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Americas CIO View

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DWS

Marketing Material

MORE SUMMER DIPS LIKELY: STAY OUT OF THE DEEP END

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IN A NUTSHELL

_ Severity of damage to jobs, profits, balance sheets and tranquility to sink in
_ Our S&P 500 Profit Indicator suggests a 50% plus year-over-year decline in the second quarter 2020 S&P 500 EPS
_ S&P 500 leverage on the climb: strains at energy, industrials, consumer discretionary
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SEVERITY OF DAMAGE TO JOBS, PROFITS, BALANCE SHEETS AND TRANQUILITY TO SINK IN

Despite Thursday's steep selloff, equity markets will either fall further this summer or they have borrowed heavily from their future returns, in our view. The ongoing surge since spring in government debt, corporate debt and equity valuations has placed the S&P 500, especially cyclical value stocks, at high risk of plunging once again. We do not expect the S&P 500 to revisit the March lows, but this is mostly because of demonstrated earnings resilience, fortified balance sheets and steadfast investor patience for and confidence in the future of the big growth stocks. However, we think severe hits to profits, balance sheets and payouts at most cyclical value stocks – to be revealed in the second-quarter reports, with a likely long road ahead to return to 2019 levels despite stimulus and reopening – will cause them to lead a summer correction. For most cyclical value industries, we think it takes three or more years for profits to recover to 2019 levels (two years for the S&P 500 overall, one year for growth and defensives). At this stage, we cannot be confident this new cycle will be long enough to accommodate that.

OUR S&P 500 PROFIT INDICATOR SUGGESTS A 50% PLUS YEAR-OVER-YEAR DECLINE IN THE SECOND QUARTER 2020 S&P 500 EPS

Our S&P 500 Profit Indicator suggests a near 15% sequential decline in four-quarter trailing S&P 500 earnings per share (EPS) from 159 dollars in the second quarter of 2019 to the first quarter of 2020 to near 140 dollars in the third quarter of 2019 to the second quarter of 2020. This suggests a second quarter of 2020 EPS of roughly 20 dollars or 15-25 dollars, down 40-65% year-over-year from 41.30 dollars in the second quarter of 2019. This overlaps with our second quarter of 2020 estimated (E) EPS of 15 dollars or our 10-20 dollars estimate range of down 50-75% year-over -year. Our Profit Indicator is one of our models used for forecasting near-term S&P 500 EPS. We designed our Profit Indicator a decade ago and it consists of six untouched inputs: 1) Manufacturing Institute for Supply Management (ISM) Purchasing Managers Index, 2) industrial production, 3) exports, 4) initial jobless claims, 5) loan growth, 6) oil prices. It has a very good record. However, we know it does not directly or fully capture the unprecedented hit to many U.S. service businesses in the second quarter, including S&P 500 retail and travel related stocks. Disruptions to normal health care or the high credit costs and rate cuts hitting banks. This indicator is more influenced by manufacturing than services and as the S&P 500 further shifts its earnings mix toward technology, communications and health care services from capital goods and commodity manufacturing this indicator will need modification. But it still helps relate recent macro data to S&P 500 EPS, even if it underestimates the second quarter EPS declines at S&P 500 consumer discretionary and financials and likely overstates damage to profits at tech. Given the speed and severity of

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this recession, hitting revenues with little cost relief yet, we think the indicator probably underestimates the second quarter S&P 500 EPS decline.

S&P 500 LEVERAGE ON THE CLIMB: STRAINS AT ENERGY, INDUSTRIALS, CONSUMER DISCRETIONARY

Corporate leverage was rising moderately over the last several years as companies took advantage of low long term interest rates and tight credit spreads to help boost buybacks. Companies are borrowing much more year-to-date to secure lifelines to cover steep losses expected during the pandemic and recovery. Net debt to earnings, before interest expenses, taxes, depreciation and amortization (EBITDA) of S&P 500 non-financial companies jumped from 160% in 2017-18 to 210% at the first quarter end. The aggregate net debt to EBITDA at the cyclical sectors of energy, materials, industrials and consumer discretionary surged from 190% to 270% at the first quarter end. This leverage will jump more when the second-quarter borrowing and trailing four-quarter EBITDA is reported. With corporate-bond yields low vs. history (nominal and likely real), debt serviceability remains manageable at most large S&P 500 firms albeit it is less comfortable than before the pandemic. We think leverage metrics deteriorate further through 2020 and do not begin to improve until into 2021. This balance-sheet damage will likely take many years to repair and until then it raises risk and lowers fair price-to-earnings ratios (P/Es).

SEVERE DAMAGE TO SMALL BALANCE SHEETS: FAVOR SMALL GROWTH > SMALL VALUE

Russell 2000 companies in aggregate had net negative net income in the first quarter of 2020 and losses will likely be huge in the second quarter of 2020. Many small cyclical value companies will require heavy borrowing to survive 2020. Russell 2000 non-financial net debt to EBITDA rose from 230% in 2017-18 to 320% at the first quarter. This debt is seizing enterprise value from equity.

STICK WITH GROWTH AND BOND-SUBSTITUTES STOCKS, FIND VALUE IN CORPORATE BONDS

In our view, growth stocks will see a modest rise in debt, with more opportunistic usage than for loss coverage, as compared with value and small caps. We think it is better to stick with growth and bond-substitutes stocks this summer and seek value at bonds. At value industries, we see corporate bonds more attractive than equity.

DAMAGED ECONOMY AND SOCIAL UNREST MAKE THE ELECTIONS A 50/50 WILDCARD

The pandemic induced a sharp recession, enormous job losses and social unrest, which makes the 2020 election simply unpredictable. Polls now predict a Democratic victory, but it is all very fluid. Our 2021E and 2022E S&P 500 EPS of 150 and 170 dollars assume no corporate tax hikes and stable economic policies and regulation. If the U.S. corporate tax rate is hiked to 28% it would reduce our 2022E S&P 500 EPS to 160 dollars. We prefer to bear the political and policy risks of tech and health care over energy and financials heading into this election. Early cycle tax hikes along with a period of government and corporate balance-sheet repair could cause another recession.

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GLOSSARY

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

A correction is a decline in stock market prices.

Cyclical is something that moves with the cycle.

Defensive stocks are stocks from companies whose sales are expected to fluctuate less than the market average as the demand for their products are less tied to business cycles.

The Democratic Party (Democrats) is one of the two political parties in the United States. It is generally to the left of its main rival, the Republican Party.

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.

EBITDA (earnings, before interest expenses, taxes, depreciation and amortization) is an accounting measure calculated using a company's net earnings, before interest expenses, taxes, depreciation and amortization are subtracted.

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

Leverage attempts to boost gains when investing through the use of borrowing to purchase assets.

In economics, a nominal value is not adjusted for inflation; a real value is.

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

The Purchasing Managers Index (PMI) is an indicator of the economic health of the manufacturing sector in a specific country or region.

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.

The Russell 2000 Index is an index that captures the 2,000 smallest stocks of the Russell-3000 index, which again comprises 3,000 small- and mid-cap U.S. listed stocks.

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

Small cap firms generally have a market capitalization of less than $2 billion.

The spread is the difference between the quoted rates of return on two different investments, usually of different credit quality.

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

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.

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

	05/15 - 05/16	05/16 - 05/17	05/17 - 05/18	05/18 - 05/19	05/19 - 05/20
S&P 500	1.7%	17.5%	14.4%	3.8%	12.8%

Past performance is not indicative of future returns.
Sources: Bloomberg Finance L.P., DWS Investment Management Americas Inc. as of 6/16/20

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