CIO View

Americas CIO View

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Marketing material

DWS

Exploring other schools of thought: All schools out for summer?

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IN A NUTSHELL

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The summer stock rally isn't easily explained by an intrinsic value framework

Despite the highest observed S&P price-to-earnings (P/E) ratio in 20 years, except 2021 when real interest rates were negative, summer brought a rally without S&P EPS growth or lower interest rates. S&P earnings per share (EPS) declined the last few quarters year-over-year (y/y) and Treasury yields climbed 25bp this summer.

Within our school of thought, an intrinsic value framework, a decline in the demanded equity risk premium (ERP) is usually required to justify a rally absent EPS growth or lower interest rates. However, the observed ERP (implied as S&P EPS yield - 10yr Treasury Inflation-Protected Securities (TIPS) yield) was already lower than normal at summer start. At 375bp (basis point) in May and now 325bp in August, both ERP observations are below the 500bp average since 2003. When investors fear recessions or U.S. Federal Reserve (Fed) hikes or jumps in yields, the observed ERP tends to be 500-600bp or even higher during panics. Thus, we think it is wrong to attribute summer's rally to avoidance of negative scenarios feared by investors, which is often dubbed "climbing a wall of worry."

Better long-term profit growth ahead? An explanation within the intrinsic school

We expect no or very slow S&P EPS growth the next few quarters. The consensus view is similar. An imminent EPS surge is very unlikely. However, the willingness of investors to pay now for a newly expected better long-term future S&P EPS growth rate estimate would justify the summer rally absent an EPS surge soon to come. We believe the summer rally is attributable to long-term excitement for artificial intelligence, which is consistent with the rally being led by Tech and other leading digital industry stocks. Not an actual ERP decline. Yet this raises the question of how to measure or imply what investors now expect in terms of improved EPS growth over the next several years and then judging if that is reasonable.

Economic growth PE premiums: Justified if long-term EPS growth exceeds CoE

In prior notes, we explained that a high PE can be justified by investors adding premiums to a fair steady-state PE for a company's economic profit growth potential. We explained fair steady-state PE estimates as: 1/ real cost of equity (CoE). The real CoE is the observed or expected 10yr TIPS yields plus estimates of a fair ERP. If trying to isolate the economic growth premium within an

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observed PE from other factors, use cyclically normalized EPS and long-term real yield estimates and an ERP estimate that reflects uncertainty on these norms. Our estimates for such S&P norms are: $220 2023 EPS, 1.50-1.75% real yields, 400bp ERP. This suggests a steady-state S&P PE of about 18 and 4000 price at 2023 end.

The history of the observed S&P PE doesn't significantly exceed steady-state estimates, thus normalized EPS and interest rate estimates are the main determinants of fair value.

However, a higher value is fair and justifiable in an intrinsic value framework if the S&P 500 will generate long-term EPS growth, plus its dividend yield, greater than its nominal cost of equity. We estimate its nominal CoE at about 8%, assuming inflation 2.0-2.5%. Here a fair PE = 1/ (real CoE - (long-term EPS growth rate + dividend yield - nominal cost of equity)). Under this construct and estimates above, long-term S&P EPS growth should exceed 6.5% for the fair PE to exceed 18. At 20.5x normal EPS, implied long-term EPS growth is 7.25%.

Under our school of thought, the S&P's summer rally was driven not by a 50bp reduction in demanded ERP, but rather a 50bp increase in the long-term S&P EPS growth rate. From about 6.75% to about 7.25%, driving the PE on normal EPS from near 19.5 in May when 10yr TIPS yield was 1.5% to a 21 PE in July and 20.5 now with 10yr TIPS yield at 1.75%. A 50bp change in real CoE or long-term real EPS growth is worth about 7.5%. When an economic growth premium is in the PE, it should raise the ERP given uncertainties of such.

Are there other explanations for the summer rally in other schools of thought?

Other summer rally explanations beyond no recession or EPS dive, which we argue isn't sufficient, include: 1) investors weren't positioned for a rally; which segment of investors and why not, 2) rallies come when inflation trends down; true when the PE rises from depressed levels, like in early 1980s; but this time the S&P PE stayed very high, 3) rallies follow the Fed's last hike, this is only true if a soft landing occurs like in 1995, 1985 and 1967 and some significant degree of hard landing was reflected in the observed PE earlier, 4) anything is possible, true of course, but rational investors must decide what's probable and make best choice available. We stay focused on trying to assess fundamentals of whether a soft landing happens with inflation near 2% in 2024 and will S&P EPS growth be healthy then and thereafter vs. expectations as implied by intrinsic valuation frameworks.

Tech and Healthcare are sectors most likely to deliver AI boosted profit growth in our view

Within the S&P 500, we find Software and digital services plus Biotech and Pharma best positioned to benefit from artificial intelligence (AI) tools and deliver strong long-term EPS growth. We think medicine maker valuations underappreciate this long-term potential.

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Glossary

Artificial intelligence is the theory and development of computer systems able to perform tasks normally requiring human intelligence.

One basis point equals 1/100 of a percentage point.

Cost of equity (CoE) is the return (often expressed as a rate of return) a firm theoretically pays to its equity investors, to compensate for the risk they undertake by investing their capital.

The dividend yield is the dividend that a company pays out each year divided by its share price.

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.

Fundamentals are data giving information about the general well-being of companies, securities or currencies and serving for the subsequent valuation of these as an investment opportunity.

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.

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

The real interest rate is the nominal interest rate adjusted for inflation as measured by the GDP deflator.

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.

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

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.

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