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Marketing Material

S&P 500 LEVERAGE UPDATE: ANOTHER YOUNG VS. OLD SECTOR SPLIT

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IN A NUTSHELL

_ Review of S&P 500 company balance sheets after the second-quarter earnings and borrowing.
_ The pandemic brought a split in S&P 500 EPS resilience and balance-sheet quality.
_ S&P 500 net debt to 12-month trailing EBITDA: 225% from 180% a year ago.
_ What will the young & healthy spend their cash on?
_ S&P 500 banks: assets/equity still healthy, but loan-loss provisions surge and net interest margins collapse.
_ Credit spreads: near full recovery, but split here too – old wider than young.
_ Our 12-month S&P 500 target is 3300: +/- 300 points depending on Senate.

REVIEW OF S&P 500 COMPANY BALANCE SHEETS AFTER THE SECOND-QUARTER EARNINGS AND BORROWING

Gross debt at S&P 500 non-financials jumped 220 billion dollars during the second quarter, cash increased by 290 billion dollars, thus net debt actually decreased by 70 billion dollars to a total of 4.25 trillion dollars. However, cash appears temporarily boosted by seasonality, inventory liquidation, deferred taxes, etc. The climb in S&P 500 gross debt is mostly at the hard hit industries bracing for full year losses and working capital needs from the pandemic. However, some industries are borrowing for need and others opportunistically. This note examines S&P 500 leverage metrics by sector and it shows the contrast between young & healthy vs. old & vulnerable sectors.

THE PANDEMIC BROUGHT A SPLIT IN S&P 500 EPS RESILIENCE AND BALANCE-SHEET QUALITY

S&P 500 earnings per share (EPS) fell 32% year-over-year in the second quarter, but half of S&P 500 earnings from tech, communications, health care, staples and utilities were flat vs. last year as the other half of S&P 500 earnings from financials, Real Estate Investment Trusts (REITs), consumer discretionary, industrials, materials and energy was down 67% year-over-year. We call the resilient half of S&P 500 earnings across five sectors the young & healthy. We call the other six sectors, which were the half of S&P 500 earnings that fell over 70% (ex. internet retail from consumer discretionary) the old & vulnerable.

Despite being the worst S&P 500 EPS decline other than the fourth quarter 2008, results were better than expected at the old & vulnerable and much better at the young & healthy. For 2020, our and the consensus S&P 500 EPS estimate is down 20% year-over-year with old & vulnerable down 35% and young & healthy up 5%. The sharp decline at old & vulnerable includes sizable losses at many companies and negative cash flow after dividends. It is at such companies where net debt jumped and leverage ratios deteriorated most. Whereas the successful defense of profits, at high levels and margins, and high surplus free cash flow at most young & healthy caused additional gross borrowing to go unused with a buildup in cash.

S&P 500 NET DEBT TO 12-MONTH TRAILING EBITDA: 225% FROM 180% A YEAR AGO

S&P 500 non-financial net debt to trailing Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) through the second quarter climbed to the highest level since 2003, but the cause is a surge at the old & vulnerable sectors and not the young & healthy. Net debt jumped at energy, industrial capital goods, airlines, REITs, and consumer discretionary excluding internet retailing. This is likely to continue in the third quarter and longer for certain companies as cash raised via debt issuance is used to cover needs.

Young: Net Debt / EBITDA for tech, communications, internet retailing, health-care, staples is 140% vs. 135% last year. If based on the second quarter end's net debt and full 2020 estimated (E) EBITDA, this leverage ratio would be 139% and 129% if based on 2021E EBITDA.

Old: Net Debt / EBITDA for energy, industrials, materials, consumer discretionary ex. internet retailing is 330% vs. 240% last year. If based on the second-quarter end's net debt and full 2020E EBITDA, this leverage ratio would be 615% and 379% if based on 2021E EBITDA.

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Net debt to market-cap ratios did not deteriorate for the S&P 500 overall vs. last year as index valuations expanded, especially at the young & healthy. But deterioration in net debt to market-cap ratios occurred at the old & vulnerable. Fortunately, the new debt issuance was at long maturities and low interest rates. Many young & healthy companies were able to refund debt or loans and build up excess cash reserves at record low borrowing rates.

WHAT WILL THE YOUNG & HEALTHY SPEND THEIR CASH ON?

Much of the old & vulnerable have several years of balance-sheet repair ahead, but shareholder pressure could soon return on the young & healthy to deploy excess cash. We expect acquisitions of some recently proven smaller high growth businesses in tech and health care and a return to strong dividend growth. We think buybacks will pick-up, but not aggressively so at these valuations until time proves them sustainable.

S&P 500 BANKS: ASSETS/EQUITY STILL HEALTHY, BUT LOAN-LOSS PROVISIONS SURGE AND NET INTEREST MARGINS COLLAPSE

Bank leverage ratios are healthy, but net interest margins collapsed. We expect to drop substantially in 2021, but a steeper yield curve needed for decent net interest margins.

CREDIT SPREADS: NEAR FULL RECOVERY, BUT SPLIT HERE TOO – OLD WIDER THAN YOUNG

We still think non-financial credit spreads of value sector issuers remain more attractive than that of their equities. Until investment-grade spreads fully recover at these sectors, we do not think the equities should trade anywhere near 20x 2021E S&P 500 EPS.

OUR 12-MONTH S&P 500 TARGET IS 3300: +/- 300 POINTS DEPENDING ON SENATE

We remain cautious on the S&P 500 overall for three main reasons: 1) U.S. elections and Democrat Sweep risk, 2) autumn being a more difficult stage for U.S. and European gross-domestic-product (GDP) recovery, the reopening V-shaped bottom likely takes a plateauing shape (initial jobless claims still above last recession's peak), 3) valuations, S&P 500 still trades over 20x its record 2019 EPS, which is within reach for 2021 but with elevated risks. We stick with a stance favoring growth and defensives and wait for a better value and cyclicals opportunity.

GLOSSARY

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

Cyclical is something that moves with the cycle.

A dividend is a distribution of a portion of a company's earnings to its shareholders.

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.

Free Cash Flow (FCF) is a measure of financial performance calculated as operating cash flow minus capital expenditures. It shows how much cash a company is able to generate after deducting the money required to maintain or expand its asset base.

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.

Investment grade (IG) refers to a credit rating from a rating agency that indicates that a bond has a relatively low risk of default.

Market capitalization, in the context of an individual firms, is the number of shares issued multiplied by the value of the shares.

Real Estate Investment Trusts (REITs) are companies, mostly listed, that own and often operate various types of real estate. They are obliged to pay out a minimum of 90% of earnings.

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.

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.

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)

	08/15 - 08/16	08/16 - 08/17	08/17 - 08/18	08/18 - 08/19	08/19 - 08/20
S&P 500	12.6%	16.2%	19.7%	2.9%	21.9%

Past performance is not indicative of future returns.
Sources: Bloomberg Finance L.P., DWS Investment Management Americas Inc. as of 9/14/20

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