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GDP LIKELY TO RECOVER, BUT WILL REAL YIELDS?

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IN A NUTSHELL

_ We expect both 2020 and 2021 to be repair years for U.S. and global gross domestic product.
_ We see a sustained recovery without overdosing on fiscal / monetary stimulus.
_ Experimental fiscal and monetary policies would come with their own risks.
_ Monitor the U.S. Federal Reserve's balance sheet, especially the mix of its liabilities.
_ The dollar is unlikely to crumble: a weak dollar little benefit in a weak global economy.
_ Our 12-month S&P 500 target is raised to 3300 with a 20 P/E on normalized S&P 500 earnings per share (EPS).

WE EXPECT BOTH 2020 AND 2021 TO BE REPAIR YEARS FOR U.S. AND GLOBAL GROSS DOMESTIC PRODUCT

We and DWS economists believe the U.S. and European economies are not likely to recover their 2019 end levels until after 2021. Although these economies bounced strongly from their lockdown lows, a full recovery is likely a two-year process in a long checkmark like shape. We attribute the V-shaped bottom to the reopening effect and spiked demand for certain consumer goods, home improvement and relocation. Consumer demand was robust in spring thanks to government aid, resilient household asset values and hope for a quick return to normal. We go into autumn with many service industries still depressed from infection risk, less government aid, slower consumer spending, and slower job gains as many industries adjust their employment and capacity for weak demand into 2021.

WE SEE A SUSTAINED RECOVERY WITHOUT OVERDOSING ON FISCAL / MONETARY STIMULUS

Although it will take time, we remain confident in a sustained recovery. Many industries should grow at a healthy pace, especially tech and healthcare, and eventually Covid-19 will fade away with a vaccine. But industries weighed down by infection risk likely face another challenging year that stimulus cannot solve. Thus, we see little sense to aggressive multitrillion dollar fiscal packages that likely stoke immune industries and tight job markets while the virus vulnerable still struggle. That said, we think more fiscal and monetary aid is needed to support the most vulnerable households and to prevent unnecessary private- and public-service job destruction. In our view, extraordinary unemployment benefits should be about half the size as before, more targeted small business support, and grant at least 0.5 trillion dollars to stricken cities. Such further stimulus through 2021 should be 1-1.5 trillion dollars, not over 3 trillion dollars. This economy needs the right medicine and dosage.

EXPERIMENTAL FISCAL AND MONETARY POLICIES WOULD COME WITH THEIR OWN RISKS

Given our expectation of a sustained, but moderate in pace, recovery that is aided with fiscal medicine, but not overdosed, we think inflation stays below the U.S. Federal Reserve's (Fed's) 2% target this year and next. If inflation does significantly exceed the Fed's 2% target in coming years, we remain very skeptical about the Fed's willingness and ability to suppress Treasury yields at or below 1%, such that 10-year Treasury Inflation Protected Securities (TIPS) yields get more negative than recent -100 basis point (bps) levels. Simply said, we do not foresee high-inflation and yield-suppression policies to come. We realize that the elections and the future of monetary-policy frameworks and setters will influence these possibilities, but we do not believe that such unorthodox measures are likely without big populist shifts in both Congress and at the Fed. Unless the economy double dips, we think it unlikely that such experimental policies will be tried.

MONITOR THE U.S. FEDERAL RESERVE'S BALANCE SHEET, ESPECIALLY THE MIX OF ITS LIABILITIES,

High fiscal deficits and further Fed balance-sheet expansion are likely through 2021. So how much deficit spending and debt monetization is too much before it sparks high inflation? We see this fiscal and monetary policy as wartime in nature. The Fed is funding enormous deficits by mass-buying Treasuries as new issuance surges. We think this has limits. We were comfortable it was within limits last recession because the Fed bought mostly existing Treasuries and bank reserves were the liability offsetting asset expansion. This time there is already a jump in cash in circulation. To the extent that banks lend out excess reserves or more likely that the Treasury department spends its account balance at the Fed, the more cash in circulation will rise. We do not know how sensitive inflation will be to this hot money, however it is higher all else equal. If inflation does overheat, the Fed's most blunt tool and yield curve control would be to hike rates paid on excess reserves.

THE DOLLAR IS UNLIKELY TO CRUMBLE: A WEAK DOLLAR LITTLE BENEFIT IN A WEAK GLOBAL ECONOMY

Because we think high inflation and Treasury-yield suppression policies (to induce deeply negative real yields) are unlikely, we think the dollar is supported at its recently softer levels. Other mature currency economies still have their challenges, thus policies that weaken the dollar would likely be followed by similar policies elsewhere. Debasing the dollar to benefit commodity prices also seems like an unlikely aspect of a Green New Deal.

OUR 12-MONTH S&P 500 TARGET IS RAISED TO 3300 WITH A 20 P/E ON NORMALIZED S&P 500 EARNINGS PER SHARE (EPS)

We expect 10-year TIPS yields or long-term real risk free interest rates to return to at least 0% over the next few years as 10-year Treasury yields slowly rise toward inflation. We think rising but still very low vs. history nominal and real yields supports a 20 trailing S&P 500 price-to-earnings ratio (P/E) and lofty growth-stock valuations. A recovery with rising rates keeps big banks our preferred value play for 2021 over energy and most industrial capital goods. Our S&P 500 target has +/- 300 points election sensitivity on outlook for corporate and investor taxes.

GLOSSARY

A balance sheet summarizes a company's assets, liabilities and shareholder equity.

One basis point equals 1/100 of a percentage point.

Excess reserves are the capital reserves held by a bank or financial institution in excess of what is required by regulators.

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.

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

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.

In economics, a real value is adjusted for inflation.

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

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.

The United States Congress is the legislature of the federal government. It is comprised of the Senate and the House of Representatives, consisting of 435 Representatives and 100 Senators.

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

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.

A yield curve shows the annualized yields of fixed-income securities across different contract periods as a curve. When it is inverted, bonds with longer maturities have lower yields than those with shorter maturities.

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 8/24/20

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