

David Bianco
Chief Investment Officer &
Strategist, Americas



In a nutshell

- Underlying deep-rooted issues make tariffs unlikely to go away completely
- 25% tariffs on half or all imports from China could shave 3 to 5 U.S. dollars off S&P 500 EPS
- Where is this conflict heading? We lay out five scenarios with S&P 500 targets
- "Next 5%+ Move" for S&P 500 remains "Down"

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Americas CIO View

Significant tariffs likely to stay: A 3 to 5 USD reset to S&P 500 EPS expected

Underlying deep-rooted issues make tariffs unlikely to go away completely

The recent round of U.S. tariffs and China retaliation boosted volatility in risky assets last week, but markets showed resilience through the week as both sides floated some conciliatory messages since their meeting in Washington from May 9 to 10. However, actions taken since then are making a deal at the G20 meeting in Osaka in late June unlikely, in our opinion. At best, we think a deal in Osaka stops additional tariffs on the remainder of all imports from China and introduces a framework and a timeline for reducing the existing tariffs from 25% slowly over time. Perhaps 5% every six months.

Since the U.S. ban on sales from a multinational telecommunications and electronics manufacturer, China expressed unwillingness for further talks until three major concerns are addressed by the United States: 1) The United States must remove all the additional tariffs imposed on China; 2) The targets set by the United States for Chinese purchases should be in line with real demand; and 3) The text of a deal should be "balanced" to ensure the "dignity" of both nations. Looking past the market's benign reaction so far, the prospects of the trade conflict subsiding soon are vanishing.

U.S. demands for intellectual property protection and less subsidies to Chinese state-owned enterprise need legislative changes and cannot happen overnight. Because these changes will take time and because any monitoring and compliance framework is never a simple matter, we think it unlikely that a grand bargain deal is struck with a big drop in tariff rates anytime soon. Because Trump is comfortable with tariffs and the U.S. economy can likely weather tariffs, especially with some visible path for slow reductions, we think significant tariffs likely stay in place for this year and next.

25% tariffs on half or all imports from China could shave 3 to 5 U.S. dollars off S&P 500 EPS

Our 2019 estimated S&P 500 earnings per share (EPS) of 169 U.S. dollars (USD) assumed a 10% tariff on 200 billion USD of Chinese goods and no further escalation. Reported first quarter earnings results corroborate this estimate being within reach as S&P 500 EPS will be 39 USD in the first quarter and higher oil prices should provide a 1 to 1.50 USD boost in the second quarter. However, if tariffs on half of China imports last through the year at 25%, it is likely to make 2019 S&P 500 EPS closer to 165 USD. And if a 25% tariff is imposed on all imports from China, the damage will be 5 to 10 USD depending on when it takes effect.

Where is this conflict heading? We lay out five scenarios with S&P 500 targets

The matrix below presents 2019 S&P 500 EPS estimates and 2019 end S&P price targets for five scenarios of tariffs applied to China imports post G20. The matrix assigns probabilities to scenarios of: 1) no tariffs on any China imports for the rest of 2019, 2) 10% tariffs on half of the imports from China, 3) 25% tariffs on half of the imports, 4) 25% tariff on all imports from China, 5) Highly punitive tariffs and trade restriction on all US and China trade leading to a recession in both countries and globally. Our view on the probabilities of these scenarios has shifted greatly since May 5.

Tariffs	S&P 500 EPS	Trailing P/E	S&P 500 2019 end price	Probability
0%	172	18.0	3096	0%
Half @ 15%	169	18.0	3042	25%
Half @ 25%	165	17.5	2888	50%
All @ 25%	160	16.0	2560	20%
Recession	132	15.0	1980	5%
		Immediate fair value	2747	100%

Source: DWS Investment Management Americas Inc. as of 5/20/19

Appendix: performance over the past 5 years (12-month periods)

	04/14 - 04/15	04/15 - 04/16	04/16 - 04/17	04/17 - 04/18	04/18 - 04/19
S&P 500	10.7%	-1.0%	15.4%	11.1%	11.2%

Past performance is not indicative of future returns.

Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 5/20/19

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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.

G20

The **Group of 20** are the largest industrialized and emerging economies in the world.

State-owned enterprise (SOE)

A **state-owned enterprise** is a legal entity that executes commercial activities on behalf of an owner government.

U.S. dollar (USD)

The **U.S. dollar (USD)** is the official currency of the United States and its overseas territories.

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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