Different leagues: Great Eight vs. great expectations, S&P 492 vs. bonds

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IN A NUTSHELL

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The Great Eight of the S&P 500 are in a totally different league from the rest

How can investors compare the Great Eight of the S&P 500 to the other mere mortal firms? Microsoft, Apple, Amazon, Alphabet, Nvidia, Meta, Tesla and Netflix have risen as titans in their heavenly realm. A digital realm that most other companies can hardly enter let alone effectively compete with such godly giants. Comparing these eight to the rest of the S&P 500 or S&P 100 or the largest S&P firms from past decades is extremely difficult. Moreover, comparing such titans to small caps or most foreign stocks or other asset classes like bonds, real estate or commodities has become farcical if not comical. One should find more earthly comparisons before concluding that other stocks or asset classes are "cheap." We present such earthly comparisons for the S&P 492 (S&P 500 minus the Great Eight) and argue the Great Eight should be evaluated on a stand-alone basis using intrinsic valuation models or constructs.

EPS yields vs. real interest rates can measure mortals, but gods require DCFs

Despite a 10% correction from its 1-year high and finally a resumption of modest year-over-year (y/y) earnings per share (EPS) growth upon generally good 3Q results so far, especially at Tech & Communications, the S&P trades at about 18.5x current EPS or an earnings yield of nearly 5.5%. Excluding the Great Eight, which trade at about 30x current EPS in aggregate and represent 18% of S&P EPS but 29% of market cap, the S&P 500 or S&P 492 trades at about 16.5x current EPS. Also, excluding Financials & Energy, the S&P 492 trades at about 18x current EPS.

We won't compare the EPS yield of the Great Eight to real interest rates, but the nearly 6% EPS yield of the S&P 492 is only 350bp above the 2.5% real yield on 10yr Treasury Inflation-Protected Securities (TIPS). Normally this spread or Equity Risk Premium is closer to 400bp or higher when VIX is well over 15 and investment grade bond spreads over 125bp and high yield over 400 basis point (bp) as all are today. And while EPS yields are higher at Financials and Energy than S&P 492, the credit spreads available from the issuers of these sectors are also higher than average credit spreads. Thus, we generally see corporate bonds as an asset class more attractive than S&P 492 right now. Otherwise, it would take over 7% EPS growth in 2024 & 2025 from the S&P 492, which we think unlikely and if US slips into a small recession it would likely be flat or down.

It's hard to know what price-to-earnings (P/E) multiple the Great Eight will be able to sustain, but over time we think it will very likely decline. If the 10yr TIPS yield stays near 2.5%, we think the aggregate PE at the Great Eight is likely to fall to 25x or less over the next two years. Thus, for investors to earn an annual 10% gain while the PE contracts from roughly 30x to 25x the required annual EPS growth must

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be 20%. Maybe the gods will deliver, maybe they won't. Building discounted cash flow (DCF) models to explore various growth scenarios and the required Capital expenditure (Capex) and other investments needed to support such growth scenarios along with testing the valuation sensitives to cost of capital assumptions are ways to reveal the most credible prophecies.

3Q EPS Tracker: Good, Tech and strong 3Q GDP boosted; cautious outlooks

245 S&P 500 companies comprising 63% of the index earnings have reported. 72% beat on EPS and 25% missed (the rest in-line), with an aggregate surprise of +7.1%, +6.8% ex Financials. Much stronger than the historic average EPS beat of +3.3% (2011-2019 avg). Bottom-up blended (actual for reported and consensus for the rest) 3Q EPS is $56.74, +3.9% y/y. Blended sales growth is +1.1% y/y. Blended pro-forma net margin is 12.9%, vs. 12.0% in 2Q23 and 12.6% a year ago.
Please see our EPS Tracker slide deck as kept up to date on the DWS Americas CIO View website.

Still watching 10yr Treasury & 10yr TIPS yields: Fed is not bond market's friend

Federal Open Market Committee (FOMC) decides on November 1st, but recent speeches suggest that the Fed is less hawkish. They see hikes so far as probably or nearly enough to sustain the decline in inflation. But a complacent Fed risks a more bearish bond market, especially given the worsening deficit. If 10yr yields exceed 5%, we think the risk of a worse than very "soft recession" will climb.

Next 5%+ S&P price move signal changed from Down to Balanced Risk

We change our signal to Balanced Risk of the next 5%+ S&P price move being up or down. We expect a rangebound S&P between 3900-4300 into yearend and 4000-4600 next year. Our fair intrinsic value targets for the S&P 500 are 4100 at 2023 end and 4500 2024 end. However, we see downside risk on the assumptions underlying these targets. Reporting season is confirming resilience and growth at the mega cap Tech/Digital firms. Thus, we're now more confident that S&P EPS will be about $222 in 2023 and between $230 to $240 in 2024 amidst slow GDP. We're likely to stick with $235 S&P EPS in 2024 or 6% growth. This assumes a resilient US job market, benign credit costs at big banks, no further dollar appreciation nor deterioration in global manufacturing output/demand, yet some contraction in consumer goods spending but no plunge. We expect positive yet very low single-digit EPS growth at most S&P sectors and industries next year, but high teens EPS growth from Tech and Communications to spruce the overall S&P EPS growth rate to 6%.

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Glossary

In business administration, the cost of capital is the cost incurred by a company in using equity capital for investments or in obtaining debt capital for them.

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

Discounted cash flow is a method used to gauge the value of a company by finding the present value of projected future cash flows.

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.

Equity risk premium is an excess return earned by an investor when they invest in the stock market over a risk-free rate. This return compensates investors for taking on the higher risk of equity investing.

The Federal Open Market Committee (FOMC) is the committee that oversees the open-market operations (purchases and sales of securities that are intended to steer interest rates and market liquidity) of the U.S. Federal Reserve.

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

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

Market capitalization, in the context of an individual firms, is the number of shares issued multiplied by the value of the shares.

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

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 S&P 100 Index is a stock market index of United States stocks maintained by Standard & Poor's. The S&P 100, a subset of the S&P 500, includes 101 (because one of its component companies has two classes of stock) leading U.S. stocks with exchange-listed options.

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

Small cap firms generally have a market capitalization of less than $2 billion.

Treasury Inflation-Protected Securities (TIPS) are a form of U.S. Treasury bonds designed to protect investors against inflation. These bonds are indexed to inflation and pay investors a fixed interest rate as the bond's par value adjusts with the inflation rate.

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.

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