DWS

# Americas CIO View

## How to position for high profit-recession risk, but low recession risk?

### We see much greater risk of a profit recession than a broad U.S. recession

Latest incoming data suggests that the risk of an S&P 500 profit recession is very high, but the risk of a broad-based U.S. recession remains low. Profit and gross-domestic-product (GDP) growth are related, but they have big differences in their magnitude of exposure to various sub segments of the economy. The dominant drivers of the broad economy remain healthy with only a gradual slowdown from an above trend pace in 2018. These include household consumption, job creation, and productivity fueled wage growth. Service consumption and related job creation continue to lead the U.S. economy and productivity has now been at a solid 1.5% growth trend for about three years as tighter labor supply is allocated to more productive uses and better skills and technology permeate large service-oriented industries like healthcare, finance, retailing, etc.

### We see many reasons for a record shattering U.S. economic expansion

For several years, we have argued that this economic expansion would set a new record for the United States. We still believe this expansion will last 12 to 15 years with the next bridge to cross being how U.S. fiscal policy is shaped by elections in 2020. Our main reason for expecting a very long expansion is that service consumption dominates the U.S. economy. Nearly 70% of GDP is consumption and nearly 70% of that is services. Consumption is lifestyle, which is sticky, and services do not have associated inventories. An economy tilted toward consumption vs. investment and also toward services vs. goods consumption is resistant to shocks. Although we expect U.S. GDP to gradually slow to 2% or slightly less as the cycle continues to age, we think it would take a big shock to push the United States into recession. In our view, composition of GDP is a more important determinant of cycle endurance than growth rate. Other important reasons to expect a long expansion include, still low inflation, very low real interest rates, affordable and arguably capped oil prices, healthy household and corporate balance sheets, and despite risk of sluggish earnings growth, high profit margins.

### Reasons rise for a near-term profit recession and sluggish growth afterward

The outlook for healthy profit growth is more challenged than for U.S. GDP. And risk of periodic profit stalls or contractions is high for the rest of this cycle, including now. We see slower global growth to come, at both emerging and developed economies. Emerging economies are shifting from being investment led, which drew heavily upon external-commodity and capital-goods supplies, to

David Bianco
Chief Investment Officer &
Strategist, Americas

**In a nutshell**

- We see much greater risk of a profit recession than a broad U.S. recession.
- We see many reasons for a record shattering U.S. economic expansion.
- Reasons rise for a near-term profit recession and sluggish growth afterward.
- Our macro outlook calls for tactical caution on riskier assets and equities, still favoring Growth over Value stocks and seeking bond substitutes.

being more consumption driven and domestically supplied. Trade conflict exacerbates the slowing in commodities and capital-goods demand. Because these trends weigh more on Europe, Japan and commodity producing countries, we see a firm U.S. dollar with more upside than downside regardless of a more dovish U.S. Federal Reserve (Fed); as dovish Fed actions are likely to be matched by other central banks. We also see persistently low U.S. interest rates and modest loan growth for the rest of the cycle, curbing financial-sector profit growth. We think record high S&P 500 net margins are sustainable until the next recession, but we think weak revenue growth intensifies competitive pressures and companies continue to partially pass forward the benefit of last year's tax cut. If the elections lead to higher corporate taxes then another profit recession is likely or possibly a full recession in 2021.

**Our macro outlook calls for tactical caution on riskier assets and equities, still favoring Growth over Value stocks and seeking bond substitutes**

Sectors with fundamentals to best weather our macro outlook are Healthcare, Communications, and Technology Services. Politics are important, but at this time, we are more concerned about global growth, trade, commodity and industrial-goods demand than uncertain U.S. healthcare policies post-election. We have a long standing preference for Growth stocks, but we must monitor valuations to ensure they do not become excessive. We think low recession risk rationally causes investors to extend their forecast horizons and Growth stocks have the highest duration; so lower interest rates boost their intrinsic value. That said, valuations are now demanding in our view. This contributes to our tactical caution on equities overall, but we still prefer Growth over Value because Growth is less exposed to profit-recession risks. Growth must be at a reasonable prices, but Value must have well protected earnings.

We have examined the latest valuations of Growth vs. Value and we identified which stocks most raise and lower their sector price-to-earnings ratios (P/Es) across S&P 500 sectors. On a trailing P/E basis, Growth is at 33% premium to Value, which is 6% higher than the average since 1992. Excluding Amazon , Growth is near its normal premium. But we are hesitant to add to Growth stocks not in the sectors / industries we over-weight and we avoid Value stocks in the sectors / industries we are under-weight. Profit-recession risk sits mostly at the Value-oriented sectors of Industrials, Materials, Energy, Retailers, Technology Equipment and even Financials if the Fed cuts aggressively.

## Glossary

### Balance sheet

A **balance sheet** summarizes a company's assets, liabilities and shareholder equity.

### Central bank

A **central bank** manages a state's currency, money supply and interest rates.

### Dove

**Doves** are in favor of an expansive monetary policy.

### Duration

**Duration** is a measure expressed in years that adds and weights the time periods in which a bond returns cash to its holder. It is used to calculate a bond's sensitivity towards interest-rate changes.

### Emerging markets (EM)

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

### 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.

### Growth stocks

**Growth stocks** are stocks from companies that are expected to grow significantly above market average for a certain period of time.

### Inflation

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

### Intrinsic value

The **intrinsic value** is the one that comes closest to the value that an objective fundamental analysis would ascribe to an asset.

### 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.

### Recession

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

**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. dollar (USD)**

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

**U.S. Federal Reserve (Fed)**

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

**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.

**Value stocks**

**Value stocks** are stocks from companies that are trading at prices close to their book value and that are therefore cheaper than the market average on that metric.

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