DWS

This is scary: Slowing rate hikes risks a higher terminal rate or worse

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IN A NUTSHELL

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Dear Fed, why slowdown when you're already late? Get to your destination asap

We think recent U.S. Federal Reserve (Fed) messaging about the pace of hikes after November's Federal Open Market Committee (FOMC) meeting was unhelpful and raises risk. Some recent FOMC member speeches, news articles and economists suggest the Fed likely shrinks rate hikes from 75bp to 50bp or 25bp starting in December. But if the FOMC believes the terminal rate should exceed 4.5%, then we see no good reason for hiking less than 75bp or issuing dovish guidance in December upon reaching 3.75-4.0% on November 2nd. We would prefer that the Fed with no gifts in actions or guidance and we'd cheer further 75bp hikes until they stop. As this would most help a stop or pause to actually happen in 1Q23. If not, instead the Fed hikes 50bp in December and signals more 50bp or 25bp hikes in 2023, we think the equity and possibly bond bear market resume into yearend. Even with a 75bp hike, we doubt the Fed signals a pause in December unless capital markets suffer adverse dislocation and dysfunction.

Now is no time to go wobbly: The fate of inflation risk premiums hangs in the balance

The Fed must win this war with inflation in both a decisive and timely fashion. It's important that investors stay confident that the Fed will fight broad-based inflation when it attacks as brazenly as it has in the US and that such an attack will be crushed swiftly. Investors want to know that the Fed will and can crush inflation with speed, not just merely eventually. Right now, history is being made that will affect inflation expectations and inflation risk premiums for years to come. This hiking cycle will determine whether future bond investors treat high inflation as a risk that lasts for roughly only one year or a risk that could last multiple years. A higher inflation risk premium will cause higher real rates.

A slower climb now risks an even higher terminal Fed Funds rate later or worse

Slowing rate hikes now risks a higher terminal rate in 2023 and thus possibly a more painful recession necessary to bring inflation down. But in the absence of a large recession that the Fed and everyone wants to avoid, it's unlikely that deflation will occur, so it's important that this high inflation (anything over 3%) comes down soon. The window will soon close for history and more importantly for creditors to judge this episode of high inflation as just a brief period of high inflation. It's becoming a long period,

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2 years at mid-2023. This is why we find the Fed's recent back-channel messaging and stock rally unwelcome at this time as it raises longer-term risks. There is more than a slightly higher terminal Fed Funds rate to consider or greater recession risk or sustained 4%+ long-term bond yields. There is the belly of the curve to consider; where most of the real economy is financed, especially consumer durable goods and much of housing and capital expenditure (capex). If it takes 2 or more years to get inflation back to Fed target/ market expectation, it also risks a material inflation risk premium settling into 2-7yr fixed or semi fixed interest rate loans. If multiyear car, home or equipment leases seem expensive now, just wait.

Dear ECB, think carefully about trying to follow the Fed with just a lag in this cycle

Europe has different dominant causes of inflation than US. US suffers from fiscal stimulus overdoses and its labor market is exceptionally tight and aggravated by new work routines across its more varied service occupations. Whereas Europe is suffering a classic wartime supply-side shock to the cost of energy, food and essentials. A wage-price spiral appears to be starting in the US, such is less clear in Europe at least currently. For these reasons, in this author's opinion and not necessarily the view of DWS, we think the European Central Bank's (ECB) terminal rate should be roughly 2-3% lower than the Fed's likely 4.75% to 5.50% 1Q23 rate. This is why we expect the dollar to only gradually lose its super-strength over the next 2 years. If the dollar loses strength early next year, we think it threatens expected US disinflation.

3Q EPS Tracker – Weak Tech, strong Energy: Still $222 & $215-225 for 2022 & 2023

We still model 2023 quarterly S&P Earnings Per Share (EPS) as: 52+55+56+57=$220. Our 4Q22E S&P EPS remains $54. We put trough quarterly non-GAAP (Generally accepted accounting principles) S&P EPS at $52 in 1Q23, down 5-10% from the 1Q22 peak ex. Energy and down 10% from the $58 2Q22 peak with Energy for 4 main reasons: 1) small recession expected for US & Europe mostly during 1H23 followed by slow growth, not a V shaped recovery, causing a 5% dip or near $3 hit from $56 in 3Q22 during 1Q23, 2) dollar strength that hits S&P EPS from 3Q22 levels by near $1 quarterly through 2023, 3) minimum book profit and buyback taxes of near $1 quarterly through 2023, 4) energy profits near $1 above 3Q22 levels quarterly through 1H23.
S&P EPS falls near 20% on average in past recessions, but more than half of past recession's average hit to S&P EPS is from Financials & Energy. Unless the recession becomes large and deflationary, we expect the hit to be similar to the 10% or less S&P EPS (GAAP) hits that occurred in the recessions of 1960, 1970 & 1980. While small disinflationary recessions hit S&P EPS less than the big deflationary recessions, we caution that significant hits to Industrials, Materials and Energy profits did eventually come, but toward the very end or even after the proper recession ended in both 1974 and 1982.

S&P > 3900 requires high conviction in 10yr Treasury yields under 4% next year

Our S&P intrinsic valuation model, using our S&P EPS estimates above, suggests that at 3900 today the S&P implies a 3.75% 10yr Treasury yield or lower by 2023 yearend. We could reasonably envision a 3.75% 10yr yield comprised of 1.0-1.50% (~1.25%) 10yr Treasury Inflation-Protected Securities (TIPS) yield with ~2.5% 10yr inflation expectation with a small inflation risk premium fully offset by risk asset hedge value of Treasury bonds. Yet, this favorable view on yields while only expecting a small recession ahead with a very small hit to S&P EPS is a big leap of faith at this very moment, especially if the Fed takes its foot off the brakes prematurely and inflation stays well over 3%. Thus, we change our Next 5%+ S&P price move from Balanced Risk to Down, as we don't think now is the time to drop our 450bp fair equity risk premium (ERP) estimate to the long-term 400bp norm. We put S&P fair value at 4000 at 2023 end with an 18.2 trailing price-to-earnings (P/E) ratio on 2023E EPS of $220, which we view as normal, not cyclically depressed, as we put 2024E EPS at about $230. S&P 2024 start fair value = ($230 - $18 for non-GAAP adj.) / (1.25% 10yr TIPS+4.0% ERP) = 4038.

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Glossary

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

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

Deflation is a sustained decrease in the general price level of goods and services.

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.

The European Central Bank (ECB) is the central bank for the Eurozone.

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.

In the United States, the Federal funds rate is the interest rate at which depository institutions (banks and credit unions) lend reserve balances to other depository institutions overnight on an uncollateralized basis.

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.

Generally accepted accounting principles, or GAAP, are a set of rules that encompass the details, complexities, and legalities of business and corporate accounting.

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

Intrinsic value is a measure of what an asset is worth. This measure is arrived at by means of an objective calculation or financial model. Financial analysis uses cash flow to determine the intrinsic, or underlying, value of a company or stock.

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 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 share buyback involves a company buying back its own shares.

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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