

## Snapshots of S&P 500 at record highs as long-term yields collapse



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### Record S&P high on dovish Fed and 10yr Treasury yield dipped under 2%

Last week the S&P 500 pushed over 2950 to set a new record high, closing at 2954 on Thursday June 20<sup>th</sup>, the day after the Federal Reserve's (Fed) June FOMC meeting. Post FOMC meeting communications exceeded the already quite dovish expectations of most investors. The FOMC maintained its slow yet solid gross domestic product (GDP) outlook, but acknowledged that inflation is still running below their 2% target and also reduced its estimate of the long-term neutral Fed Funds rate from 2.8% to 2.5%. The post meeting press release and conference suggested that cuts are likely as soon as the next meeting, July 30-31, especially if risks to growth, including the trade conflict, escalate. Following these messages from the Fed, markets quickly moved to price in multiple cuts to the Fed Funds rate over the coming year with the 2yr Treasury yield falling to 1.75% and the 10yr Treasury yield fell to 2.0% with a brief dip under 2%.

### The G20 meeting is an important juncture to markets and central banks

The June 28-29 G20 meeting in Japan, which will be followed by a special meeting between President Trump and President Xi to discuss the U.S.-China trade conflict, remains an important juncture for markets and global central bank policies. The Fed acknowledged that with inflation below their target, it has the ability and stands ready to be more accommodative to help ensure the longevity of this cycle against threats to growth, including a continued or escalating trade conflict. We believe that it is very unlikely that the G20 meeting produces a grand deal that quickly lowers the existing 25% US tariffs on imports from China. Accordingly, we think it likely that the Fed cuts the Fed Funds rate by 25bp or 50bp on July 31. If the summit does not produce an agreement to hold off on any further tariff hikes this year, then the cut could be 50bp. Because it is unlikely that existing tariffs are cut and that further tariffs and other trade restrictions could soon come, we expect consensus S&P earnings per share (EPS) estimates for 2019 to drop to \$160-\$165 following the G20 meeting and during a weak 2Q reporting season.

### Tariffs, lower interest rates and weak oil prices will limit S&P EPS growth

We have repeatedly signaled that without a tariff truce, material downside risk exists on our 2019E S&P EPS of \$169. We previously published that if existing tariffs continue through the year, we would cut our S&P EPS estimate by \$3-5. Given lower interest rates and weaker oil prices, in part associated with the expected continuation of existing tariffs, we are likely to cut our S&P EPS estimate to \$164 following the G20 meeting. If additional tariffs are imposed on China imports following the G20 meeting, we will likely cut our 2019E S&P EPS to about \$160 and introduce a 2020E S&P EPS of \$165-170. This trade conflict threatens flat S&P EPS for 1 or 2 years.

### Greatest EPS risk at Industrials, Energy, Tech and now also Financials

Continued tariffs will negatively affect Industrials, Materials and equipment oriented industries at Technology. Weak oil prices and very low interest rates, despite a ten year old expansion, will weigh on the Energy and Financial sectors ability to generate EPS growth over the next several quarters. If additional tariffs on China imports are introduced, it will likely limit any EPS growth from the Consumer Discretionary sector. These are the sectors that we are most tactically cautious on for the summer until some path to resolving this trade conflict is more apparent and likely. We continue to expect the S&P to fall below 2800 when G20 U.S.-China trade negotiations disappoint and a U.S. fiscal fight begins to brew for the autumn to posture for the 2020 elections.

### Seek shelter at bond substitute domestic equities and IG corporate credit

We see greater risk from continued trade conflict to the global cyclical sectors of the S&P 500 than to Emerging Market (EM) Asia or China equities. Tariffs on China imports will mostly be paid by the importing companies. China listed companies are more domestic consumption oriented and less sensitive to export activity than China's economy. Because of fiscal and monetary stimulus in progress and also because exports are a much smaller driver of China's growth than a decade ago, only a quarter of China's exports are to the US, we expect China's economy and its currency to prove resilient to this conflict. We think the best reward vs. the risk for an eventual de-escalation of the trade conflict is EM Asia equities. We think U.S. investors should keep full and even a moderate over-weight to this region despite a likely volatile summer, while being under-weight developed market global cyclical sectors. We suggest over-weights on solid secular growth stocks and bond substitute defensives. Yields on investment grade credit is low vs. normal but the credit spread is attractive. The outlook for Banks and most Financials is getting cloudy. We remain constructive on valuations, benign credit costs and dividend payout ratio upside, but pressure on net interest margins from collapsed interest rates is a risk we must carefully monitor.

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## Definitions

Consumer discretionary is a sector of the economy that consists of businesses selling nonessential goods and services.

Earnings per share is calculated as a companies' net income minus dividends of preferred stock all divided by the total number of shares outstanding.

The federal funds rate is the interest rate at which banks actively trade balances held at the Federal Reserve.

The Federal Open Market Committee (FOMC) is a committee that oversees the open-market operations of the U.S. Federal Reserve.

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 Group of Twenty or G20 is an international forum of the governments and central bank governors from 19 individual countries—Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi-Arabia, South Africa, South Korea, Turkey, the United Kingdom and the United States—along with the European Union (EU), founded in 1999 with the aim of promoting international financial stability.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

The S&P 500 Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

The U.S. Federal Reserve Board (Fed) implements U.S. monetary policy.

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