

Fed is taking elevator up, S&P EPS will take stairs down



IN A NUTSHELL

- As the Fed uses the elevator to lift rates, S&P EPS will likely take the stairs down
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- DWS profit indicator is turning down, suggests S&P EPS turns down sequentially
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As the Fed uses the elevator to lift rates, S&P EPS will likely take the stairs down

The U.S. Federal Reserve (Fed) usually hikes rates with a staircase like climb by 25bp per meeting for a year or more, but usually cuts them in larger sizes like an elevator going down. Yet this time, the Fed is using the elevator to lift rates quickly to fight the highest inflation in four decades. Rates on a quick elevator up, means the economy and profits likely take the stairs down. Inflation hasn't yet peaked, thus neither has clarity on future hike sizes nor the top-floor. S&P earnings per share (EPS) cuts are starting, which we expect to continue in staircase like fashion downward for the rest of this year. We expect a small recession in 4Q22-1Q23 and unemployment to climb to 4.2% from 3.6%. Bottom-up consensus 2023E S&P EPS will likely be cut from \$250 to \$230-235 by early 2023 or less if oil is below \$100/bbl and Euro stays near \$1.00.

S&P EPS falls 20% from 4-qtr high to low on average in recessions since 1950

Since 1950, S&P EPS declined by 21% on average in recessions as measured from peak to trough trailing 4-qtr EPS. In shallow and short recessions like 1960 and 1970, S&P EPS declined 10-15%. During the long and severe recession of the financial crisis, S&P EPS fell 45% from 4-qtr peak to trough. As discussed in prior notes, we expect the next recession to be mild and without deflation (rather just disinflation). A mild recession with disinflation from high levels, suggests a smaller than usual recessionary hit to S&P EPS, perhaps like 1980, if 1982 doesn't follow. But we also acknowledge risks from S&P profits and margins surging to record highs since late last year, led by digital firms and consumer goods producers/retailers. Thus, there could be closer to usual recessionary set-backs at Materials, Retailers, Consumer and Capital Goods. While we see the pandemic profit surge at digital firms as lasting, a mild recession and strong dollar will stall their profit growth. We expect growth at Health Care and at still recovering Consumer Services and Aerospace & Defense. These segments should help contain a 4-qtr S&P EPS decline to well less than 10% if the recession stays mild. Quarterly S&P EPS has been flattish at about \$55 for the last several quarters or \$220 annualized. Thus, perhaps a \$210-220 4-qtr trough next four quarters, if credit costs don't surge and commodity prices don't collapse.

DWS profit indicator is turning down, suggests S&P EPS turns down sequentially

Quarterly S&P EPS y/y growth rates and many DWS profit indicator elements have been distorted by the sharp swings of the pandemic; first diving then surging in recovery. But sequential quarterly S&P EPS growth already slowed sharply since late last year; quarterly S&P EPS was \$54-55 since 3Q21 and likely 2Q21. But now, our profit indicator suggests profits will decline sequentially in 3Q. The profit indicator suggests a slight sequential downturn as of now, but recent data elements suggest an accelerating deteriorating trend. Also, foreign exchange (FX) is a headwind not incorporated in our profit indicator.

Our sector strategy: Tilts toward Health Care, Utilities, Banks, Aerospace

Our most favored sector remains Health Care (since year start). We see Pharma and Biotech as plays on impressive R&D investment and innovation in medicine. If the 2020's turnout to be another great decade for stocks, HC likely plays a big part. We overweight Utilities given upside risks on natural gas and electricity prices. We think Utilities are an attractive bond substitute with inflation protection, thus attractive non-cyclical real EPS and dividend yields. We expect its share of total energy production and distribution to rise with electric vehicles. We don't expect Russian natural gas to be shut off this winter, but intermittent disruptions or slow-flow possible if fighting intensifies in Ukraine or with ceasefire/territorial negotiations. Natural gas will be an essential commodity this winter and likely this decade. We are most cautious on Autos, Materials, Retailing, and cyclical parts of Industrials and Tech, including Machinery and Semiconductors. Our preferred cyclical sector is Financials/ Banks. We don't expect a financial crisis or surge in credit costs. We are equal-weight Energy. It helps protect against intermediate term risks, but faces long term challenges.

Downside risks increasing around our 2022 yearend S&P target of 4100

We're concerned about 1H challenges of conflict, broadening inflation, Fed hiking and slowing growth persisting in 2H and that the lame duck session of Congress might attempt to pass some anti supply-side, investor unfriendly legislation. Global, European and US policy risks remain high. The S&P is likely to stay mostly between 3700-4100 for the rest of the year and early next with risk of materially breaking that range more to the downside.

Glossary

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

Disinflationary describes a slowing of the pace of price inflation.

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.

The **financial crisis** refers to the period of market turmoil that started in 2007 and worsened sharply in 2008 with the collapse of Lehman Brothers.

FX is the abbreviation for **foreign exchange**, i.e. currencies.

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.

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

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