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Marketing Material

THIRD-QUARTER REPORTING AHEAD: SUDDENLY LAST SUMMER

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IN A NUTSHELL

_ The third quarter S&P 500 EPS ahead: Will summer be the best of 2020? What is ahead for winter?
_ The third quarter S&P 500 EPS is five dollars above the second quarter: Half from lower loan loss provisions and higher oil.
_ If our 34 dollars estimate is crushed, it is likely from tech, communications and health care.
_ DWS S&P 500 EPS profit indicator suggests a bounce, but not robust profit conditions.
_ The third quarter is suddenly last summer and likely the best of 2020 with a slow winter ahead.
_ S&P 500 P/E is very high, even on annualized third quarter EPS, and Vix remains very elevated.

THE THIRD QUARTER S&P 500 EPS AHEAD: WILL SUMMER BE THE BEST OF 2020? WHAT IS AHEAD FOR WINTER?

Next week, third-quarter earnings season begins with the kickoff by big banks. Our longstanding third quarter 2020 S&P 500 earnings-per-share (EPS) estimate of 34 dollars compares to bottom-up consensus of 33 dollars, which is down 22% year-over-year vs. our more rounded estimate of down 20% year-over-year. Given the strong bounce in economic activity this summer, we expect S&P 500 results to beat bottom-up expectations by at least the usual 3% aggregate beat with results likely finalizing between 34-36 dollars or down 15-20% year-over-year, but up about 25% sequentially from depressed second quarter.

This note reviews the macro indicators we monitor to help us forecast and fine-tune our estimates into earnings season. However, as noted last quarter, there is been a big reduction in S&P 500 EPS sensitivity to U.S. gross domestic product (GDP); as the pandemic recession hit services hardest, which dominate U.S. GDP, whereas S&P 500 non-financials are more manufacturing oriented. Moreover, S&P 500 EPS has substantially shifted toward digital businesses in recent years, which were further boosted by social distancing. The Atlanta Fed GDP now model forecasts near 9% sequential quarter-over-quarter real U.S. GDP growth for the third quarter, which is 35% on a seasonally adjusted annualized basis.

THE THIRD QUARTER S&P 500 EPS IS FIVE DOLLARS ABOVE THE SECOND QUARTER: HALF FROM LOWER LOAN LOSS PROVISIONS AND HIGHER OIL

Bottom-up S&P 500 EPS appears conservative to us, but more so at tech, communications, and health care than at financials, energy, and industrials. Bottom-up puts tech plus communications flat sequentially and health care down 5%. However, computer and semiconductor shipments climbed sequentially and we believe software and advertising also improved. Health care is 20% of U.S. GDP and the return of patients to hospitals and doctor's offices for normal care should boost earnings, especially devices and supplies. Tech and health-care profits were very resilient in the second quarter, but it is conservative of consensus to not expect a sequential climb given secular trends and history of exceeding guidance.

IF OUR 34 DOLLARS ESTIMATE IS CRUSHED, IT IS LIKELY FROM TECH, COMMUNICATIONS AND HEALTH CARE

It makes sense that consensus earnings are up sequentially at the obvious beneficiaries of exiting a recession. Financials should have lower loan loss provisions sequentially given macro improvement, adding about 1.50 dollars to S&P 500 EPS. However, loan books are shrinking and ultimate credit costs remain uncertain, large reserve builds ahead of winter probably continue. Energy should add 1.00 dollar to S&P 500 EPS and might be profitable in the third quarter as West-Texas-Intermediate (WTI) oil averaged 40 dollars per barrel in third quarter vs. 28 dollars per barrel in the second quarter. Manufacturing activity turned back on in late second and third quarter as indicated by the manufacturing Institute for Supply Management (ISM) and industrial production, but it is still well below pre-pandemic levels. Yet given good activity at transports (non-passenger) and manufacturing being switched on again, Industrials likely add at least 1.00 dollar to S&P 500 EPS. We also expect the consumer sectors to add at least 1.00 dollar as U.S. retail sales climbed in third quarter and internet and essential big-box S&P 500 retailers are where consumers have turned to safely shop, making less frequent but larger purchases per trip. Thus, if 34 dollars is beaten big, it is likely form big beats at tech, communications, health care, and consumer sectors.

DWS S&P 500 EPS PROFIT INDICATOR SUGGESTS A BOUNCE, BUT NOT ROBUST PROFIT CONDITIONS

Our profit indicator tracks six macro data points to help estimate S&P 500 EPS growth: 1) mfg. ISM, 2) industrial production, 3) exports, 4) initial jobless claims, 5) loan growth and 6) oil prices. Our indicator is designed to indicate earnings growth when over 50. Its third-quarter average was 53.5, up from 46 in the second quarter and first quarter. It recovered into expansion territory, but to levels of modest operating profit growth before items such as loan loss provisions, taxes, foreign-exchange rates, buybacks, etc. Being above 50 for the first time since the third quarter of 2019 is encouraging, but September was flat with August and the level is below 2017 levels after the 2015-2016 profit recession. The dollar fell in third quarter vs. second quarter, assisting S&P 500 EPS growth; but likely offset by no share shrink. Unless our profit indicators materially improve, it suggests flat fourth-quarter S&P 500 EPS from the third quarter.

THE THIRD QUARTER IS SUDDENLY LAST SUMMER AND LIKELY THE BEST OF 2020 WITH A SLOW WINTER AHEAD

Summer was an important and successful step on the pandemic recession recovery path, but a journey remains to recoup profits, GDP and jobs to pre-pandemic levels. We fear that progress will sharply slow in Q4-Q1 and very possibly flat line until we get to next spring, after winter virus risks and when clarity should emerge on policies post-election.

S&P 500 P/E IS VERY HIGH, EVEN ON ANNUALIZED THIRD QUARTER EPS, AND VIX REMAINS VERY ELEVATED

The S&P 500 price-to-earnings ratio (P/E) is 24x on four-quarter trailing and annualized quarterly EPS estimates through the first quarter of 2020. Our P/E / Vix ratio is in "realistic" territory, but only because volatility index (Vix) is so high, and near "denial." In mid 2009, the Vix was still high and trailing P/E a bit over 20, but four-quarter trailing EPS collapsed 35% from peak vs. 15% this time, thus S&P 500 traded at 13x its peak EPS vs. 21x this time.

GLOSSARY

Bottom-up is an approach which focuses on approaching a problem through the smallest elements (e.g. individual corporate results).

The US Dollar is the common currency of the United States of America and is the most held reserve currency in the world.

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.

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.

The Institute of Supply Management (ISM) Indices track different areas of the U.S. economy, such as manufacturing activity and industrial production.

Loan-loss provisions are an allowance for bad loans, for example due to customer defaults or a renegotiation of the terms of a loan.

Real GDP is GDP adjusted for a given measure of price inflation in an economy.

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.

A share buyback involves a company buying back its own shares.

The VIX is the popular name for the Chicago Board Options Exchange's Volatility Index. It is a popular measure of the stock market's expectation of volatility based on S&P 500 index options.

West Texas Intermediate (WTI) is a grade of crude oil used as a benchmark in oil pricing.

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