CIO View

Americas CIO View

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Marketing material

Stubborn inflation, deteriorating US fiscal health to curb bonds and stocks

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IN A NUTSHELL

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After the debt deal: US fiscal health to be 2024 focus of bond market and voters

Suspending the debt ceiling until Jan 2025 should make fiscal health a greater concern of the bond market and a key Nov 2024 general election issue. The deficit remains too high at 5%+ for a full employment economy (another strong jobs report today), which risks a continued upward trend in debt/ gross domestic product (GDP) (now 120%) that along with higher refunding interest rates might risks a concerning jump in federal interest expense of GDP to late 1980s levels. Higher short and long-term nominal and real interest rates underlies the debt problem.

DWS CIO Day views: S&P at 4200 June 2024, if Fed cuts, then pivot on election is expected

Quarterly S&P earnings per share (EPS) growth likely stays stalled until 2H24, but up about 5% in 2024 & 2025. 2026 is likely flat or down somewhat on household and corporate tax hikes and perhaps another small recession in 2026. We expect very little real S&P EPS growth 2022-2026. If we're surprised to the upside, it's most likely from Tech/Digital and Health Care. Those concerned about growth risks from inflation staying high should not forget that these two sectors provided among the best inflation protection over the past few years. Intangible assets might take the high ground as preferred inflation protections. That said, we prefer Health Care right now and expect Tech to cool the rest of this year as the economy stalls. If inflation requires the U.S. Federal Reserve (Fed) to hike further, Tech could sell off sharply.

Love the 2020s?: Slow global growth, interest rates to pre financial crisis norms

Global growth revised to 2.8% for 2023 and 3.0% for 2024. US to fall into a mild recession in 2H23, Euro area flatlines and China's reopening bounce fades with maybe 6% growth this year, but likely no better than 5% next. For inflation, slowly trending downward but risks remain. We have US and Europe consumer price index (CPI) at 4.3% and 5.7% this year and both 2.5% in 2024. The 2024 target includes weak GDP expectations, some job losses and/or more central bank tightening. We expect the Fed to pause in June, because they signaled so and want to watch data, but the most recent inflation and jobs data and suspended debt ceiling suggest at least another hike soon. We kept our Fed Funds peak terminal rate estimate at 5.25-5.5%. It might take 3 years to get to 3.5%

For global equities, we see limited downside as well as limited upside. We expect a 0-10% total return for 12 months. Earnings growth should resume in late 2024, but at a slow pace. Price earnings multiple expansion seems to be capped because of soft GDP outlook and positive real interest rates. We like European small caps, banks and the telecommunication sector. Artificial Intelligence is overpriced short term. In the US, we prefer Communications, Health Care, the biggest Banks and our preferred defensives are Defense, Utilities. Within Real Estate the dramatic rate shock has probably been digested in listed Real Estate Investment Trusts (REITS), but still needs to feed through private real estate transactions. Fundamentals are solid with reduced building activity, low vacancy rates and rent hikes across non-office sectors.

On the commodities and currencies front, our 12-month strategic view is for a somewhat weaker dollar as the recession moves into rear view and European Central Bank (ECB) closes the gap with the Fed Funds rate by hiking to 4.0% and holding. We cut our oil price target from about $100/bbl to $85/bbl as Russia supply and penetration into global markets remains resilient so far. For gold, geopolitical tensions, the end of rate hiking in sight, a somewhat weaker dollar a year from now and further buying by emerging markets (EM) central banks should push gold to USD 2200/oz.

We note that our sector strategy has moved to Equal-weight (EW) Materials from Under-weight (UW), by adding to Metals (copper/gold plays) and Chemicals, but we are still cautious on other parts of Materials and Industrials outside of Aerospace & Defense, Rails and Airlines. In REITs, we are slightly UW, but with preferences in data center and cell tower properties and adding to retail. We have been opportunistically reducing our UW on Retailers in Staples and the Consumer Discretionary sector as most take their turn in lowering guidance and the stocks swooning.

What's inside Americas CIO View notes? Look for key tables and charts

The Americas CIO View is published several times a month and issued in both 1-page text only summary format and also a more detailed multiple page PDF format with numerous tables and charts to support the note's featured topic and our S&P EPS estimates, index targets as well as exhibits featuring our current S&P sector strategy and favored asset class allocations for US taxable investors in collaboration with our US multi-asset team.

We show DWS CIO day and debt ceiling update exhibits and non-GAAP S&P EPS quality. Accounting quality tends to be cyclical and seasonal with biggest gaps between GAAP and non-GAAP EPS during recessions and 4th quarters. Quality was poor last year and below par for 1Q23. Beyond non-GAAP, we expect cash taxes to rise further relative to provisions and note that high inflation causes inadequate depreciation expense relative to maintenance capex needs.

Glossary

The consumer price index (CPI) measures the price inflation as a percentage, year over year, of a basket of products and services that is based on the typical consumption of a private household.

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.

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

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

The federal funds rate is the interest rate at which depository institutions trade federal funds (balances held at Federal Reserve Banks) with each other overnight. When a depository institution has surplus balances in its reserve account, it lends to other banks in need of larger balances. A bank with excess cash, which is often referred to as liquidity, will lend to another bank that needs to quickly raise liquidity.

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.

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.

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.

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

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