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DWS

Marketing Material

READY OR NOT, NORMAL HERE WE COME: BUT HARD TO FIND FOR MANY

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IN A NUTSHELL

- The return to normal will likely come slowly as individuals regain their confidence
- First quarter S&P 500 EPS is not a story about the whole, but rather two very distinct parts
- Poor quality: First GAAP S&P 500 EPS was 21 dollars vs. non-GAAP S&P 500 EPS of 33 dollars
- Sticking with virtual and essential: underweight financials, REITs, energy, industrials
- We prefer corporate and municipal credit. Still cautious on equities, prefer growth vs. value

THE RETURN TO NORMAL WILL LIKELY COME SLOWLY AS INDIVIDUALS REGAIN THEIR CONFIDENCE

The severe economic damage of widespread non-essential activity lockdowns to U.S. and European economies is moving behind, but we expect a slow recovery with elevated setback risks because the virus still circulates in the United States and other Western countries; risking new flare-ups or a hard to extinguish smolder. It appears that only China and Asian Pacific nations smothered their initial outbreaks with strict regional quarantines, social isolation, masks, and other preventions. The virus is spreading rapidly in Russia, Brazil, India and other large parts of the world making a resurgence anywhere still possible. Thus, global travel will likely remain highly restricted all year and trade depressed owing to weak economies, border restrictions and trade disputes.

The recovery in spending on travel, dining, and other social activities will likely be slow. Not just because of changed behavior to prevent infection, but also from hits to spending power. Lower institutional revenue and personal income from hits to earnings and balance sheets of many private and public employers. We expect countless small service businesses, retail, restaurants, lodging, entertainment, education, daycare, and big industries like domestic energy and transportation and related equipment manufacturing (many S&P 500 industrials), will operate well below 2019 levels through 2020 and probably 2021. This will depress tax revenue and public spending and jobs.

Big cities will be especially challenged, as their purpose is to be a place where people meet from near and far, for business or pleasure, often for crowded events via crowded travel. Pandemics attack cities, where we plan, produce, trade, and also live, learn, and play. Thus, a pandemic is among the worst shocks a skilled service economy can suffer. Although internet connectivity and the virtual world mitigate this shock, it is not a cure. And while going virtual is a lifeboat for some, it cannot carry all and it stirs the waters. This makes a pandemic shock still severe in the modern world and more unevenly distributed. If you work in tech, congratulations. But many other organizations and employees are injured and afraid. This gap raises populist risks.

FIRST QUARTER S&P 500 EPS IS NOT A STORY ABOUT THE WHOLE, BUT RATHER TWO VERY DISTINCT PARTS

First quarter S&P 500 earnings per share (EPS) is finishing at 33 dollars or down "only" about 15% year-over-year. The beats and miss stats are irrelevant. The most revealing figures of the earnings season are that the 50% of S&P 500 EPS in the first quarter from tech, communications, health care, staples and utilities was up 6% year-over-year and the 50% of S&P 500 EPS from financials, Real Estate Investment Trusts (REITs), energy, materials, industrials and consumer discretionary was down 35%. The aggregate S&P 500 EPS decline of 15% does not represent any S&P 500 sector, but these stats for the two S&P 500 halves represent the sectors within them well. The first half, which we call the "young & healthy" all had sector EPS growth of 3% to 7%.

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The other "old & vulnerable" half of the S&P 500 had 20% to 45% EPS declines at each sector, except REITs which were down a low single digit percent as missed rents are in forbearance.

POOR QUALITY: FIRST GAAP S&P 500 EPS WAS 21 DOLLARS VS. NON-GAAP S&P 500 EPS OF 33 DOLLARS

The gap between generally accepted accounting principles (GAAP) and non-GAAP EPS gaped to spreads not seen since the recession of 2008 and 2001. The losses at many companies in the "old & vulnerable" sectors and greater losses expected in the second quarter caused a surge in corporate borrowing. Issuance of corporate credit is setting a blowout year-to-date record. U.S. corporate debt issuance for 2020 is already one trillion dollars or triple this time last year. Like earnings, the story of S&P 500 balance sheets has also become a story that must be told in two halves, with the aggregate not representing most S&P 500 sectors. Healthy profits and cash piles at tech cannot be used by energy and retailers to offset their losses and high debt.

STICKING WITH VIRTUAL AND ESSENTIAL: UNDERWEIGHT FINANCIALS, REITS, ENERGY, INDUSTRIALS

Except for tech, health care, staples and utilities, we expect 2021 earnings for all other S&P 500 sectors to be below that of 2019. We maintain only these four sectors as overweights as every sector's valuation now requires a quick rebound to 2019 earnings levels to be attractive, in our view. The communications sector should be about even with its 2019 earnings in 2021, but only because of its internet giants which we stay overweight, but we are cautious on traditional media and networks. We raise materials and consumer discretionary from under to equal-weight. At this time, we only over or underweight our sector tilts by 1% point each. Given strong outperformance, we reduce our health care overweight from 3% to 1%.

WE PREFER CORPORATE AND MUNICIPAL CREDIT. STILL CAUTIOUS ON EQUITIES, PREFER GROWTH VS. VALUE

We believe that higher quality corporate and municipals credit deserves a higher than usual allocation within multi-asset portfolios. We over-weight credit and Treasury bills and underweight equities by 10% points compared to our strategic asset allocation. Within equities we prefer U.S. large cap equities and stick with our more than three-year preference for growth over value. We seek value in credit and growth in equities.

GLOSSARY

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

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.

Generally accepted accounting principles, or GAAP, are a set of rules that encompass the details, complexities, and legalities of business and corporate accounting.

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

Large cap firms generally have a market capitalization of more than 10 billion dollars.

A Real Estate Investment Trust (REIT) is a company that owns and, in most cases, operates income-producing real estate. REITs sell like a stock on the major exchanges and invest in real estate directly, either through properties or mortgages.

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

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).

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.

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