# Not Goldilocks for Stocks: Job market still too hot, profit growth still too cold

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IN A NUTSHELL

— The S&P 500 is not U.S. GDP and direction of bond yields is not same for profits
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## The S&P 500 is not U.S. GDP and direction of bond yields is not same for profits

U.S. gross domestic product (GDP) hasn't stalled or even slowed much from 525bp of U.S. Federal Reserve (Fed) hikes the last 18 months. Resilience is from a robust service economy and service job creation. But S&P earnings per share (EPS) is flat to slightly down since Fed hikes started, stuck at $220 of annualized S&P EPS since 1Q22. Flat S&P EPS is broad based, flat ex. Energy (down) & Financials (up) and incl. Tech (flat). In 2024, we expect 7% S&P EPS growth; mostly from Tech, Communication Services, Health Care and mostly from Amazon and Tesla at Consumer Discretionary. We think high interest rates in the U.S. with a very sluggish world economy challenge S&P EPS growth at other sectors. In 2024, we expect flattish y/y Energy (up) & Financial profits (flat/down) and flattish profits at traditional Auto, most Retailers, Consumer Goods, Capital Goods, Transports, Telecom/Cable, Materials, and REITS. Challenges to S&P EPS growth beyond the big digital firms include DWS forecasts for very slow U.S., European and China GDP, which remains centered on weak goods manufacturing and construction, but also still too steamy inputs costs from materials (fuel) to labor (wages/benefits) and still a very strong dollar.

## DWS CIO Day: S&P at 4500 Sep 2024, Markets discounting a goldilocks world

Sticky inflation, the economic resilience of the U.S. and Europe, and the external effects of China's weakening economy were dominating topics for this CIO Day. For the Eurozone, we neither expect a recession nor a significant upswing. For the U.S., we still see a "soft" recession in early 2024. We cut China's GDP growth in 2023 from 6.0% to 4.8% and 2024 from 5.0% to 4.5%.

Quarterly S&P EPS likely stays flattish until 2024, but up likely about 7% in 2024 & 2025. S&P EPS could be hit in 2025 and/or 2026 by household or corporate tax increases and perhaps another small U.S. recession if the budget deficit needs to be addressed after the Nov. 2024 election. Those concerned about the risk of inflation reaccelerating next year or 2025 from unproductive fiscal spending or inadequate monetary policy resolve should not forget that Tech and other big digital firms provided among the best inflation protection the past few years. Digital firms with intangible assets seem to have seized the high ground as investors preferred secular inflation protection play. That said, we prefer Health Care and expect Tech to cool the rest of this year as the economy slows and the Fed signals a long hold after its last hike. Within Tech, we prefer Communications Equipment and Software.

Despite gains expected for world equities, the upside expected is similar at short duration bonds and tail risk is to the downside for equities in our view, given: 1) a harder landing is possible in western economies or stubborn core inflation, 2) Chinese housing, banking, currency risks are facing many global cyclical value stocks, and 3) adequate earnings growth or valuation challenges at growth stocks from current bond yields or perhaps higher from US fiscal deterioration. In our view, the S&P reaching 5000 remains unlikely the next 12-months and we think a 4000 to 4800 range prevails through 2024. US mega-cap growth is too expensive in our view to expect further large upside next year. On the other hand, a change in market leadership towards cheaper value stocks doesn't seem imminent as that likely requires higher than forecasted GDP growth in US, EU and China.

## Rising bond yields don't mean a better economy or strong profit growth ahead

We aren't receiving much of a signal from the yield curve other than the Fed is likely to eventually cut overnight interest rates to about 4% or less. We have no disagreement here. But rising long-term yields and the still substantially inverted 10-2yr curve suggest that the recent rise in yields is less about imminent cyclical acceleration, but rather longer-term yields rising secularly owing to higher inflation risk and/or higher real interest rates required to contain such inflation risk. Bond market angst from nearly 3 years of inflation well above the Fed's 2.0% target, elevated U.S. deficits and rising debt/GDP, along with less Treasury bond policy buyers, suggests to us that rising long-term yields are more likely to pressure PE multiples than be a harbinger of strong or double-digit S&P EPS growth next year.

In our intrinsic valuation models for the S&P 500 and sectors, if we assume a 1.6% 10yr Treasury Inflation-Protected Securities (TIPS) yield (2% now) and a 400bp equity risk premium (ERP), then the fair steady-state trailing S&P price-to-earnings (P/E) ratio is nearly 18, which supports a fair S&P value of near 4000 at 2023 end. We find a 5-10% premium to steady-state value for long-term economic profit growth to be reasonable, but 10% or more is a difficult to justify for the S&P 500 in aggregate, even after we reviewed all S&P industries and looked for where more generous premiums could be rationalized.

## Glossary

A budget deficit is created whenever the spending in a public budget exceeds the income within a given time period.

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.

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 markt over a risk-free rate. This return compensates investors for taking on the higher risk of equity investing.

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

The term Goldilocks economy refers to a state of the economy, where there is neither a threat of inflation due to an overheating economy, nor a threat of a recession.

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

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

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

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

A soft landing is when an economy's rate of growth slows in a controlled fashion without major disruptive effects on employment, external balances etc.

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

A yield curve shows the annualized yields of fixed-income securities across different contract periods as a curve. When it is inverted, bonds with longer maturities have lower yields than those with shorter maturities.

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