DWS

Americas CIO View

How much Value is to be found abroad?

Upon underperformance of foreign equities in 1H18, we examine latest valuations

As noted last week, foreign equities underperformed U.S. equities in the first half of 2018. So we thought it opportune to revisit our comparative valuation analysis of regional equity indices. While we continue to most prefer Growth stocks in the U.S. and Emerging Markets (EM) Asia, we still see better Value opportunities in Europe over most Value sector stocks in the U.S. The exception being Financials, as we consider big U.S. Banks to be the most attractive reward for risk opportunity in Financials globally and most attractive Value opportunity in the U.S.

However, other than big Banks, we think investors should prefer Value stocks in Europe over same-sector Value stocks in the U.S., particularly Energy, Materials and Industrials.

We compare regional equity index PEs on current and normalized EPS estimates

The valuation metrics we regularly compare across the major global equity regions include trailing and forward 1-year (1yr) price-to-earnings ratio (PE) and 10-year trailing average equity-time-value-adjusted PE or "Bianco PE." Our Bianco PE provides insights into the normalized earnings power of regional equity indices, as suggested by the 10-year trailing earnings history, using a method that accounts for differing dividend payout and thus earnings reinvestment ratios across regions. We consider the Bianco PE to be a better cyclically adjusted PE than the Shiller PE, whether used to compare the valuation of the S&P 500 (S&P) now to its long-term history or the valuation of the S&P to foreign equity markets. We present detailed Bianco PE metrics for the major regional equity markets below.

Europe, EM and EM Asia all trade at larger-than-history discounts to the S&P

On a trailing 12-month earnings-per-share (EPS) basis, the S&P is trading at 19.3x. Other regions: Europe 14.7x (24% discount vs. 12% historical avg.), Japan 13.2x (31% discount vs. 13% avg. premium), EM 12.3x (36% discount vs. 26% avg.), and EM Asia 13.1x (32% discount vs. 24% avg.). On a Bianco PE basis, the S&P is trading at 20.7x. Japan is trading in line with the S&P at 21.3x, while the other regions are trading at even bigger discounts than on the simple trailing PE basis: Europe 12.9x (38% discount vs. 25% historical avg.), EM 9.0x (56% discount vs. 41% avg.) and EM Asia 12.4x (40% discount vs. 36% avg.).

David Bianco
Chief Investment Officer &
Strategist, Americas

In a nutshell

- Upon underperformance of foreign equities in 1H18, we examine latest valuations
- We compare regional equity index PEs on current and normalized EPS estimates
- Europe, EM and EM Asia all trade at larger than history discounts to the S&P
- Be thoughtful about the implied normalized EPS from calculations based on history
- S&P PE compared to Europe adjusted for differing earnings contribution by industry
- We reiterate our preference for big U.S. Banks over U.S. Energy stocks
- Opportunistic Summer Shopping: U.S. & Asia Growth, U.S. Banks, European Value

Be thoughtful about the implied normalized EPS from calculations based on history

The Bianco PE for the S&P is 20.7x, which implies that within a normalized trailing year S&P EPS is $130 given the S&P's price at about 2700. This is well below the $166 bottom-up forward consensus S&P EPS. But any cyclically normalized EPS estimate based on past earnings results must be adjusted for reasonably long-lasting changes in the drivers of EPS. One of the more recent changes versus history is the U.S. statutory corporate-tax-rate cut from 35% to 21%. Given the global mix of S&P pretax profits and our expectation that a quarter of the tax savings is passed forward to customers, we estimate that this tax rate change adds about 7.5% to normalized S&P EPS versus history. This raises the Bianco PE method's implied trailing normal S&P EPS from $130 to about $140. Further adding the 12% S&P EPS growth we expect in 2018, excluding the tax-cut benefit, puts the forward earnings power of the S&P at $157. This suggests that our estimated $160 2018 S&P EPS aligns reasonably well with the normalized earnings power implied by the S&P's 10-year equity-time-value-adjusted history plus the benefit of the corporate-tax cut. From separate analysis, we consider $160 in 2018 to be normal or sustainable S&P EPS.

S&P PE compared to Europe adjusted for differing earnings contribution by industry

One way we compare the S&P's PE to the MSCI Europe is by taking the PE of every S&P industry and weighting it by the earnings contribution of that same industry in Europe. For instance, the next-12-month forward S&P PE, based on bottom-up consensus estimates, is 16.4x. However, using the earnings weights of European industries it's 14.7x. This is because lower PE industries in the S&P, like the automotive industry, make larger earnings contributions in Europe. Thus, to compare the S&P's PE to Europe at 13.5x on an equivalent-industry-earnings-weight basis, we compare this adjusted 14.7x to 13.5x, which is a 9% premium and therefore below the 21% premium when using 16.4x for the S&P.

We reiterate our preference for big U.S. Banks over U.S. Energy stocks

As assumed in our EPS forecasts, if the U.S. Federal Reserve (Fed) hikes at least 3 more times over the coming year, then Banks are trading at less than 12x their likely forward earnings, even if the curve goes flat (which is not our base case); if West Texas Intermediate (WTI) oil price averages $65/barrel (bbl) or less over the coming year then Energy trades over 20x its likely forward earnings. We think this large valuation gap is excessive.

Opportunistic Summer Shopping: U.S. & Asia Growth, U.S. Banks, European Value

The S&P is still well supported by strong earnings growth, to be on display again in 2Q reporting and still low long-term interest rates. Provided the risk of a recession stays low and 10yr Treasury yields do not exceed 3.5%, we consider an 18x trailing PE reasonable and fair for the S&P. If the S&P is below 2700 this summer, it provides a

good opportunity to add to U.S. Growth stocks and Banks. If further weakness abroad persists, this could add value to EM Asia Growth and European Value.

Glossary

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.

MSCI Europe Index

The **MSCI Europe Index** is designed to measure the performance of the large- and mid-cap segments of 15 developed markets in Europe.

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.

Shiller P/E

The cyclically adjusted price-to-earnings ratio, commonly known as CAPE, Shiller P/E, or P/E 10 ratio, is a valuation measure usually applied to the U.S. S&P 500 equity market. It is defined as price divided by the average of ten years of earnings (moving average), adjusted for inflation.

Valuation

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm’s stock price in relation to its earnings.

West Texas Intermediate (WTI)

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

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