DWS

Americas CIO View

Equities offer smaller, but still better risk premium than bonds

Fed maintains quarterly hiking pace: Is the neutral rate above or below 3%?

Last week, the U.S. Federal Reserve (the Fed) hiked by another quarter point to 2.0-2.25% as expected. The dot plot indicates one more hike in 2018 and three hikes in 2019. To us, there are a few signs that the Fed is getting close to the neutral rate: 1) the Fed dropped the "accommodative" language in the FOMC statement; 2) the 10y-2y Treasury yield spread is already under 25 basis points (bps); 3) the long-term federal funds target rate estimate is now 3.0%, below the 3.75% & 3.5% estimates at 2014 & 2015 end. The latest dot plot suggests the Fed will reach 3% at 2019 year-end. If the neutral federal funds rate is below 3% for this cycle, then the yield curve will likely go flat. A flat curve isn't a big worry, it just means that the long-term bond market thinks the federal funds rate is above what's needed to contain inflation. If inflation stays contained at about 2% then the Fed will be able to cut rates on the first sign of any economic slowing. Ending a hiking cycle by cutting rates upon slowing, but without a recession soon following is a classic soft landing. This has occurred: 1966, 1985, 1995. We think this likely occurs again in late 2019 or early 2020 and that this expansion continues well into the 2020s.

Low bond yields support 18+ PE, but mind rising yields & peak EPS growth

Normally the cost of equity (CoE) is 300-400bps above Treasury yields, i.e. the equity risk premium (ERP). The S&P ERP is usually 200-250bps above investment grade (IG) credit spreads. This suggests that the nominal CoE should be 6.5% when the cost of long-term corporate debt is 4.25%. Large S&P firms of solid IG status can borrow for 10 years at 4.25% or 125bp over Treasury yields right now vs. 130bps average the last 30 years. This suggests a 2.25% real cost of debt if inflation is 2%. This plus a 200-250bps premium suggests a real cost of equity of ~4.5% for large S&P firms of solid IG status, which supports a 22 S&P PE on steady-state S&P EPS.

But, in our view, real borrowing rates will rise slowly along with higher Treasury Inflation Protected Securities (TIPS) yields as the Fed hikes rates through 2019. And we expect the S&P ERP to stay larger than normal vs. IG credit spreads as Fed hiking continues. Also, the ~25% S&P EPS growth in 2018 should slow to 5-7% in 2019 and beyond. To value the S&P 500, we use a 3.5% long-term Treasury yield plus a 400bps ERP (same as 1.5% investment grade (IG) credit spread plus 2.5% incremental risk premium), i.e. 7.5% nominal cost of equity or 5.5% real. This translates to an 18 price-to-earnings ratio (PE) on normal S&P EPS. At 18.6x our 2018E EPS,

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In a nutshell

- Fed maintains quarterly hiking pace - we expect this expansion to continue well into the 2020s.
- Low bond yields support 18+ PE, but mind rising yields & peak EPS growth.
- ERP spread over credit spreads has been declining, but still attractive.
- The gap of HY spread vs. IG spread tightest since 1990.
- For 3Q earnings season, we expect companies' comments and estimates on the trade conflict impact to be much more cautionary.

the S&P is trading at a 5.4% offered real CoE, slightly richer than our fair value estimate.

ERP spread over credit spreads has been declining, but still attractive

Strong S&P rally in the last two years squeezed the premium of S&P implied ERP vs. U.S. long-term IG credit spread by ~100bps from 4% to 3%. But it's still higher than the 2.2% average since 1987. Equities are more attractive to us than fixed income. We overweight equities and underweight fixed income with 63% and 32% allocations respectively. Within equities our CIO view is neutral on regions and sectors globally, but Emerging Markets (EM) Asia likely to offer the best returns in the next 12 months.

The gap of HY spread vs. IG spread tightest since 1990

U.S. corporate spreads at both investment grade and high yield (HY) remain very tight (IG 125bps and HY 350bps). The bond market suggests that U.S. corporates can and have fared well around federal funds rate normalization. Under the new tax law, companies can use repatriated cash to retire some of their debt while also being able to boost dividend and buyback payouts. Currently, HY credit spread is only 215bps higher than IG credit spread, at low levels only touched several times in the last three decades: 1997, 2007, and 2014. We think the outperformance of HY over IG has run its course and the trend is likely to reverse in the next 12 months. We lowered high yield corporate credit allocation from 5% to 4% last week.

What to watch during 3Q earnings season?

3Q earnings season reporting will start in two weeks. We expect S&P to deliver another quarter of 20%+ strong earnings-per-share (EPS) growth. But we think companies' comments and estimates on trade conflict impact will be much more cautionary especially for 2019 EPS despite having basically dismissed any material profit impact from tariff during 2Q reporting. We think the current ~$180 consensus 2019 S&P EPS is too high. Normally S&P's next calendar year consensus EPS starts to get cut when the current calendar year is over, but this year the cuts might happen earlier given the new development on trade conflict. Other things to watch include signs of margin pressure, capital expenditure (capex) guidance and foreign exchange (FX) comments.

Glossary

Basis point

One **basis point** equals 1/100 of a percentage point.

Capital expenditures (capex)

Capital expenditure (Capex) are funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment.

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.

Federal funds rate

The **federal funds rate** is the interest rate, set by the Fed, at which banks lend money to each other, usually on an overnight basis.

High Yield (HY)

High-yield bonds are issued by below-investment-grade-rated issuers and usually offer a relatively high yield.

Inflation

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

Investment grade (IG)

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

Nominal

In economics, a **nominal** value is not adjusted for inflation; a real value is.

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.

Risk premium

The **risk premium** is the expected return on an investment minus the return that would be earned on a risk-free investment.

Spread

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

Treasuries

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).

U.S. Federal Reserve Board (the Fed)

The **U.S. Federal Reserve Board**, often referred to as "**the Fed**", is the central bank of the United States.

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.

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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.

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