DWS

U.S. equities – a tough choice, but a good one

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In a nutshell

- We consider the market slump exaggerated and continue to expect U.S. equities to be underpinned by robust corporate results.
- Investors are currently facing a dilemma: do they trust the robust U.S. economic data or do they distrust some long-term developments?
- We see a number of risks that, cumulatively, could put markets under further significant pressure. But this is not our core scenario.

A question of perspective: U.S. equities are struggling – but are more resilient than other assets

What do you think of a soccer game that ends in a brittle 1:1? It depends on your perspective. Some spectators will think they have just wasted the previous 90 minutes. Others may feel they have been entertained despite the lack of a victor. The teams' own assessment will depend heavily on the course of the game and prior expectations. If you went into the game as a favorite or were ahead until the 70th minute, you will complain about the two lost points. But for the team that went into the game as the underdog or was losing before the equalizing goal, it may feel like a point won.[1]

The same applies to the S&P 500, which will decide in a few weeks whether to end the year as a plus or minus. Whether one is satisfied with a return close to zero depends on expectations and the time of entry. Only those investing during the very few weeks of the past year, in which the index traded below its current level, will be ahead. But expectations, in the shape of returns in the two previous years of around 10% and 20% plus, are likely to make for deep disappointment. And yet those who compare the S&P 500's performance with that of most bond indices or indeed most other equity indices may be quite satisfied. After all, the longest U.S. bull market in history is still in place.

This ambivalence between nervousness and ever-higher record levels is characteristic of this stock market upswing, now often called "the most unloved in history." The most commonly used stock-market barometer for nervousness, the Vix, barely shows signs of unease, remaining very low by historical standards in 2018. Two other indices paint a different picture: the Vvix, which reflects the volatility of volatility, and the kurtosis[2] , which shows how often events occur outside the normal expectation range.

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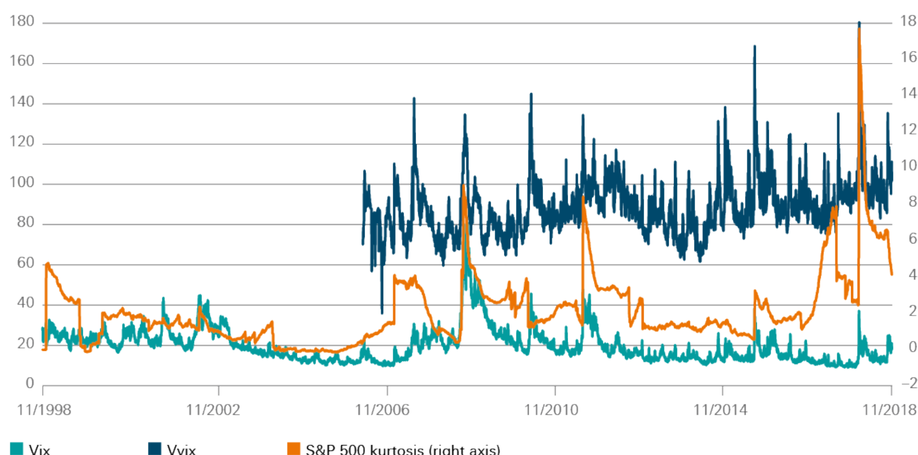
[1] For our less soccer-savvy readers: the loser gets zero and the winner three points. If there is a tie, both teams receive one point each.
[2] Kurtosis describes the shape of a probability-distribution curve. The more outcomes occur at the tails of the curve, the higher the number.

Capital markets are more nervous than thought



Source: Thomson Reuters Datastream as of 11/19/18

Strong economy, cloudy markets

Why these preliminary remarks on the nature of this stock-market cycle? Essentially to underscore how cautiously we are approaching capital-market forecasts – not only those of other investors, but also our own. We are aware of the problems arising from the current framework. The U.S. economy remains robust. We expect only a slight slowdown in global growth next year. Financing conditions remain supportive overall and there are few warning signals from the bond markets as corporate balance sheets are mostly sound. Earnings growth is likely to have peaked, but we believe earnings more than likely will continue to grow. At the same time, and this is an important component of our positive assessment, inflation remains moderate which gives the U.S. Federal Reserve (Fed) some room to take it easy on future interest-rate hikes if it wishes to. A further important point is that despite all the concern about the Fed's interest-rate hikes, it has only raised the federal funds rate by 2% in three years. In the last cycle of interest-rate hikes, from 2004 to 2006, investors had to cope with an increase of 4.25 percentage points in just two years.

Which brings us back to market risk. It certainly is not a great display of confidence if markets react with a degree of panic every time the Fed raises rates or reiterates that it wants to continue doing so for the time being. Investors are fretting about U.S. interest-rate rises that are large only from today's perspective, not a historical one.

Less about a black swan than about many grey rhinos

Before we go into more detail on the current opportunities and risks in the U.S. equity market, let us briefly outline the uncertainties that are, we believe, the biggest obstacles to a more optimistic view of the capital markets by investors. As these risks are not unknown, the term "black swan" is out of place; "grey rhinoceros[3]"

[3] In contrast to so-called "black swans" – unforeseen events with extreme consequences – "grey rhinos" refer to the major financial and economic risks that are highly visible and highly consequential but ignored even so. See: https://www.scmp.com/week-asia/opinion/article/2106257/can-xi-jinping-head-grey-rhinos-chinas-economy

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may be more appropriate: it stands for risks that are well known, but underestimated:

- First and foremost is the retreat, after ten years of unconventional central-bank policy, from quantitative easing (QE) to quantitative tightening. During the QE period, the balance sheets of the European Central Bank (ECB), the Bank of Japan (BOJ) and the Fed together increased from 3 trillion U.S. dollars to 15 trillion U.S. dollars.
- Closely related to this, many investors are worried about the impact on equity markets as the 30-year bond-market rally draws to a close. From a risk-return perspective, yields on U.S. government bonds of close to 3% look quite interesting to equity investors who, in our view, will have to make do with mid-single-digit yields.
- The question of how China, whose economic output has increased almost thirteen fold (in dollar terms) over the past 20 years (while U.S. gross domestic product (GDP) has "only" slightly more than doubled over this period), will deal with a noticeable slowdown in growth, or a major test of the stability of its capital markets.
- Rising global populism and protectionist tendencies.
- U.S.-China trade disputes that have broad support among both U.S. political parties.
- A U.S. president who continues to surprise U.S. allies with unconventional ideas and measures.
- A U.S. economy that, despite full employment, has been given a massive stimulus, resulting in a budget deficit of 4% of GDP, equivalent to almost 1 trillion U.S. dollars and thus roughly equivalent to the forecasted U.S. GDP growth in 2018.
- Finally, we should not forget the European concerns. There is no precursor either for Brexit, in whatever way this long and dramatic process plays out, nor for Italy's budget discussions with Brussels.

Profit growth remains robust despite slowdown

After the euphoria-dampening warnings from the equity-investment leaflet back to something more positive and tangible: the short to medium-term outlook for U.S. equities, which we still believe is capable of the typical year-end rally, especially after the S&P 500's 6.5% correction in October, echoing its big fall in the autumn of 2011. This correction prompted us to take a more tactically positive view of U.S. equities (see Americas CIO View of 11/19/18). Our price target for September 2019 remains unchanged at 3,000 points for the S&P 500. We have issued this price target after weighing all opportunities and risks. But we freely admit that the longer the forecast horizon the higher the risk that one of the rhinos marches in. Many political decisions have taken a negative turn from a market perspective in the course of the year already, which might be one of the reasons that the MSCI AC World Index is down by 5.1% (as of 11/20/18) for the year.

In line with our strategy, in which we have often said that tactical trading will become increasingly important in the coming years, we

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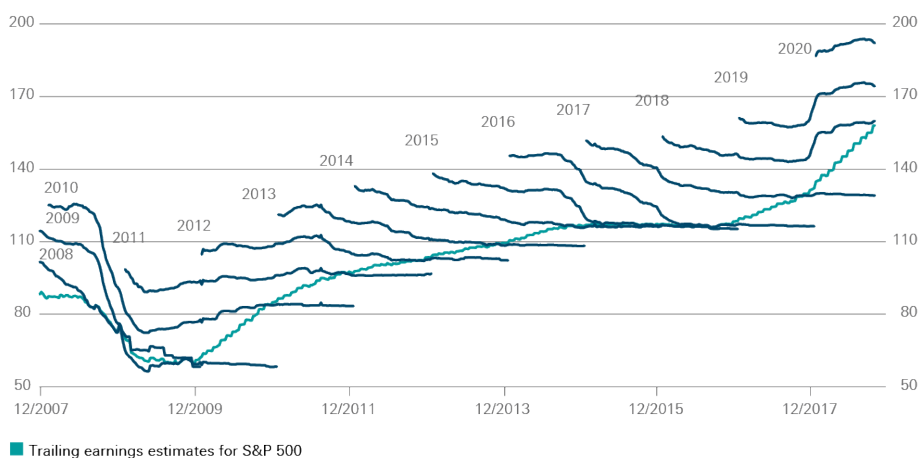
are concentrating on the opportunities arising from exaggerated market reactions. David Bianco, our Head of U.S. Equities and DWS Chief Investment Officer for the Americas, said following the stock-market correction at the end of October: "Will this correction end in a full-blown correction, i.e. will it exceed a fall by ten percent? I don't think so. Major corrections are caused by a significant macroeconomic shock, by major revisions of earnings forecasts or large jumps in interest rates. I don't expect all that." What we are expecting, however, is a sharp slowdown in corporate earnings growth in the coming year, which most probably reached a peak this year, at 22%. As this fiesta was mainly due to special effects such as tax cuts, dollar repatriation and rising oil prices, it is no surprise that the party cannot go on. But consensus still anticipates earnings-per-share (EPS) growth of 10%, which we see at just under 6%. We are also skeptical about the 2020 EPS growth rate, which the consensus also still sees at just under 10%.

Remarkable, even if this is only a slight decline, is the fact that in October the consensus adjusted its 2019 EPS estimates downwards for the first time in a year. And this is precisely where we currently see a great risk to our own assessment: the sustainability of U.S. earnings, given record-high margins, and rising wage, raw material and refinancing costs.

For the time being, however, we are still assuming that many companies will succeed in passing on higher costs to their customers, whose buying power should be assisted by rising wages, given record-low U.S. unemployment.

Impressive dynamics of U.S. earnings growth



Source: Thomson Reuters Datastream as of 11/19/18

If share prices nevertheless fall while earnings estimates remain quite stable, as they have been recently, this means the key valuation figures have suffered. In concrete terms, the price-to-earnings (P/E) ratio for the S&P 500, based on earnings estimates for the next twelve months, has fallen from a record high of over 21 at the beginning of the year to below 18 now. "If one corrects this by one P/E point, which a handful of big technology firms alone contribute to the P/E, one is no longer far removed from the long-term average of 16," David Bianco says.

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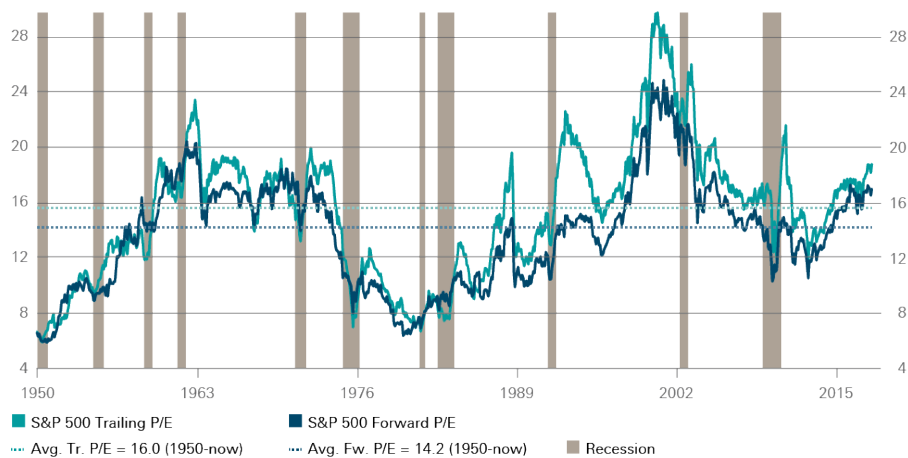
Valuations in line with long-term average



Source: Thomson Reuters Datastream as of 10/31/18

Speaking of technology – the nervousness of current investors also reflects the weakness of the former, long-standing drivers: growth stocks, associated primarily in recent times with technology and Internet-based businesses. In a broader definition, the Nasdaq can be taken as a proxy for the U.S.

Been there before. Previous relative setbacks in growth stocks

Source: Thomson Reuters Datastream as of 11/19/18

In the very short term and in absolute terms, the slump looks dramatic, as some heavyweights have already reached bear-market territory (i.e. 20% down from their peak). But for the market as a whole, the development is far less dramatic. Especially since those setbacks have often occurred in the past without reversing the longer-term trend. Of course, we do not want to project blindly from the past to the future, but we continue to believe that the technology trend – i.e. the great wave of digitalization – will continue for years to come, supporting the economic cycle and equities. But we believe we will have to look still more closely at stock selection.

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After the mid-term elections - has the uncertainty disappeared?

In recent months, many market participants have pointed out that market nervousness could subside and confidence return once the U.S. midterm elections were over, when clarity would prevail. In many previous publications we have pointed out that we take a different view and that uncertainty is unlikely to subside dramatically after the elections, even if, as has happened, they played out in line with investors' expectations. Donald Trump's party, the Republicans, have lost their majority in the House of Representatives and Washington faces a divided government. Yet Trump hailed a "great victory" in a tweet. It was an unconventional response – and his administration might continue to govern in an unconventional way as it has until now. We are therefore wary of drawing parallels with other divided governments in U.S. history. Even now the expectation that Trump would temper his tone and style given the need to work with the Democrats seems to have dissipated among spectators . The controversal interim replacement of the Attorney General, as well as his abrasive trip to Europe[4] , in which he criticized Emmanuel Macron, the French President, showed that he would remain true to his confrontational line.

Tactically optimistic

To summarize: The macroeconomic picture is not bad overall and the U.S. economy does not seem to be running out of steam yet, so that it could celebrate the longest upswing in its history next summer. According to our Chief Economist for the Americas, Josh Feinman, "America's economic cycles are getting longer and longer. They don't die of old age but rather of excesses that either express themselves through inflationary pressure or financial imbalances that arise especially when the private sector becomes too optimistic and takes on too much risk." We don't see this in the U.S. at the moment.

Nevertheless, the Fed will have to master a very difficult balancing act in coming years to achieve a soft landing. It will have to judge whether the weakening fiscal stimulus and the general slowdown in economic momentum will be sufficient to counteract any economic overheating – and not large enough to provoke a strong downturn in growth.

For the time being, however, we continue to regard as the real strength of the economy that it is neither too hot nor too cold. David Bianco sums it up as follows: "Our positive view is based on the following premises: In 2019 the average oil price will trade above $60/barrel, U.S. inflation will not exceed 2% sustainably, so that 10-year U.S. government bonds will not exceed 3.5%. Moreover, the dollar is not strengthening any further, which, measured by the dollar index, means that it will not exceed 100 on average in 2019." (As of 11/19/18: 96.4.)

What also provides some support for our positive short-term view, despite two disappointing months, are two seasonal effects. First,

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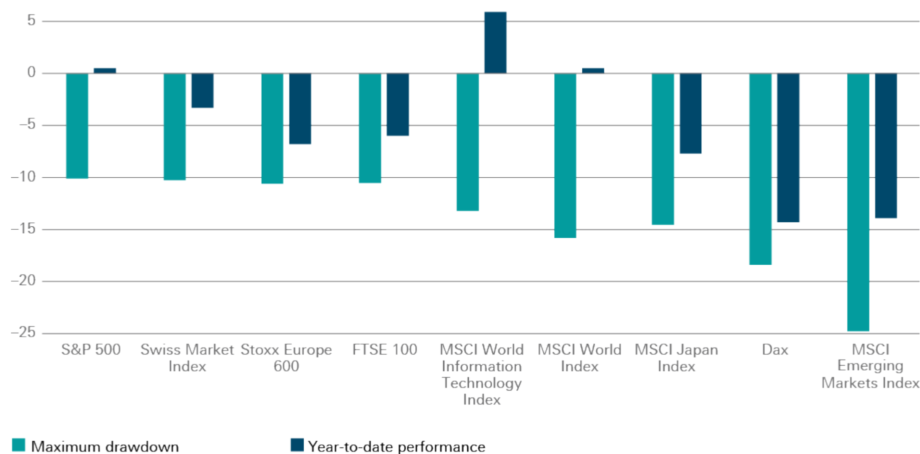
[4]https://www.washingtonpost.com/politics/five-days-of-fury-inside-trumps-paris-temper-election-woes-and-staff-upheaval/2018/11/13/e90b7cba-e69e-11e8-a939-9469f1166f9d_story.html

the fourth quarter is traditionally the strongest of the year. This will be hard to achieve this year, but even after poor autumn returns, the S&P 500 in the past has still regularly managed to pull off a year-end rally. Secondly, the U.S. reporting season is largely over, which in turn means that the so-called blackout period is over. Companies are now allowed to buy back their own shares, which will play an important role given that nobody likes to buy U.S. shares as much as they do.

In addition to the better quarterly figures relative to other markets, the brisk buy-back activity is likely to help the U.S. to remain one of the very few stock exchanges to still show a positive total return this year. It has also suffered a smaller maximum drawdown than the other markets.

Strongest of the pack so far this year – the S&P 500



Sources: Thomson Reuters Datastream, DWS Investment GmbH as of 11/20/18

Anyone with a fundamentally more pessimistic view of the markets will probably be of the opinion that what has risen the most also has the greatest potential for correction. We take a different view and believe the U.S. market can pick up momentum again. We see 3,000 as our target for the S&P 500 over a 12-month period, although we know that the index could also move quickly further down if some of the risks we have mentioned materialize cumulatively.

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Glossary

Bank of Japan (BOJ)

The **Bank of Japan (BOJ)** is the central bank of Japan.

Bear market

Technically, a **bear market** refers to a situation where the index's value falls at least 20% from a recent high.

Black swan

Black swan is a term for an unexpected, highly improbable event with far-reaching economic consequences.

Brexit

Brexit is a combination of the words "Britain" and "Exit" and describes the exit of the United Kingdom of the European Union.

Bull market

A **bull market** is a financial market where prices are rising - usually used in the context of equities markets.

CBOE Volatility Index (Vix)

The **CBOE Volatility Index (Vix)** is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index. It is a popular measure of the volatility of the S&P 500 as implied in the short term option prices on the index.

Democratic Party (Democrats)

The **Democratic Party (Democrats)** is one of the two political parties in the United States. It is generally to the left of its main rival, the Republican Party.

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.

European Central Bank (ECB)

The **European Central Bank (ECB)** is the central bank for the Eurozone.

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.

Government (sovereign) debt/bonds

Government (sovereign) debts/bonds are debt/bonds issued and owed by a central government

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Gross domestic product (GDP)

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.

House of Representatives

The United States **House of Representatives** is a legislative chamber consisting of 435 Representatives, as well as non-voting delegates from Washington, D.C. and U.S. territories. Representatives are elected for two-year terms and each state's representation is based on population as measured in the previous Census.

Inflation

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

Kurtosis

The **Kurtosis** describes the shape of a probability distribution curve. The higher the number, the more outcomes occur at the tails of the curve.

Margin

Margin describes borrowed money that is used to purchase securities.

MSCI AC World Index

The **MSCI AC World Index** captures large- and mid-cap companies across 23 developed- and 24 emerging-market countries.

Nasdaq 100 Index

The Nasdaq 100 is an equity index which contains the 100 biggest common stocks listed on the Nasdaq composite index.

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.

Quantitative easing (QE)

Quantitative easing (QE) is an unconventional monetary-policy tool, in which a central bank conducts broad-based asset purchases.

Quantitative Tightening (QT)

Quantitative Tightening (QT), as opposed to Quantitative Easening, describes the process of a Central Bank reducing its monetary stimulus by shrinking its balance sheet.

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Republicans

The **Republican Party (Republicans)**, also referred to as Grand Old Party (GOP), is one of the two major political parties in the United States. It is generally to the right of its main rival, the Democratic Party.

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.

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.

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Volatility

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

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