

David Bianco  
Chief Investment Officer &  
Strategist, Americas



### In a nutshell

- Economic profit growth is very difficult to achieve at regional index levels
- Economic EPS growth is a simplified proxy for proper economic profit growth
- Economic EPS growth = Real EPS growth – (EPS retention ratio \* Real CoE)
- Shiller vs. Bianco PE: Inflation only vs. reinvestment adjusted 10-yr trailing EPS
- Using trailing vs. forward EPS is the main debate right now on the S&P PE
- What economic profits are to businesses, alpha is to investment managers

All opinions and claims are based upon data on 4/13/2018 and may not come to pass. This information is subject to change at any time, based upon economic, market and other considerations and should not be construed as a recommendation. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect. Deutsche Investment Management Americas, Inc.

CRC 056941 (04/2018)

## Americas CIO View

### Economic EPS growth: Does any region have it this cycle?

#### Economic profit growth is very difficult to achieve at regional index levels

A business that generates economic profit is a business that makes better use of the capital it employs than other similar risk businesses. Companies that generate economic profit under free-market conditions tend to boost economic productivity and societal prosperity. Investors tend to prefer such companies and award them higher valuations versus their broad regional index.

#### Economic EPS growth is a simplified proxy for proper economic profit growth

While many individual companies generate economic profits, it's very difficult for the full set of companies in a regional index to generate economic profits and especially to increase their economic profits. In this note, we introduce economic earnings-per-share (EPS) growth as a proxy for proper economic profit growth metrics and see if any of the major global regions are achieving such growth this cycle. It appears that only the U.S. and EM (emerging markets) Asia are doing so on a secular basis, or setting cyclical EPS bounce aside. These two regions both have high Tech sector representation. Japan has turned the corner on its poor capital allocation of the past, but it will take more time to tell if it can sustain secular economic EPS growth.

#### Economic EPS growth = Real EPS growth – (EPS retention ratio \* Real CoE)

It is well understood that inflation doesn't represent value-added EPS growth. Only real EPS growth raises a company's real value. What is less understood is that real EPS growth only represents economic profit growth when that EPS growth exceeds a threshold that accounts for the portion of earnings retained rather than paid out to shareholders as dividends. If real EPS growth is less than the retention ratio times a fair real cost of equity (CoE), then investors would be better off if earnings were paid as dividends instead. As then, the dividend yield should exceed the prior real EPS growth rate.

#### Shiller vs. Bianco PE: Inflation only vs. reinvestment adjusted 10-yr trailing EPS

The concept that EPS growth should exceed inflation whenever companies reinvest part of their earnings is the principle underlying the calculation of our Bianco price-to-earnings (PE) multiple and why we have long argued that Shiller PE misleads; because it fails to account for changes in S&P 500 dividend payout ratios across time. Because payout ratios also differ across global regions and sectors, we consider Shiller PE unreliable for valuation comparisons

across such global equity-market segments. Europe remains cheap on Bianco PE, but this requires a continued recovery in the earnings power of Europe versus its last cycle. We believe this will happen, albeit slowly and probably not to the fullness of prior-cycle earnings peaks. EM is cheap on Bianco PE, but we prefer EM Asia as its low Bianco PE being truly attractive is less dependent on a return to high commodity prices of the last cycle.

### **Using trailing vs. forward EPS is the main debate right now on the S&P PE**

Shiller PE continues to point to an overvalued S&P 500, as it has for many years. But Bianco PE also points to a somewhat expensive market on 10-yr trailing average S&P EPS adjusted for both inflation and fair return on reinvestment. It is only on a forward PE that the S&P is attractive at about 17x 2018 expected EPS vs. its 30-yr average PE. This is why this earnings season is so important. If this earnings season, which will include benefits of the U.S. corporate-tax-rate cut, supports our 2018 expected S&P EPS of \$155 or higher, we expect stocks to rally strongly.

### **What economic profits are to businesses, alpha is to investment managers**

Just as measuring economic profits requires a risk-adjusted cost of capital, measuring true alpha requires analysis that incorporates all the risks taken to generate any outperformance vs. a benchmark. It's well understood that beating a benchmark from a persistent tilt toward securities with a beta to the benchmark above one is not true alpha. Similarly, any persistent tilt toward other risk factors, like size and value, per Fama & French, is also not true alpha.

All opinions and claims are based upon data on 4/13/2018 and may not come to pass. This information is subject to change at any time, based upon economic, market and other considerations and should not be construed as a recommendation. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect. Deutsche Investment Management Americas, Inc.

CRC 056941 (04/2018)

## Glossary

### Cost of equity (CoE)

Cost of equity (CoE) is the return (often expressed as a rate of return) a firm theoretically pays to its equity investors, to compensate for the risk they undertake by investing their capital.

### Earnings per share (EPS)

**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)

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

### Inflation

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

### Price-to-earnings (P/E) ratio or multiple

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

### S&P 500

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

All opinions and claims are based upon data on 4/13/2018 and may not come to pass. This information is subject to change at any time, based upon economic, market and other considerations and should not be construed as a recommendation. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect. Deutsche Investment Management Americas, Inc.

CRC 056941 (04/2018)

## Risk warning

Investments are subject to investment risk, including market fluctuations, regulatory change, possible delays in repayment and loss of income and principal invested. The value of investments can fall as well as rise and you might not get back the amount originally invested at any point in time.

Investments in Foreign Countries – Such investments may be in countries that prove to be politically or economically unstable. Furthermore, in the case of investments in foreign securities or other assets, any fluctuations in currency exchange rates will affect the value of the investments and any restrictions imposed to prevent capital flight may make it difficult or impossible to exchange or repatriate foreign currency. Foreign Exchange/Currency – Such transactions involve multiple risks, including currency risk and settlement risk. Economic or financial instability, lack of timely or reliable financial information or unfavorable political or legal developments may substantially and permanently alter the conditions, terms, marketability or price of a foreign currency. Profits and losses in transactions in foreign exchange will also be affected by fluctuations in currency where there is a need to convert the product's denomination(s) to another currency. Time zone differences may cause several hours to elapse between a payment being made in one currency and an offsetting payment in another currency. Relevant movements in currencies during the settlement period may seriously erode potential profits or significantly increase any losses.

High Yield Fixed Income Securities – Investing in high yield bonds, which tend to be more volatile than investment grade fixed income securities, is speculative. These bonds are affected by interest rate changes and the creditworthiness of the issuers, and investing in high yield bonds poses additional credit risk, as well as greater risk of default.

Hedge Funds – An investment in hedge funds is speculative and involves a high degree of risk, and is suitable only for “Qualified Purchasers” as defined by the US Investment Company Act of 1940 and “Accredited Investors” as defined in Regulation D of the 1933 Securities Act. No assurance can be given that a hedge fund's investment objective will be achieved, or that investors will receive a return of all or part of their investment. Commodities – The risk of loss in trading commodities can be substantial. The price of commodities (e.g., raw industrial materials such as gold, copper and aluminium) may be subject to substantial fluctuations over short periods of time and may be affected by unpredicted international monetary and political policies. Additionally, valuations of commodities may be susceptible to such adverse global economic, political or regulatory developments. Prospective investors must independently assess the appropriateness of an investment in commodities in light of their own financial condition and objectives. Not all affiliates or subsidiaries of Deutsche Bank Group offer commodities or commodities-related products and services.

All opinions and claims are based upon data on 4/13/2018 and may not come to pass. This information is subject to change at any time, based upon economic, market and other considerations and should not be construed as a recommendation. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect. Deutsche Investment Management Americas, Inc.

CRC 056941 (04/2018)

Investment in private equity funds is speculative and involves significant risks including illiquidity, heightened potential for loss and lack of transparency. The environment for private equity investments is increasingly volatile and competitive, and an investor should only invest in the fund if the investor can withstand a total loss. In light of the fact that there are restrictions on withdrawals, transfers and redemptions, and the Funds are not registered under the securities laws of any jurisdictions, an investment in the funds will be illiquid. Investors should be prepared to bear the financial risks of their investments for an indefinite period of time.

Investment in real estate may be or become nonperforming after acquisition for a wide variety of reasons. Nonperforming real estate investment may require substantial workout negotiations and/ or restructuring. Environmental liabilities may pose a risk such that the owner or operator of real property may become liable for the costs of removal or remediation of certain hazardous substances released on, about, under, or in its property. Additionally, to the extent real estate investments are made in foreign countries, such countries may prove to be politically or economically unstable. Finally, exposure to fluctuations in currency exchange rates may affect the value of a real estate investment.

Structured solutions are not suitable for all investors due to potential illiquidity, optionality, time to redemption, and the payoff profile of the strategy. We or our affiliates or persons associated with us or such affiliates may: maintain a long or short position in securities referred to herein, or in related futures or options, purchase or sell, make a market in, or engage in any other transaction involving such securities, and earn brokerage or other compensation. Calculations of returns on the instruments may be linked to a referenced index or interest rate. In such cases, the investments may not be suitable for persons unfamiliar with such index or interest rates, or unwilling or unable to bear the risks associated with the transaction. Products denominated in a currency, other than the investor's home currency, will be subject to changes in exchange rates, which may have an adverse effect on the value, price or income return of the products. These products may not be readily realizable investments and are not traded on any regulated market.

## Hong Kong

The contents of this document have not been reviewed by any regulatory authority in Hong Kong. You are advised to exercise caution in relation to the investments contained herein. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice. This document has not been approved by the Securities and Futures Commission in Hong Kong nor has a copy of this document been registered by the Registrar of Companies in Hong Kong and, accordingly, (a) the investments (except for investments which are a "structured product" as defined in the Securities and Futures Ordinance (Cap. 571 of the Laws of Hong Kong) (the "SFO")) may not be offered or sold in Hong Kong by means of this document or any other document other than to "professional investors" within the meaning of the SFO and any rules made thereunder, or in other circumstances which do not result in the document being

All opinions and claims are based upon data on 4/13/2018 and may not come to pass. This information is subject to change at any time, based upon economic, market and other considerations and should not be construed as a recommendation. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect. Deutsche Investment Management Americas, Inc.

CRC 056941 (04/2018)

a “prospectus” as defined in the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32 of the Laws of Hong Kong) (“CO”) or which do not constitute an offer to the public within the meaning of the CO and (b) no person shall issue or possess for the purposes of issue, whether in Hong Kong or elsewhere, any advertisement, invitation or document relating to the investments which is directed at, or the contents of which are likely to be accessed or read by, the public in Hong Kong (except if permitted to do so under the securities laws of Hong Kong) other than with respect to the investments which are or are intended to be disposed of only to persons outside Hong Kong or only to “professional investors” within the meaning of the SFO and any rules made thereunder.

### **Singapore**

Singapore Interests in the funds mentioned herein are not allowed to be made to the public or any members of the public in Singapore other than (i) to an institutional investor under Section 274 or 304 of the Securities and Futures Act (Cap 289) (“SFA”), as the case may be, (ii) to a relevant person (which includes an Accredited Investor) pursuant to Section 275 or 305 and in accordance with other conditions specified in Section 275 or 305 respectively of the SFA, as the case may be, or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA.

### **Important Information**

Deutsche Asset Management is the brand name of the Asset Management division of the Deutsche Bank Group. The respective legal entities offering products or services under the Deutsche Asset Management brand are specified in the respective contracts, sales materials and other product information documents. Deutsche Asset Management, through Deutsche Bank AG, its affiliated companies and its officers and employees (collectively “Deutsche Bank”) are communicating this document in good faith and on the following basis.

This document has been prepared without consideration of the investment needs, objectives or financial circumstances of any investor. Before making an investment decision, investors need to consider, with or without the assistance of an investment adviser, whether the investments and strategies described or provided by Deutsche Bank, are appropriate, in light of their particular investment needs, objectives and financial circumstances. Furthermore, this document is for information/discussion purposes only and does not constitute an offer, recommendation or solicitation to conclude a transaction and should not be treated as giving investment advice. Deutsche Bank does not give tax or legal advice. Investors should seek advice from their own tax experts and lawyers, in considering investments and strategies suggested by Deutsche Bank. Investments with Deutsche Bank are not guaranteed, unless specified.

Investments are subject to various risks, including market fluctuations, regulatory change, possible delays in repayment and

All opinions and claims are based upon data on 4/13/2018 and may not come to pass. This information is subject to change at any time, based upon economic, market and other considerations and should not be construed as a recommendation. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect. Deutsche Investment Management Americas, Inc.

CRC 056941 (04/2018)

loss of income and principal invested. The value of investments can fall as well as rise and you might not get back the amount originally invested at any point in time. Furthermore, substantial fluctuations of the value of the investment are possible even over short periods of time. The terms of any investment will be exclusively subject to the detailed provisions, including risk considerations, contained in the offering documents. When making an investment decision, you should rely on the final documentation relating to the transaction and not the summary contained herein. Past performance is no guarantee of current or future performance. Nothing contained herein shall constitute any representation or warranty as to future performance. Although the information herein has been obtained from sources believed to be reliable, we do not guarantee its accuracy, completeness or fairness. Opinions and estimates may be changed without notice and involve a number of assumptions which may not prove valid. We or our affiliates or persons associated with us or such affiliates ("Associated Persons") may (i) maintain a long or short position in securities referred to herein, or in related futures or options, and (ii) purchase or sell, make a market in, or engage in any other transaction involving such securities, and earn brokerage or other compensation.

The document was not produced, reviewed or edited by any research department within Deutsche Bank and is not investment research. Therefore, laws and regulations relating to investment research do not apply to it. Any opinions expressed herein may differ from the opinions expressed by other Deutsche Bank departments including research departments. This document may contain forward looking statements. Forward looking statements include, but are not limited to assumptions, estimates, projections, opinions, models and hypothetical performance analysis. The forward looking statements expressed constitute the author's judgment as of the date of this material. Forward looking statements involve significant elements of subjective judgments and analyses and changes thereto and/or consideration of different or additional factors could have a material impact on the results indicated. Therefore, actual results may vary, perhaps materially, from the results contained herein. No representation or warranty is made by Deutsche Bank as to the reasonableness or completeness of such forward looking statements or to any other financial information contained herein.

This document may not be reproduced or circulated without our written authority. The manner of circulation and distribution of this document may be restricted by law or regulation in certain countries, including the United States. This document is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, including the United States, where such distribution, publication, availability or use would be contrary to law or regulation or which would subject Deutsche Bank to any registration or licensing requirement within such jurisdiction not currently met within such jurisdiction. Persons into whose possession this document may come are required to inform themselves of, and to observe, such restrictions. Unless notified to the contrary in a particular case, investment instruments are not insured by the Federal Deposit Insurance Corporation ("FDIC")

All opinions and claims are based upon data on 4/13/2018 and may not come to pass. This information is subject to change at any time, based upon economic, market and other considerations and should not be construed as a recommendation. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect. Deutsche Investment Management Americas, Inc.

CRC 056941 (04/2018)

or any other governmental entity, and are not guaranteed by or obligations of Deutsche Bank AG or its affiliates.

© 2018 Deutsche Asset Management Investment GmbH  
Publisher: Deutsche Asset Management Investment GmbH,  
Mainzer Landstraße 11-17, 60329 Frankfurt am Main, Germany

All opinions and claims are based upon data on 4/13/2018 and may not come to pass. This information is subject to change at any time, based upon economic, market and other considerations and should not be construed as a recommendation. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect. Deutsche Investment Management Americas, Inc.

CRC 056941 (04/2018)