CIO View
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DWS

The AI speed train accelerates: Look far ahead, watch your speed

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IN A NUTSHELL

- Tech executives are racing ahead at full speed: What's the upside for investors?
- Raised 12-month S&P 500 target to 5600: 21.5x trailing $260 EPS in June 2025
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Tech executives are racing ahead at full speed: What's the upside for investors?

The Artificial Intelligence (AI) speed train accelerates as tech companies stoke the boiler with heaps of capital expenditure (capex) and very optimistic outlooks. Will this capex deliver high returns on capital? Is there still big upside for AI chip spending (volume/price) next year given the surge and rush to get ahead of others this year? Despite the swift speed of capex this year and stretched valuations, we believe that most trillion-cap stocks and the market overall will climb modestly higher in a year provided the titans of Tech and Communications keep delivering and guiding to 15% earnings per share (EPS) growth. DWS analysts and our tech focused portfolio managers believe that the Great Eight will deliver with exciting new AI products and enhancements. Thus, we lift our 12-month S&P target more than the usual bump up for the passage of time and normal EPS growth owing to a higher rate of EPS growth now expected for 2025 & 2026. While we expect dips around the US election, we expect such dips to be short-lived if political power is balanced after the election and an even-handed tax and spending plan emerges to restore fiscal health. We think the degree of fiscal discipline ahead will affect the degree of monetary easing.

Raised 12-month S&P 500 target to 5600: 21.5x trailing $260 EPS in June 2025

Slowing inflation, vanishing recession fears and especially surging AI related capex and optimism pushed current S&P EPS yields vs. bonds yields to levels not seen since the late 1990's. Our target 21.5 price-to-earnings (PE) ratio on trailing 4-quarter S&P EPS is above what current bond yields plus a normal equity risk premium (ERP) would support. However, we now expect 10% S&P EPS growth to be sustained into 2026. We raise our 2025E S&P EPS to $270 from $265 on 15-20% EPS growth at the Great Eight stocks and 7% from the rest; and while we do not formally estimate 2026 S&P EPS at this moment, our target assumes it is near $300.

Our 21.5x PE target relies on multiple years ahead of strong S&P EPS growth

At 2026 end, we expect the S&P 500 to trade at roughly 20x trailing EPS or roughly 6000, assuming no recession on the horizon at that time and that 10yr Treasury Inflation-Protected Securities (TIPS) yields are 2% or less. Forecasting well into the future is obviously uncertain, but constructive views on this market cannot be substantiated without approximating longer-term S&P EPS and being comfortable with an outlook for an above normal growth rate for a few years. Our robust S&P EPS growth outlook

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through 2026 underlies the 15% "growth premium" included in our trailing 21.5 PE target for June 2025, which is 3 points higher than 1 divided by long-term real interest rates plus a 350-400bp (basis point) ERP or the 18.5 average S&P PE since 1995.

Normal and healthy EPS growth expected in Europe, Asia stronger on a bounce

Beyond the US, EPS growth should be healthy and support respectable price gains over the next 12-months. We estimate 6% EPS growth in Europe, 9% in Japan and 13% in Emerging Markets (EM). With Europe returning to EPS growth, its record PE discount to the US should not expand. Recent snap elections in France have created political uncertainty. However, the populistic government in Italy did not prevent Italian stocks from outperforming. We also favor equities in Japan. The competitive position of Japanese companies and their exports are much improved from the weak yen and modest price increases so far. Furthermore, we think Japan is relatively well positioned if geopolitical tensions worsen.

Focused on the EPS outlook: Optimistic on EPS, but subpar compensation seen

Earnings growth best explains S&P 500 gains in recent years and the longer-term past. There is no need to seek new theories. High uncertainty remains on all that drives interest rates, earnings and "growth premiums" over the next year. While we see good reasons for optimistic outcomes, we think it's important to seek compensation for uncertainty and even optimism. At current valuations, we see subpar compensation for the risks ahead even with our optimistic EPS and interest rate expectations. Furthermore, while the earnings trends support it, we are concerned by the persistent leadership momentum at the S&P 500 and now the 35% concentration from eight stocks all at valuations and aggregate market caps that suggest great expectations. Just as earnings drive stocks and the market over time, we believe portfolios could benefit from diversification. We think even optimists should consider diversification and demand better compensation for the risks and the concentration of the Great Eight.

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Glossary

Artificial intelligence is the theory and development of computer systems able to perform tasks normally requiring human intelligence.

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.

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.

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.

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.

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.

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.

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.

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm's stock price in relation to its earnings.

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