CIO View
Americas CIO View

October 22, 2021

DWS

Marketing Material

Shortages? Not in the nexus between the physical and digital world

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IN A NUTSHELL

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- Opportunities in the nexus: We favor firms that provide or utilize digital solutions
- Energy – Little control over pricing, or regulations or in delivering the alternatives
- Health Care – Productivity of more medicines, innovative devices, telemedicine
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Supply-side constrained physical economy induces digital solutions/ alternatives

The makers and movers of physical goods still warn of heightened costs and operational challenges likely lasting at least through the end of the year. Shortages of materials, supply chain delays, consequent higher input costs, along with intensifying labor supply strains in the industries of hard work has been the manager announcement on repeat play this autumn. The causes are many, ranging from what should pass pandemic supply-side disruptions against still lopsided goods demand given the lingering everything from home lifestyle. Also, perhaps less of a stick and carrot in the labor market and challenging demographics; continued trade tensions and import tariffs; uncertainty on taxes and regulations that affect the supply side, especially fossil fuels. These issues are getting plenty of attention and last week we discussed the risks to the companies raising prices to address these challenges, as price hikes discourage customers and encourage competitors. This week, we revisit the opportunities that these physical challenges present digital firms and the solutions that the digital world can provide physical companies looking to raise productivity instead of price.

Opportunities in the nexus: We favor firms that provide or utilize digital solutions

We expect another good quarter of revenue and earnings growth from most digital firms (Tech/Communications) in 3Q, as most of these firms aren't supply chain or labor constrained. But, it will be interesting to observe where the digital and physical world intersect. We think some physical firms will point to increased usage of digital tools and presence to mitigate cost pressures and deliver goods to customers as promised, on time with stable pricing. Some big retailers, fast food restaurants and financial services are pointing to more digital customer interface derived cost savings. Yet some digital world firms are feeling physical economy pressures, internet retailers (shipping costs) and cheaper tech hardware/devices. That said, we expect biggest supply pressures at Auto, Consumer Goods, Materials, Industrials. Some of these firms will likely raise prices to protect margins, thus longer-term risks.

Energy – Little control over pricing, or regulations or in delivering the alternatives

Energy firms have little to no control over product pricing, as quintessential price takers. Yet, the recent surge in oil and natural gas prices benefits their profitability. We're skeptical about the sustainability of current oil prices given a firm US dollar with recent strength on rising short-term yields. The bond market seems confident the Fed will fight inflation. But slower growth in China, with RMB interest rate and foreign exchange (FX) implications poses risk to oil prices. And reducing carbon emission goals continues to gain public policy support and from private enterprise, consumers and many investors. Regulations might keep US oil production well below potential, but global supply should temper prices. If not, US supply potential exists. Maybe oil prices are just rising in response to broad inflation, a switch in the usual causality. The falling share of energy of US gross domestic product (GDP) limits the risk to the economy from upward oil prices. Higher oil still adds to S&P earnings per share (EPS), but Energy's small share of profits and the likely limited upturn in capital expenditures (capex) on materials and equipment this time suggests a minor S&P EPS benefit.

Health Care – Productivity of more medicines, innovative devices, telemedicine

We think healthcare is where the economy's next major inflation vs. productivity battle will be fought. Healthcare is the biggest part of personal consumption expenditures and rising. Healthcare is where demand is likely to pressure physical economy supply over the long-term, especially for skilled labor. For this reason, we expect healthcare providers to continue to seek productivity enhancers of medicines to reduce sickness and extend longevity and more innovative medical devices and telemedicine to save valuable healthcare worker time.

3Q S&P EPS reporting: A strong start with Financials beat by 22%

The first week of 3Q earnings season is mostly Financials. Big banks beat analyst expectations on revenue and strongly on EPS with more loan reserve release and strong capital market activities. Close to 65% of Financials sector by earnings have reported and in aggregate they beat on EPS by 22% and on sales by 4.2%. This and next week are the busiest of this earnings season with 41% and 18% of the index earnings to be reported. We did expect strong beats at Banks and good beats at digital companies of Tech/Communications and also Health Care. But we expect the rest of companies will have less than 5% beats. 3Q S&P EPS likely finishes at roughly $53, sequentially flattish vs. 2Q21, signaling that the giant leaps in sequential quarterly S&P EPS of the past 5 quarters may be coming to an end.

GLOSSARY

Capital expenditure (Capex) are funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment.

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.

FX or foreign exchange is the currency — literally foreign money — used in the settlement of international trade between countries.

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.

The personal consumption expenditure (PCE) measure is the component statistic for consumption in gross domestic product (GDP) collected by the United States Bureau of Economic Analysis (BEA).

Productivity measures how much economic output is produced for a given level of inputs (such as capital and labor).

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

Telemedicine refers to diagnostics and therapy bridging a spatial or temporal distance between docotor and patient.

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as of 10/20/21; 086135_1 (10/2021)

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