EPS, 2) normal long-term real risk free interest rates, and 3) normal or a fair equity risk premium (ERP). We consider normalized S&P 500 EPS for 2020 through 2022 to be 155 dollars, 165 dollars and 175 dollars. There remains high uncertainty on normalized S&P 500 EPS for 2022 and beyond for reasons that include corporate tax rate risk. If the U.S. corporate tax rate rises to 28% from 21%, we would likely adjust our 2022E S&P 500 EPS to 170 dollars, but probably raise to 180 dollars if no change.

The greatest uncertainty in our valuation framework is the long-term real risk free interest rate. Although observed 10-year Treasury Inflation Protection Securities (TIPS) yields are -0.9% now, we believe that beyond 2021, assuming a healthy economic expansion that supports healthy S&P 500 EPS growth, 10-year TIPS yields will rise to 0%. This suggests 10-year Treasury yields rise from 0.7% today to something closer to expected inflation after 2021. We recognize that monetary policy might suppress Treasury yields below inflation, but we think this can only last for so long without risking problematic inflation. Treasury and TIPS yields can differ somewhat for reasons beyond the inflation breakeven, as Treasuries are more liquid, have more regulatory and policy demand and also offer a strong risk asset hedge. For these reasons, we think TIPS yields are a better indication of long-term real interest rates than Treasury yields minus inflation estimates. In valuing the S&P 500, we use a normalized long-term real risk free interest rate of 0%, 10-year TIPS yields are usually positive. Despite lower EPS contributions from financials and energy, we use a 5% ERP versus the usual 4% history given uncertain macro conditions, including interest rates. Applying a 20 trailing price-to-earnings (P/E) ratio to our normalized S&P 500 EPS estimates suggests yearend fair values for 2020, 2021 and 2022 of 3100, 3300 and 3500. These are not 12-month targets or tactical signals as variation comes along the way.

RAISED 2021E S&P 500 EPS AND FAIR P/E TO 20 FROM 19: WHY STILL TACTICALLY CAUTIOUS?

We remain tactically cautious for the same reasons: 1) virus uncertainty and how it affects the economy, politics, and earnings, 2) concerns about the efficiency and affordability of fiscal support until a vaccine, 3) election related tax and other regulatory risks to profits, 4) great uncertainty on long-term real interest rates and the P/E investors will pay under the conditions that bring negative real yields. Our framework suggests growth vs. value is in decent balance now. Value could outperform in 2021, led by big banks, if gross domestic product (GDP) recovers well with modestly higher inflation and Treasury yields. But unorthodox fiscal-monetary policy that boosts inflation, suppresses Treasury yields and weakens the dollar (possibly with higher tax rates) probably hurts the stock market and all cyclicals the most. Policy makers must find the right balance of assisting the economy, without interference that risks misdirecting it or distorting capital markets. Thus, elections and U.S. Federal-Reserve (Fed) policies are key.

GLOSSARY

Cyclical is something that moves with the cycle.

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.

Growth stocks are stocks from companies that are expected to grow significantly above market average for a certain period of time.

A hedge is an investment to reduce the risk of adverse price movements in an asset.

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

Liquidity refers to the degree to which an asset or security can be bought or sold in the market without affecting the asset's price and to the ability to convert an asset to cash quickly.

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.

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.

The risk premium is the expected return on an investment minus the return that would be earned on a risk-free investment.

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

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).

Treasury Inflation-Protected Securities (TIPS) are a form of U.S. Treasury bonds designed to protect investors against inflation. These bonds are indexed to inflation and pay investors a fixed interest rate as the bond's par value adjusts with the inflation rate.

The U.S. dollar (USD) is the official currency of the United States and its overseas territories.

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

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm's stock price in relation to its earnings.

Value stocks are stocks from companies that are trading at prices close to their book value and that are therefore cheaper than the market average on that metric.

Yield is the income return on an investment referring to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

APPENDIX: PERFORMANCE OVER THE PAST 5 YEARS (12-MONTH PERIODS)

	07/15 - 07/16	07/16 - 07/17	07/17 - 07/18	07/18 - 07/19	07/19 - 07/20
S&P 500	5.6%	16.0%	16.2%	8.0%	12.0%
U.S. Treasuries (10-year)	8.0%	-3.8%	-2.7%	10.6%	13.8%

Past performance is not indicative of future returns.
Sources: Bloomberg Finance L.P., DWS Investment Management Americas Inc. as of 8/18/20

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