DWS

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Still in love with equities?

There may be few alternatives to equities. However, that is no longer a sufficient reason to buy into every dip.

- Despite some warning signs, it is probably too early to give up on equities, especially if and when leading economic indicators begin to stabilize.
- Low interest rates remain supportive for global markets.
- Even in choppier markets, equity investors should still be able to capture the dividend and buyback yields.

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Since our CIO Day[1] in August, we have turned a little more constructive on equities. Partly, that is due to some very recent encouraging political developments. At the time of writing, a "No-Deal Brexit" is no longer the only choice for the UK. Italy has a new government. The U.S.-Chinese trade conflict continues, but is not running out of control as talks will supposedly resume. Protests in Hong Kong are, at the very least, no longer escalating. None of this would be enough, however. Political tailwinds could quickly turn into headwinds again. Instead, a little bit of historical perspective might be helpful.

The current upswing in global stock prices is now in its 10th year. Especially in the early stages, it was frequently labelled the most unloved bull market in history. That was because investors were famously slow to increase their risk exposure, after the sobering experience of the global financial crisis. Following the stock market nadir of early 2009, it took a while for risk appetite to return. Central-bank action of the hitherto unthinkable helped TINA to catch on. The TINA concept describes the idea that "There Is No Alternative" to equities in an ultra-low interest-rate environment.

Put succinctly, our view rests on the idea that equity markets will continue to dance to the TINA tune, potentially for quite a while longer. The universe of bonds offering negative, nominal interest rates keeps growing. The problem with TINA, though, is that lower bond yields are often a sign of a cyclical downturn, meaning lower economic growth and lower company earnings. We agree with our economists that the U.S. yield-curve inversion should not be seen as an indicator of a pending global recession. Low interest rates can help support elevated valuation levels only for as long as earnings are expected to be resilient, however. And that was precisely one of the reasons why we turned more cautious before the summer. In our view, analyst expectations for profit growth have been too high for much of the year. Negative nominal or negative real interest rates could potentially have unintended negative consequences on particular sectors, such as financial services.

Two other reasons for caution were that we had some concerns about both the longer-term earnings prospects, especially in the U.S., and about the quality of the earnings growth seen in recent years.
Events such as the recent increase in U.S. tariffs on imports from China and their impact on earnings, can no longer be safely dismissed as mere temporary aberrations. Instead, they may mark the beginning of the end of several key drivers behind the increase of net margins for the S&P 500 during the past 25 years. Profitability increases were partly a result of decades of globalization, as leading multinationals

[1] Global meeting held quarterly, in which we define our economic and market outlook across all asset classes for the next 12 months

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rapidly expanded abroad. By contrast, corporate managers are now forced to consider shifting their global supply chains in reaction to every new U.S. policy announcement or Chinese retaliatory measure. Given the cost of such actions, they are unlikely to be reversed even if tariffs are eventually rolled back.

Moreover, we also fear that the quality of reported U.S. earnings may have declined in recent years. Threats to global supply chains and corporate sentiment are not the only reasons why profits in the U.S. and elsewhere may struggle to continue their familiar upward path of recent decades. Especially for large U.S. multinationals, business profitability also benefited from lower effective tax rates, thanks to their international expansion. Under President Trump, the U.S. corporate tax cut provided an additional boost in 2018. However, there seems to be little political appetite for further tax giveaways to big businesses on either side of the Atlantic. Similarly, companies have long benefited from lower interest expenses from lower net debt and lower interest rates. Despite the recent declines, the additional net benefit looks set to be marginal at best. Meanwhile, we expect buybacks to slow further in favor of higher dividend payouts, given current valuations and slower earnings growth.

Does any of this matter? It might not in the short term. The main reasons we have turned more constructive are some encouraging signs that the global economy may be regaining some momentum. For example, several Japanese capital-goods companies see no further deterioration of their order books. That gives us some confidence for a stabilization of leading economic indicators in the fourth quarter. If so, our expectations for 5% global earnings-per-share (EPS) growth in 2020 remain realistic. As, back in 2007, Chuck Prince, at the time Citigroup's CIO, honestly if somewhat unwisely put it, "as long as the music is playing, you've got to get up and dance. We're still dancing."[2]

This suggests longer-term investors should be worried indeed, if indiscriminate TINA had been the only thing underpinning equity-market returns in the decade since. Fortunately, that has not been the case. Much of the global gains in stock prices over the past 10 years has been driven by the U.S. Calculated in U.S. dollars, non-U.S. equities are still trading below the January 2008 level. This is partly due to industry composition: Within U.S. indices, the service sector and especially companies with a heavy focus on digital technology are more strongly represented than, for example, in European indices. There may be few alternatives to equities overall, but we believe plenty to choose within the global equities universe.

Previous historical episodes of U.S. yield-curve inversions were typically accompanied by rising equity markets, driven by a shift of active funds towards defensive and growth sectors, out of cyclical and value companies. We would argue that investors have already front-loaded this sector rotation, evidenced by the rapid rise in the valuation premium of growth over value during the past 2 years (~70% price-to-earnings (PE) premium of growth vs. value according to our calculations). Paying careful attention to sector weightings is therefore likely to be critical going forward. We prefer overweighting technology and growth in this environment as low interest rates are likely to support this premium. Future profits naturally carry more weight in growth stocks. If they continue to be discounted by a lower factor, that increases their present value. The snag, though, is that it also makes them more vulnerable if and when profits turn out to be less sustainable than thought.

For balance, we are also overweighting financial services, which seem to offer good value for money and should benefit from a stabilizing macroeconomic environment. Tactically, we have recently upgraded industrials back to neutral. Since the downgrade in early July, the sector has only marginally underperformed despite increased trade tensions. By contrast, we are downgrading utilities to underweight, which have had a great run since July as global interest rates collapsed. All in all, we believe equity investors should be able to capture the dividend and buyback yield over the next 12 months. And if our confidence in a stabilization of leading macroeconomic indicators proves justified, we should be able to raise our index targets, too.

[2] Financial Times, July 9, 2007 "Citigroup chief stays bullish on buy-outs"

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THE VALUATION PREMIUM OF GROWTH STOCKS CONTINUES TO SWELL

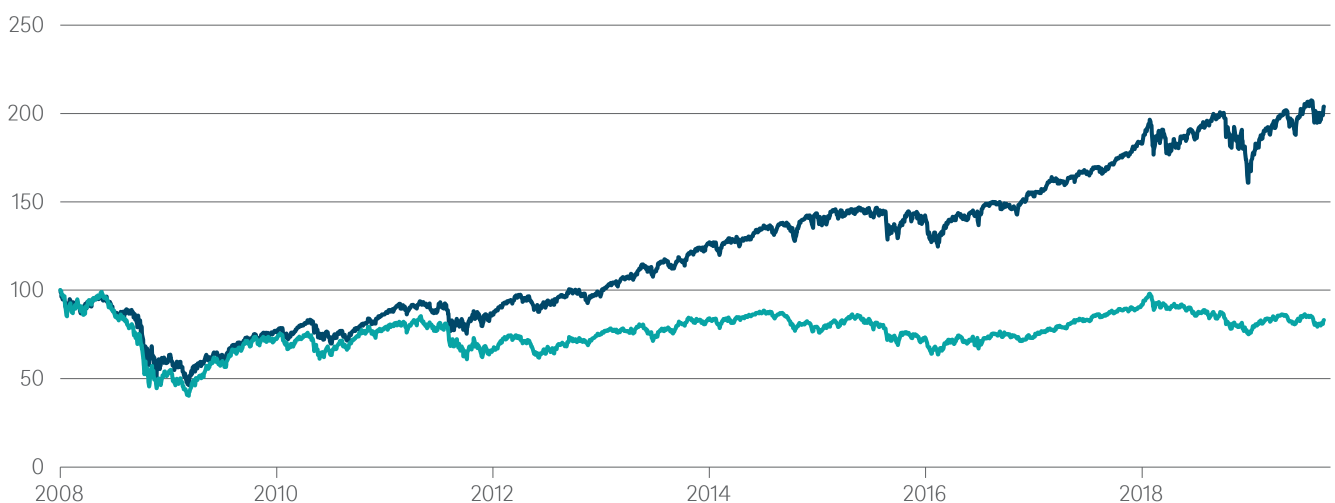
Growth stocks continue to see their valuation multiples expand. Meanwhile, value stocks continue to gain value, if this is defined as a discount to the market. This cannot go on forever.

Price-earnings premium* of growth** vs. value stocks***

*based on next-12-months consensus earnings forecasts; Sources: Refinitiv, DWS Investment GmbH as of 9/10/19
**MSCI ACWI Growth Index
***MSCI ACWI Value Index

AMERICA FIRST

A look at the past 11 years of stock-market returns reveals interesting divergences between the United States and the rest of the world.
indexed: 1/1/08 = 100



U.S. equities* Non-U.S. equities**

*MSCI USA Index
**MSCI AC World ex USA Index
Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 9/6/19

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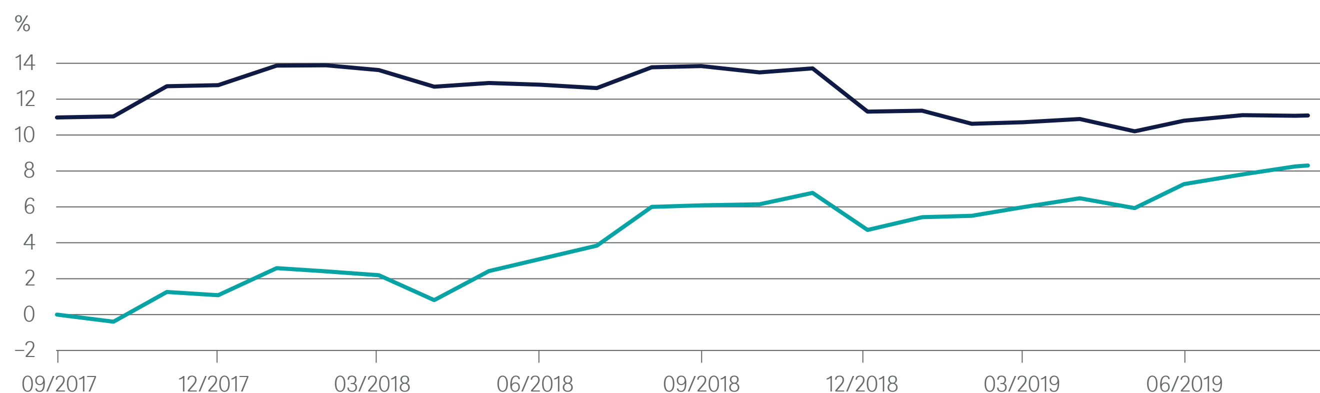
Valuations overview

UNITED STATES: NEUTRAL (NEUTRAL)*

We are a little more cautious about U.S. equities. In the short term, there could well be further corrections, not least because earnings expectations still look quite high in several key sectors. Of course, any signs of progress in the trade dispute would probably be warmly welcomed by markets. The same would be true if the U.S. Federal Reserve delivered larger-than-expected interest-rate cuts. Unfortunately, we do not think either development is particularly likely.

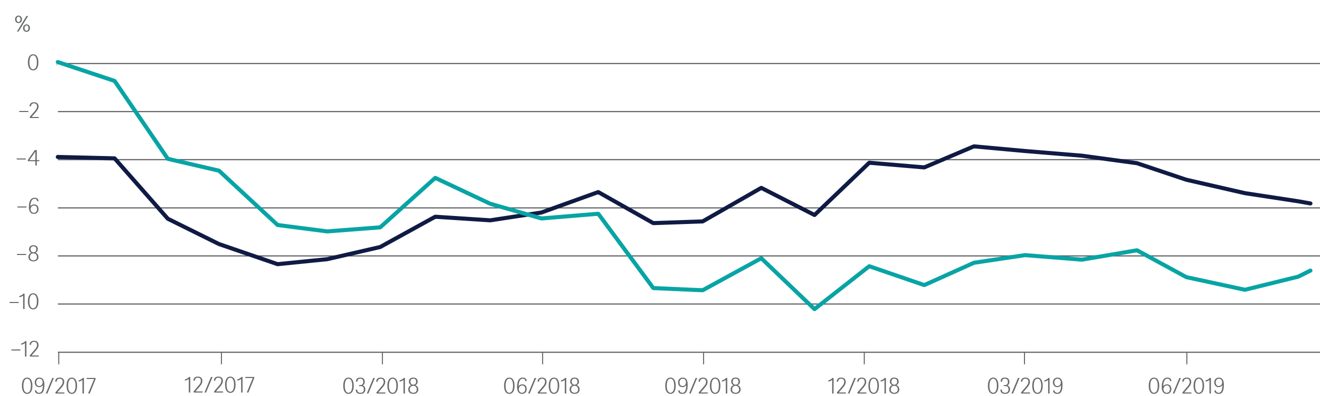


Relative valuation (P/E ratio): S&P 500 vs. MSCI AC World Index

Relative performance: S&P 500 (in dollars) vs. MSCI AC World Index (in local currency)

EUROPE: NEUTRAL (NEUTRAL)*

Political risks have lately been receding in Europe. Italy has a new government, reducing the likelihood of a conflict with the European Union. The UK will probably avoid a chaotic, disorderly Brexit at the end of October. Alas, these positive developments are taking place against a darkening economic backdrop, especially in trade-dependent countries such as Germany. But given the relatively weak performance of European equities over the past decade, we think that a lot of bad news is already priced in.



Relative valuation (P/E ratio): Stoxx Europe 600 vs. MSCI AC World Index

Relative performance: Stoxx Europe 600 (in euros) vs. MSCI AC World Index (in local currency)

* Our assessment is relative to the MSCI AC World Index, the last quarter's view is shown in parentheses.
Sources: FactSet Research Systems Inc., DWS Investment GmbH as of 9/6/19

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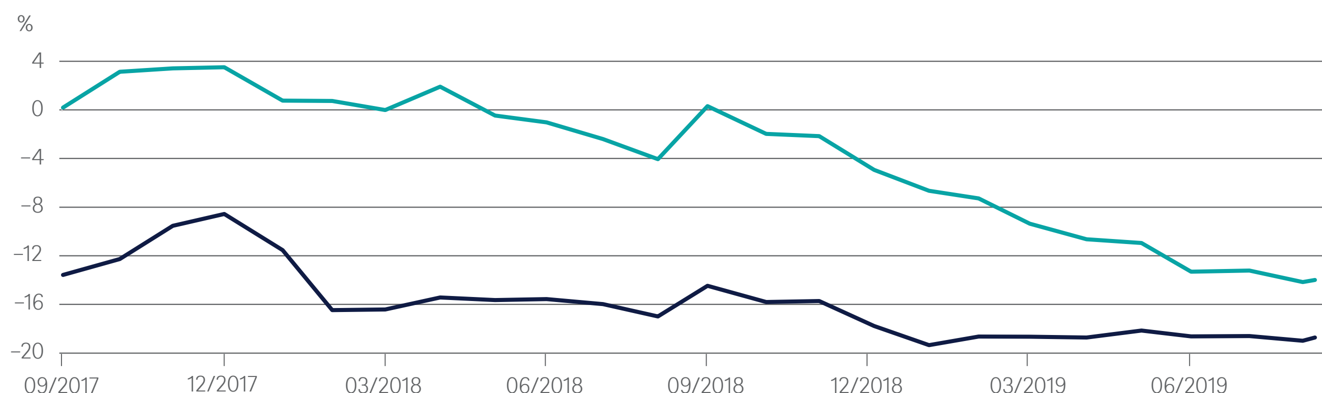
JAPAN: NEUTRAL (NEUTRAL)*

Japanese equities continue to look tempting in valuation terms. Unfortunately, they still lack any obvious triggers for a re-rating over the next couple of months. Earnings still appear to be under pressure as trade tensions continue to take their toll. If hopes for a trade deal with the U.S. materialize, that may well improve sentiment. However, that would also depend on the precise scope of any such deal as well as on progress in Japan's own trade conflict with South Korea.

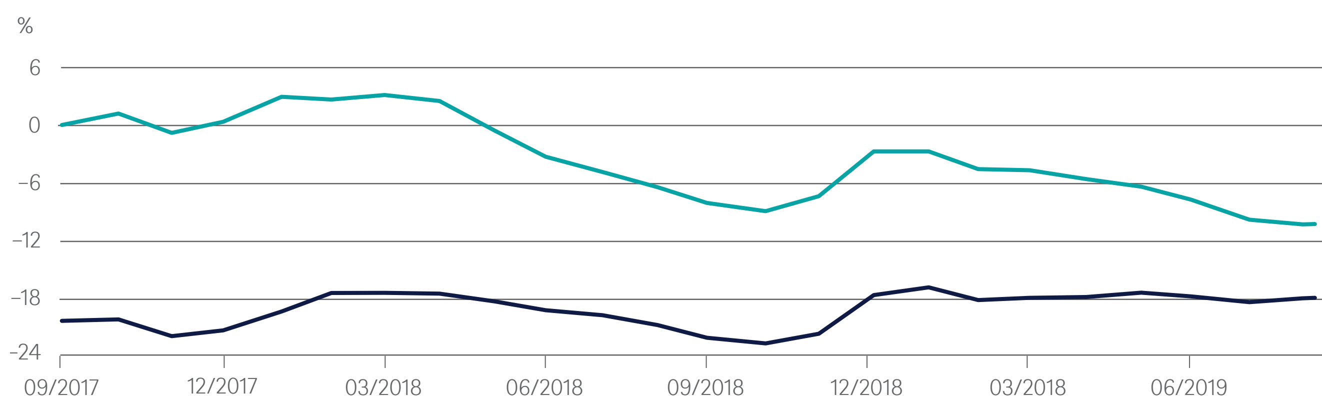


Relative valuation (P/E ratio): MSCI Japan Index vs. MSCI AC World Index

Relative performance: MSCI Japan Index (in yen) vs. MSCI AC World Index (in local currency)

EMERGING MARKETS: NEUTRAL (NEUTRAL)*

Emerging markets remain heavily exposed to various trade conflicts, creating some near-term risks. In the longer term, they should probably benefit from fading headwinds, notably given that the Fed has shifted from higher to lower U.S. interest rates since the end of last year. Structural reforms should also help in several key countries. Compared to industrialized countries, we believe emerging-market equities should deliver pretty solid earnings growth in 2020.



Relative valuation (P/E ratio): MSCI Emerging Markets Index vs. MSCI AC World Index

Relative performance: MSCI Emerging Markets Index (in dollars) vs. MSCI AC World Index (in local currency)

* Our assessment is relative to the MSCI AC World Index, the last quarter's view is shown in parentheses.
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GLOSSARY

Brexit is a combination of the words "Britain" and "Exit" and describes the exit of the United Kingdom of the European Union.

A bull market is a financial market where prices are rising - usually used in the context of equities markets.

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.

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

The Euro Stoxx 50 is an index that tracks the performance of blue-chip stocks in the Eurozone.

The European Union (EU) is a political and economic union of 28 member states located primarily in Europe.

The financial crisis refers to the period of market turmoil that started in 2007 and worsened sharply in 2008 with the collapse of Lehman Brothers.

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

The MSCI AC World Index captures large- and mid-cap companies across 23 developed- and 24 emerging-market countries.

The MSCI Emerging Markets Index captures large- and mid-cap representation across 23 emerging-market countries.

The MSCI Japan Index is designed to measure the performance of the large- and mid-cap segments of the Japanese market.

The MSCI ACWI Growth Index captures large- and mid-cap securities across 23 developed- and 26 emerging markets, classified as growth stocks.

The MSCI ACWI Value Index captures large- and mid-cap securities across 23 developed- and 26 emerging-markets classified as value stocks.

The MSCI AC World ex USA Index captures large- and mid-cap companies across 22 developed- and 23 emerging-market countries, excluding the United States.

The MSCI USA Index is designed to measure the performance of the large- and mid-cap segments of the U.S. market.

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

The real interest rate is the nominal interest rate adjusted for inflation as measured by the GDP deflator.

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.

The Stoxx Europe 600 is an index representing the performance of 600 listed companies across 18 European countries.

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

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.

A yield-curve inversion is when the yields on bonds with shorter duration are higher than the yields on bonds that have a longer duration.

PERFORMANCE / Overview

Performance in the past 12-month periods (in %)

	08/14 – 08/15	08/15 – 08/16	08/16 – 08/17	08/17 – 08/18	08/18 – 08/19
MSCI AC World Index	–5.8%	7.9%	17.8%	12.0%	0.3%
MSCI Emerging Market Index	–22.9%	11.8%	24.5%	–0.7%	–4.4%
MSCI Japan Index	4.2%	2.9%	13.7%	9.0%	–5.6%
S&P 500	0.5%	12.6%	16.2%	19.7%	2.9%
Stoxx Europe 600	9.4%	–1.9%	12.5%	5.7%	3.0%

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