CIO View

Americas CIO View

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Marketing material

The pre pandemic rollback: Where justified, overdone or more to go

IN A NUTSHELL

– Distinguishing which pandemic effects were temporary versus long-lasting is key
– Investors anchoring from Feb 2020 prices; first for rebound, now for rollback risk
– Our sector strategy: Tilts toward Health Care, Banks and Domestic Defensives
– DWS ad hoc CIO day: We cut our global equity indices targets by ~5%

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Distinguishing which pandemic effects were temporary versus long-lasting is key

After the initial sharp recession and bear market of early 2020, the pandemic brought strong S&P earnings per share (EPS) growth and the highest price-to-earnings (P/E) ratios across the S&P 500 since 1999. As discussed previously in these notes, supercharged S&P EPS growth was led by its digital businesses and its consumer goods producers and retailers upon the pandemic's work and lifestyle shifts and huge government household stimulus. As we enter the second half of 2022, it's clear that goods demand has cooled upon fading stimulus, reversion to service consumption and, most importantly, the hit to consumer real purchasing power and confidence from the highest inflation rates in 40+ years. Given consumption pattern normalization and rising cycle longevity threats from high inflation and geopolitical conflict, investors are rolling back stocks to pre pandemic prices. We see these rollbacks as justified in some areas, but unjustified in others. The difference rests on assessing temporary versus long-lasting pandemic effects, more closely examining fair valuations relative to higher interest rates and considering world order uncertainty risks to healthy global growth.

Investors anchoring from Feb 2020 prices; first for rebound, now for rollback risk

The S&P 500 ended 2019 at 3230 and closed at 3386 on Feb 19, 2020, if S&P falls 8-12% more from its 2022 bear market low of 3666 it revisits pre pandemic prices. The Communications, Financials and Real Estate Investment Trusts (REITs) have fully rolled back to 2019 end or early 2020 highs. The only three sectors priced 20% or more above pre pandemic levels are Energy, Materials and Technology. The other sectors delivered moderate price or total returns. However, Consumer Discretionary performance varies greatly by industry since pre pandemic with rollbacks at apparel, housing, most of fast food, hotels, combustion cars, yet still large gains at electric vehicle despite the recent sharp decline, and still good gains at many mega-cap retailers and internet retailing. We think the rollback at most Retailers is justified, including internet retail, and see more downside for electric vehicles.

We see the rollback at Financials, especially Banks, as overdone given low PEs and rising overnight interest rates should aid EPS at Banks. We also see the Communications rollback as an overreaction to less of a stay at home economy. We think the rollback at Consumer Discretionary and Industrials is mostly justified, but largely complete, and from here see potential large upside at

Aerospace, but more downside at Machinery. The gains at Staples were moderate, but we see this sector as less defensive in this environment and prefer REITs and Utilities. Health Care remains our most preferred sector. We think the sectors most at risk to further rollback are Materials and Technology on the risk of recession and/or higher interest rates.

Our sector strategy: Tilts toward Health Care, Banks and Domestic Defensives

With our new 12-month strategic cross-asset forecasts at DWS in mind, we made adjustments to our sector strategy. We raise Energy from under-weight (UW) to equal-weight (EW), Real Estate from EW to over-weight (OW). We lower Tech from EW to UW. We also made changes to some industries: Auto Components and Road & Rail are moved from UW to OW; Diversified Financial Services from EW to OW; Gas Utilities and Wireless Telecommunication Services from UW to EW; Health Care Providers & Services from OW to UW; Tobacco from EW to UW. We currently OW Health Care, Communication Services as our preferred GARP (growth at a reasonable price) plays, Financials, Utilities and Real Estate in Value; EW Energy; UW Industrials, Tech, Consumer Discretionary, Consumer Staples and Materials.

DWS ad hoc CIO day: We cut our global equity indices targets by ~5%

Incoming inflation reports stayed persistently high and surprised central bankers. We now assume that the Fed Funds Rate reaches 3.5% by yearend, a level that we consider to be above “neutral”, i.e. a level that is likely to start to slow down economic activities and lift unemployment. Germany remains exposed to the rising risk of gas import disruptions from Russia, which could trigger an energy crisis in Europe. Reflecting this deteriorating macro outlook we lower our June 2023 equity index targets by ~5%. Our new June 2023 targets for the S&P 500 is cut from 4,400 to 4,200, Stoxx 600 target from 460 to 430, MSCI Japan target from 1,200 to 1,150, and MSCI EM target from 1,110 to 1,060. We are still comfortable with our $225 and $235 S&P EPS estimates for 2022 and 2023. We lower our yearend S&P 500 target to 4,100 from 4,400 on EPS risk concerns.

Glossary

Technically, a bear market refers to a situation where the index's value falls at least 20% from a recent high.

Consumer discretionary is a sector of the economy that sells non-essential goods and services.

Consumer staples is a sector of the economy selling essential products.

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.

MSCI is a company providing indices and other analytical tools for investors.

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

A Real Estate Investment Trust (REIT) is a company that owns and, in most cases, operates income-producing real estate. REITs sell like a stock on the major exchanges and invest in real estate directly, either through properties or mortgages.

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.

Important information – EMEA, APAC & LATAM

Important information – North America

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