From valuation risk to earnings risk

The danger of recession is more evident now in market valuations but not in earnings forecasts

IN A NUTSHELL

- With many equity markets down by more than 20%, defensive sectors very pricey and institutional investors extremely bearish, it's tempting to think "everything is priced in".
- But we believe that the confluence of many negative developments will keep markets nervous over the coming months as earnings estimates are likely to be further revised downwards.
- On a 12-month horizon we hope for greater clarity about the war, energy supplies, growth and margin pressure, and how financial markets will cope with quantitative tightening and the end of the Fed put.

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From valuation to earnings risk – fear of a German energy crisis triggers "peak DAX bearishness"

The confluence of economic, geopolitical and monetary/inflationary risks is keeping investors on high alert, as can be seen in elevated volatility levels in various financial markets. Despite some recent positive news from Russian gas exports through the Nordstream 1 pipeline, this issue still poses significant economic risks for Europe going into the winter season. On a 12-month horizon, however, we see mid-single digit upside potential for global equities on receding volatility levels, which for Europe would increase to potentially double-digit gains if the war in Ukraine came to a bearable end.

Inflation keeps surprising on the upside

Incoming inflation numbers still don't offer any sign of relief. Forcing the economy to contract appears to be only way to put the inflation genie back into the bottle. Markets are already reflecting this looming recessionary scenario as the probability grows that the U.S. Federal Reserve (Fed) will move in rapid, big steps. The U.S. yield-curve[1], a frighteningly reliable leading indicator of recession in six to nine months, has inverted in mid-July and is trading at a 22-year record low.

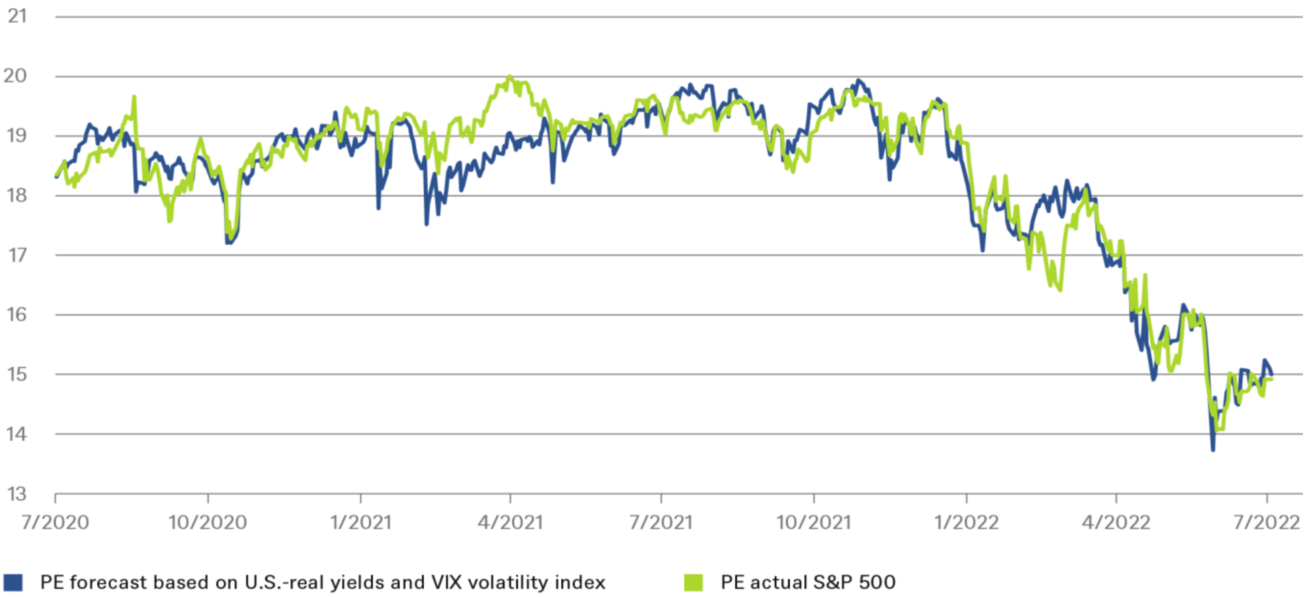
Valuation multiples recede to more "normal" levels; if only earnings estimates were realistic

Following the 20% decline in global equity markets we are no longer concerned about valuation levels. Most valuation metrics have come down and are now trading close to historical averages and in line with the long-term interest rate relationship. We calculate that the year-to-date increase in the risk-free rate (approximated by U.S. Treasury 10-year real rates[2] moving from -1% to +0.6%) and the equity risk premium (approximated by the volatility index VIX[3] moving from 17 to 27) have lowered the S&P 500 by 1,300 points. This valuation adjustment was necessary as the Fed started to reverse its unconventional monetary policy of the past 5 years. Most of the adjustment should be complete by now. We therefore feel comfortable

[1] Inversion: 2-year Treasury yields are higher than 10-year yields. It reached -0.22% points on July 13th.
[2] As calculated from implicit inflation estimates (breakevens) derived from 10y-U.S. inflation-protected Treasuries.
[3] Implied volatility index from S&P 500

sticking to our 18 times target PE for the next twelve months (NTM) EPS estimates, which should take us to our 4,200 June 2023 S&P 500 target, with a constructive 12-month view for equities from current levels.

U.S.- real yields and volatility explain most of the recent S&P moves

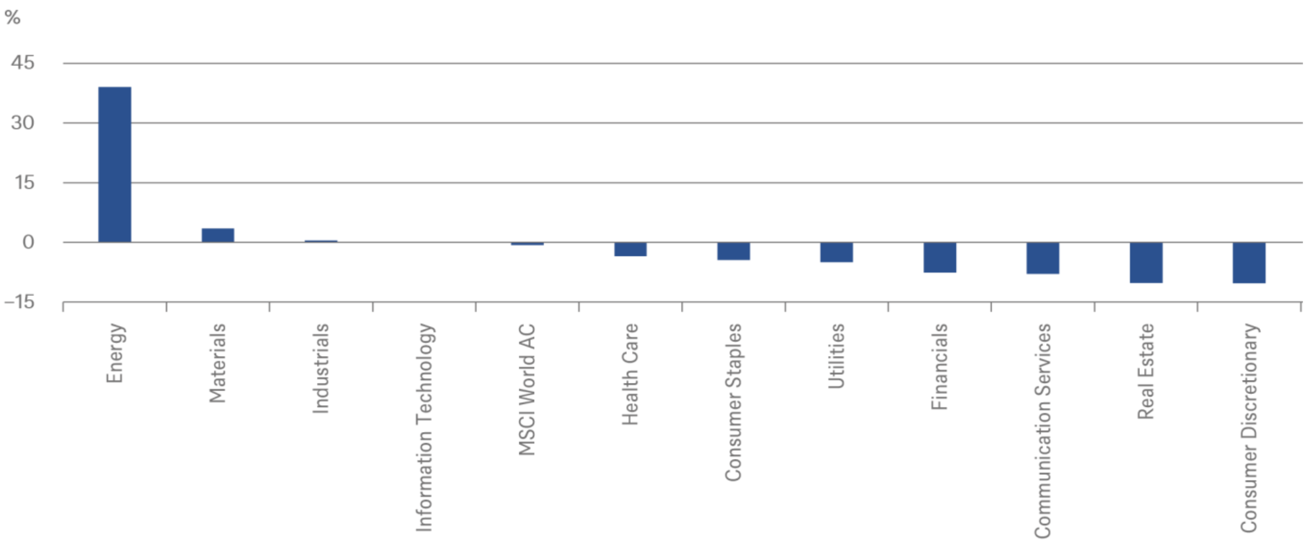


Sources: FactSet Research Systems Inc., DWS Investment GmbH as of 7/19/22
Forecasts are not a reliable indicator of future performance. Forecasts are based on assumptions, estimates, opinions and hypothetical models that may prove to be incorrect.

We believe analysts' earnings forecasts are still too optimistic – not least because of the dollar's strength

However, near-term we remain cautious, as we are still worried about unrealistically high earnings expectations for 2023. We expect profit margins to fall from here over the coming quarters. The economic slowdown, high input costs and falling real wages should all weigh on profitability. While cyclical sectors are obviously most at risk, IT spending on semi-conductors and software, too, might be dented. The extraordinary strength of the U.S. dollar will add to the earnings pressure on U.S. companies, with the negative currency impact doubling between the first and second quarter of the current year.

Changes in global earnings forecasts by sector for 2023 between March 1st and July 19th



Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 7/19/22
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The market's anxiety shows itself in pricey defensive sectors

Some of the market's uncertainty is already reflected in record-high safety premia for safe haven sectors like telecoms, staples and utilities. We would wait for more earnings downgrades in cyclical sectors before considering any downgrade in defensive market segments. We remain committed to our overweight in healthcare. Furthermore, we have become more positive on the energy sector where a structural shortage of supply should keep oil prices high, unless we are faced by a deeper recession than we expect.

German Dax has been hit particularly hard

The proximity of the war in Ukraine and the risk of impaired energy supplies means Germany's Dax index has been hit particularly hard in recent months. We now believe that investment sentiment has moved towards "peak Dax-bearishness". Trading at a 40% P/E-ratio discount to the S&P 500, we calculate that share prices are discounting at least a 50% probability of a severe recession in Germany, with 30% or more EPS cuts due to a pending energy crisis. A complete cut off in Russian natural gas supply would undoubtfully push the German economy into a short recession but we feel great progress has been made preparing the economy for this scenario. Therefore, fears that the Dax might fall towards its historical valuation low of around 1 time its book value (currently equivalent to an index level of approximately 9,000) appear overblown to us.

Accumulating risks, bearish market positioning, and no trigger for a quick recovery

A war in Europe, record inflation rates, increasingly hawkish central banks, no more Fed put but instead untested Quantitative Tightening in the middle of an economic slowdown: that, together with a mild U.S. recession is our base case and it makes for a hard-to-digest mix for investors. How these factors – each of them scary enough –will play out is highly uncertain. According to the latest Bank of America Fund Manager Survey[4], institutional investors' sentiment and positioning is extremely bearish, which by itself would suggest that this is a timely entry point into markets. They have already corrected to a significant extent (with the U.S. and Europe down by more than 20% from their peak and the MSCI Emerging Markets index down by a third). This took the Stoxx 600 down to its pre-Covid level, but the S&P 500 still trades 15% above its early 2020 levels, admittedly on much higher earnings forecasts.

But we are skeptical about these earnings forecasts, which seem to take 2021 earnings as a "normal" base even though the past two years have been heavily distorted by the sharp swings of the pandemic. Sequential quarterly S&P EPS growth has already slowed sharply since late last year. But our profit indicator continues to suggest that profits will decline sequentially in Q3. The profit indicator suggests a slight sequential downturn as of now, but recent data elements suggest an accelerating deteriorating trend. In addition, the strong dollar is a headwind that is not incorporated in our profit indicator. Consensus earnings forecasts for the S&P 500 in 2023 now stand at USD 250, which we believe might be some 5-10% too high.

Therefore, on balance, giving high uncertainty and little reason to believe that a single turn of events could brighten the outlook to a significant effect[5], we expect that the coming months will be characterized by nervous sideways trading on markets. It is not any more about pricing in a recession, but pricing in the severity of it.

[4] Bank of America Global Research: Global Fund Manager Survey, July 19th.
[5] A ceasefire in Ukraine might be the most surprising, sudden event, but whether this would change the course of the U.S. economy and its rate outlook is less than clear.

Glossary

The book value is the net value of a company's physical and intangible assets

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.

The Dax is a blue-chip stock-market index consisting of the 40 major German companies trading on the Frankfurt Stock Exchange.

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.

Hawks are in favor of a restrictive monetary policy.

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

The MSCI Emerging Markets Index captures large- and mid-cap representation across 23 emerging-market countries.

The price-to-earnings (P/E) ratio compares a company's current share price to its earnings per share.

Profit Margin is an accounting figure which describes profit in relation to revenue in percent.

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

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

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

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

A safe-haven investment is an investment that is expected to retain or even increase its value in times of market turbulence.

The Stoxx Europe 600 is an index representing the performance of 600 listed companies across 18 European countries.

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

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

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