CIO View

Americas CIO View

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Marketing material

DWS

Growth at any price?: Tech investors pay 1999 growth premiums again

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IN A NUTSHELL

– Tech investors pay-up like it's 1997-1999, yet central banks fear it's 1980-1982
– Significant growth premium returns to S&P PE: Lost for 20 years by Tech wreck
– Growth premiums are risky: Adds to interest rate and risk premium uncertainties
– The S&P is now a growth index! And more concentrated by stocks and 1 sector
– Just because big Tech is expensive, doesn't make the rest of the S&P cheap

Tech investors pay-up like it's 1997-1999, yet central banks fear it's 1980-1982

We see similarities to and lessons from 1999 for Tech investors and 1980 for central banks. If Tech investors aren't more valuation conscious, the risk of losses or a long future period of sub fair returns is high. If central banks retreat from their inflation fight too soon, the risk of inflation reaccelerating and thus cause for higher interest rates shouldn't be ignored. We expect the challenges of returning the U.S. economy to healthy growth and inflation rates, combined with very demanding growth premiums now embedded in the valuations of the digital and Tech titans dominating the S&P 500, will lead to greater equity market volatility.

Significant growth premium returns to S&P PE: Lost for 20 years by Tech wreck

At 4550, the S&P 500 trades at 20.7x our 2023E S&P earnings per share (EPS) and 19.4x our 2024E S&P EPS. We estimate a fair price-to-earnings (PE) ratio for a company or index expected to generate long-term nominal EPS growth, plus its dividend yield, that is equal to its nominal cost of equity (CoE) to be: 1/ real CoE.

We estimate a fair long-term nominal total return on S&P 500 ownership, i.e. its cost of equity, at about 8%. This consists of a 5.5% real cost of equity and a long-term inflation assumption of about 2.5%. This valuation construct for a fair steady-state PE (1/ real CoE) suggests that the forward 4-quarters observed S&P PE of about 20 is 10% above its fair steady state forward PE of 18.2. This is before making any adjustments to our non-GAAP (generally accepted accounting principles) S&P EPS estimates for accounting quality or any adjustments for the possibility of current S&P EPS being above long-term norms. We happen to think that forward S&P EPS and margins are close to sustainable norms, despite margins still well above history. But we strongly advocate at least a 5% reduction to our and most other non-GAAP S&P EPS estimates for more accurate accounting quality. Thus, we see the S&P 500 as trading with a 15% premium to a fair steady-state PE. This is the highest growth premium since 2002 and contrasts with the growth discount from 2002 until the pandemic. The Tech wreck and stagflation of the 1970s eviscerated past S&P 500 growth premiums.

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Growth premiums are risky: Adds to interest rate and risk premium uncertainties

Short and long-term interest rates remain more uncertain than usual owing to the ongoing inflation fight by central banks as well as fiscal and global factors that could cause interest rates to return to pre 2008 financial crisis norms despite very slow economic growth. The fair equity risk premium (ERP) for the S&P 500 entails gauging cyclical risks as well as uncertainties related to normalized S&P EPS estimates. These two key valuation factors, future interest rates and a fair equity risk premium, have long vexed investors; but a significant growth premium at the index level introduces another big dimension of risk.

Estimating a fair growth premium requires evaluating the feasibility of earning returns on capital above the cost of capital on new investments. Not just the returns earned on new investment, but also the size of the new investments and for how many years such strong returns and investment growth will continue. How certain are such economic profit growth estimates in a competitive world, particularly in Tech, and among the largest companies?

The S&P is now a growth index! And more concentrated by stocks and 1 sector

None of the uncertainties about growth premiums above are new to growth stock investors. They know the risks and volatility that usually comes with investing in such stocks and the importance of diversification to help guard against these risks. Today, the S&P 500 is a growth index and more concentrated by stocks and one sector or similar industries than ever, save perhaps 1972 and 1999. While we might be willing to assign a moderate growth premium to the S&P of not much more than 10%, we think it's important to consider diversifying away from the very large and concentrated growth premium at Tech. The Tech sector trades at 30x forward EPS, which is a 50% premium to the S&P PE, but also represents an about 65% growth premium vs. 15% at the S&P. We are under-weight on Tech and are seeking less demanding growth stocks at Health Care and select Industrials and Consumer industries.

Just because big Tech is expensive, doesn't make the rest of the S&P cheap

S&P EPS growth and broader U.S. corporate profits have been stalled for two years. We expect 2Q23 earnings season to indicate that profit growth challenges remain and likely continue through the year. We still expect a small recession and more importantly a shallow recovery and slow growth afterward. Provided no sharp job market damage, we continue to expect S&P EPS for 2023, 2024 & 2025 of about $220, $235 & $245. This EPS outlook supports an immediate S&P 500 fair value of about 4000, unless the market stays willing to pay aggressively and very upfront for the growth potential, large but uncertain, at Tech.

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Glossary

Portfolio concentration measures single stock exposures of a portfolio. There are different metrics to measure concentration. A few examples are: (1) Concentration ratios, calculated as aggregate weight of a given number (3, 5, 10, etc.) of stocks in the portfolio; (2) Acar-Bhatnagar concentration index is a measure of market concentration. It has two alternative approaches: (i) A calibrated summation of the absolute departures from the uniform distribution case (A1); and (ii) A summation of the absolute differences among segment shares Pi and Pj (A2). (3) The Herfindhal-Hirschman Index (HHI) is a measure of market concentration by summing up the square of each stock's weight in a portfolio. The HHI index is always below 1 and a number close to 1 indicates high concentration.

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.

Nominal 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.

Real cost of equity (CoE) is nominal CoE less inflation.

Diversification refers to the dispersal of investments across asset types, geographies and so on with the aim of reducing risk or boosting risk-adjusted returns.

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.

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.

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

Profit Margin is an accounting figure which describes profit in relation to revenue in percent.

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.

Stagflation is the combination of the words "stagnation" and "inflation," referring to a period where inflation is high while the economy is stagnating.

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

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