

Further tightening required: Fed Funds rate exceeding 5% raises many risks



David Bianco
Americas Chief
Investment Officer

IN A NUTSHELL

- DWS CIO Day: Higher Fed Funds rate, 4100 S&P target pushed to March 2024
- Markets too quickly dismissed sticky inflation risk, taming inflation won't be easy
- Some risks might emerge very soon: Silicon Valley Bank fails on a deposit run
- S&P 4Q22 EPS fell a bit short of low expectations, 2023 EPS still drifting down
- S&P EPS quality deteriorating, quality metrics suggest unsustainable cash flow

DWS CIO Day: Higher Fed Funds rate, 4100 S&P target pushed to March 2024

The main theme of our CIO day was sticky inflation will force more hikes from central banks. This suggests a delayed but perhaps worse than slight recession. Our economists forecast 3.9% and 5.7% inflation for US and Europe in 2023. The U.S. Federal Reserve (Fed) Funds rate is expected to peak at near 5.5% in June. The European Central Bank (ECB) policy rate to peak at 4%. Both terminal rates likely come with long holds through 2023. We raised our 10yr Treasury yield 12-month forecast from 4.2% to 4.3%; which includes an expectation of a ~2.50% 10yr breakeven inflation rate and ~1.75% 10yr Treasury Inflation-Protected Securities (TIPS) yield. Long-term yields remain very uncertain for 2024, higher is possible, but if Fed hikes subdue inflation soon they could be well lower than our forecasts. DWS raises 12-month Euro target to \$1.10 from \$1.05 and keeps \$100/bbl oil.

We pushed our 4100 S&P 500 target to March 2024, but slightly boosted most European equity index targets with the 3-month roll forward in time. We see high near-term 10% plus correction risk for the S&P 500 as it would be uncommon for it to find bottom while the Fed is hiking above neutral rates with S&P Earnings per share (EPS) stalled or declining and the current price-to-earnings (P/E) ratio still quite high. We estimate the fair value range for the S&P 500 for the rest of 2023 is 3700-4000.

Markets too quickly dismissed sticky inflation risk, taming inflation won't be easy

Stocks rallied strongly in January into February as 2yr Treasury yields fell from their 5% autumn highs on a sanguine consensus view of steadily declining inflation that would allow the Fed to cut by 2023 end without a recession. We cautioned repetitively against such premature optimism. Since early February (until Silicon Valley Bank), all Treasury yields climbed as all macro reports year to date (YTD) and 4Q22 revisions show inflation still running too hot at the core; despite disinflation at goods, which is being driven by a goods demand/ manufacturing recession in progress.

A very tight labor market that is upset about purchasing power of pay, but also struggling to boost its productivity, suggests that unit labor costs could get stuck well above the Fed's inflation target this year and next. Unfortunately, time is running out for the Fed to afford to be patient with inflation. Yields are creeping upward and the bond market is losing patience with high interest rate uncertainty/ volatility. This puts Fed in a tough spot of having to fight harder and take more hard landing risk. Also, Chair Powell's Senate testimony last week reminded us that the longer it takes to tame inflation, the more politically difficult it will get.

This information is subject to change at any time, based upon economic, market and other considerations and should not be construed as a recommendation. Past performance is not indicative of future returns. Forecasts are not a reliable indicator of future performance. Forecasts are based on assumptions, estimates, opinions and hypothetical models that may prove to be incorrect. Alternative investments may be speculative and involve significant risks including illiquidity, heightened potential for loss and lack of transparency. Alternatives are not suitable for all clients. Source: DWS Investment GmbH.

Some risks might emerge very soon: Silicon Valley Bank fails on a deposit run

As 3-24 month Treasury bills and notes exceed 5%, it not only raises alternatives to equities but also for bank deposits, as most still yield lower and are unlikely to go quite that high. Thus, competition among banks for saver deposits will intensify. In this fight, smaller banks are disadvantaged. They offering less services and sometimes less safety is perceived and moreover they lack the excess of deposits and reserves as at the giant banks. The risks will obviously be greater for banks that mismanage their duration risk or have lower quality "flighty" deposit bases. Of course, some banks are more exposed to the more challenged parts of the economy like commercial real estate or less capital available for unprofitable early-stage enterprises. All considered, we think it important the Fed considers how to keep fighting inflation while helping to protect smaller regional and community banks. We'd be more reassured if the Fed didn't hike the Discount rate upon further Fed Funds rate hikes.

S&P 4Q22 EPS fell a bit short of low expectations, 2023 EPS still drifting down

S&P 4Q EPS finished at \$53.30 vs. \$53.85 consensus earnings season start and our long standing \$54 estimate. Some headline 4Q S&P EPS surprise figures are slightly positive, but only from analysts cutting 1-3 days before reporting for many companies. 2023 analyst consensus EPS still drifting down. It's \$224 now vs. \$230 at year start and \$251 last June. 1Q & 2Q 2023 consensus S&P EPS has been cut most to \$50.94 and \$54.57, -7.1% and -5.2% y/y. Consensus expects 2.5% y/y growth in 3Q and now 10% EPS y/y growth in 4Q, but this has significant downside risk. Profit margins in most developed markets still at risk.

S&P EPS quality deteriorating, quality metrics suggest unsustainable cash flow

Aside from stalled S&P EPS growth, another concern is deteriorating S&P earnings quality. The Generally Accepted Accounting Principles (GAAP) to non-GAAP EPS ratio averages 86% out of recessions, usually above 90% for healthy mid-cycle quarters. However, it fell toward 78% 2022 and 73% in 4Q, borderline levels only seen during recessions. Another metric we monitor is: $(\text{Net income} + \text{D\&A}) / (\text{CFO} - \text{Stock Option Expense})$. Free Cash Flow vs. Net Income is more an indication of investment activity than earnings quality. But comparing Cash Flow from Operations (CFO) to Net Income + Depreciation & Amortization (D&A) over several years helps reveal reported earnings quality. This measure is at a two-decade high for non-GAAP based EPS or 15% higher than usual, and 10% higher than usual GAAP based, suggesting earnings overstate true profitability and steady-state free cash flow.

Glossary

Amortization is an accounting term which refers to the periodical reduction of the book value of intangible assets (such as patents) or bank loans.

Breakeven rates provide a useful measure of average inflation expectations derived from inflation linked sovereign bonds

Core inflation excludes items which can be susceptible to volatile price movements, e.g. food and energy.

In relation to currencies, **depreciation** refers to a loss of value against another currency over time.

The **discount rate** is the interest rate charged to commercial banks and other depository institutions for loans received from the country's central bank's discount window.

Disinflation 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 **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.

Free Cash Flow (FCF) is a measure of financial performance calculated as operating cash flow minus capital expenditures. It shows how much cash a company is able to generate after deducting the money required to maintain or expand its asset base.

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

Operating Cash Flow is an accounting term that measures the amount of cash generated by a company through its usual business activities.

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

Productivity measures how much economic output is produced for a given level of inputs (such as capital and labor).

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

Purchasing power is the value of a currency expressed in terms of the number of goods or services that one unit of money can buy.

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

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.

Unit labor costs (ULC) measure the average cost of labor per unit of output.

The **United States Senate** is a legislative chamber consisting of 100 Senators, with each state being represented by two Senators. Senators are elected for six year, overlapping terms in their respective state.

Important information – EMEA, APAC & LATAM

DWS is the brand name of DWS Group GmbH & Co. KGaA and its subsidiaries under which they do business. The DWS legal entities offering products or services are specified in the relevant documentation. DWS, through DWS Group GmbH & Co. KGaA, its affiliated companies and its officers and employees (collectively "DWS") are communicating this document in good faith and on the following basis.

This document is for information/discussion purposes only and does not constitute an offer, recommendation or solicitation to conclude a transaction and should not be treated as investment advice.

This document is intended to be a marketing communication, not a financial analysis. Accordingly, it may not comply with legal obligations requiring the impartiality of financial analysis or prohibiting trading prior to the publication of a financial analysis.

This document contains forward looking statements. Forward looking statements include, but are not limited to assumptions, estimates, projections, opinions, models and hypothetical performance analysis. No representation or warranty is made by DWS as to the reasonableness or completeness of such forward looking statements. Past performance is no guarantee of future results.

The information contained in this document is obtained from sources believed to be reliable. DWS does not guarantee the accuracy, completeness or fairness of such information. All third party data is copyrighted by and proprietary to the provider. DWS has no obligation to update, modify or amend this document or to otherwise notify the recipient in the event that any matter stated herein, or any opinion, projection, forecast or estimate set forth herein, changes or subsequently becomes inaccurate.

Investments are subject to various risks. Detailed information on risks is contained in the relevant offering documents.

No liability for any error or omission is accepted by DWS. Opinions and estimates may be changed without notice and involve a number of assumptions which may not prove valid. DWS does not give taxation or legal advice.

This document may not be reproduced or circulated without DWS's written authority.

This document is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, including the United States, where such distribution, publication, availability or use would be contrary to law or regulation or which would subject DWS to any registration or licensing requirement within such jurisdiction not currently met within such jurisdiction. Persons into whose possession this document may come are required to inform themselves of, and to observe, such restrictions.

For institutional / professional investors in Taiwan:

This document is distributed to professional investors only and not others. Investing involves risk. The value of an investment and the income from it will fluctuate and investors may not get back the principal invested. Past performance is not indicative of future performance. This is a marketing communication. It is for informational purposes only. This document does not constitute investment advice or a recommendation to buy, sell or hold any security and shall not be deemed an offer to sell or a solicitation of an offer to buy any security. The views and opinions expressed herein, which are subject to change without notice, are those of the issuer or its affiliated companies at the time of publication. Certain data used are derived from various sources believed to be reliable, but the accuracy or completeness of the data is not guaranteed and no liability is assumed for any direct or consequential losses arising from their use. The duplication, publication, extraction or transmission of the contents, irrespective of the form, is not permitted.

© 2023 DWS Investment GmbH

Issued in the UK by DWS Investments UK Limited which is authorised and regulated in the UK by the Financial Conduct Authority.

© 2023 DWS Investments UK Limited

In Hong Kong, this document is issued by DWS Investments Hong Kong Limited. The content of this document has not been reviewed by the Securities and Futures Commission.

© 2023 DWS Investments Hong Kong Limited

In Singapore, this document is issued by DWS Investments Singapore Limited. The content of this document has not been reviewed by the Monetary Authority of Singapore.

© 2023 DWS Investments Singapore Limited

In Australia, this document is issued by DWS Investments Australia Limited (ABN: 52 074 599 401) (AFSL 499640). The content of this document has not been reviewed by the Australian Securities and Investments Commission.

© 2023 DWS Investments Australia Limited

as of 3/13/23; 095010_1 (03/2023)

Important information – North America

The brand DWS represents DWS Group GmbH & Co. KGaA and any of its subsidiaries, such as DWS Distributors, Inc., which offers investment products, or DWS Investment Management Americas Inc. and RREEF America L.L.C., which offer advisory services.

This document has been prepared without consideration of the investment needs, objectives or financial circumstances of any investor. Before making an investment decision, investors need to consider, with or without the assistance of an investment adviser, whether the investments and strategies described or provided by DWS, are appropriate, in light of their particular investment needs, objectives and financial circumstances. Furthermore, this document is for information/discussion purposes only and does not and is not intended to constitute an offer, recommendation or solicitation to conclude a transaction or the basis for any contract to purchase or sell any security, or other instrument, or for DWS to enter into or arrange any type of transaction as a consequence of any information contained herein and should not be treated as giving investment advice. DWS, including its subsidiaries and affiliates, does not provide legal, tax or accounting advice. This communication was prepared solely in connection with the promotion or marketing, to the extent permitted by applicable law, of the transaction or matter addressed herein, and was not intended or written to be used, and cannot be relied upon, by any taxpayer for the purposes of avoiding any U.S. federal tax penalties. The recipient of this communication should seek advice from an independent tax advisor regarding any tax matters addressed herein based on its particular circumstances. Investments with DWS are not guaranteed, unless specified. Although information in this document has been obtained from sources believed to be reliable, we do not guarantee its accuracy, completeness or fairness, and it should not be relied upon as such. All opinions and estimates herein, including forecast returns, reflect our judgment on the date of this report, are subject to change without notice and involve a number of assumptions which may not prove valid.

Investments are subject to various risks, including market fluctuations, regulatory change, counterparty risk, possible delays in repayment and loss of income and principal invested. The value of investments can fall as well as rise and you may not recover the amount originally invested at any point in time. Furthermore, substantial fluctuations of the value of the investment are possible even over short periods of time. Further, investment in international markets can be affected by a host of factors, including political or social conditions, diplomatic relations, limitations or removal of funds or assets or imposition of (or change in) exchange control or tax regulations in such markets. Additionally, investments denominated in an alternative currency will be subject to currency risk, changes in exchange rates which may have an adverse effect on the value, price or income of the investment. This document does not identify all the risks (direct and indirect) or other considerations which might be material to you when entering into a transaction. The terms of an investment may be exclusively subject to the detailed provisions, including risk considerations, contained in the Offering Documents. When making an investment decision, you should rely on the final documentation relating to the investment and not the summary contained in this document.

This publication contains forward looking statements. Forward looking statements include, but are not limited to assumptions, estimates, projections, opinions, models and hypothetical performance analysis. The forward looking statements expressed constitute the author's judgment as of the date of this material. Forward looking statements involve significant elements of subjective judgments and analyses and changes thereto and/or consideration of different or additional factors could have a material impact on the results indicated. Therefore, actual results may vary, perhaps materially, from the results contained herein. No representation or warranty is made by DWS as to the reasonableness or completeness of such forward looking statements or to any other financial information contained herein. We assume no responsibility to advise the recipients of this document with regard to changes in our views.

No assurance can be given that any investment described herein would yield favorable investment results or that the investment objectives will be achieved. Any securities or financial instruments presented herein are not insured by the Federal Deposit Insurance Corporation ("FDIC") unless specifically noted, and are not guaranteed by or obligations of DWS or its affiliates. We or our affiliates or persons associated with us may act upon or use material in this report prior to publication. DB may engage in transactions in a manner inconsistent with the views discussed herein. Opinions expressed herein may differ from the opinions expressed by departments or other divisions or affiliates of DWS. This document may not be reproduced or circulated without our written authority. The manner of circulation and distribution of this document may be restricted by law or regulation in certain countries. This document is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, including the United

States, where such distribution, publication, availability or use would be contrary to law or regulation or which would subject DWS to any registration or licensing requirement within such jurisdiction not currently met within such jurisdiction. Persons into whose possession this document may come are required to inform themselves of, and to observe, such restrictions.

Past performance is no guarantee of future results; nothing contained herein shall constitute any representation or warranty as to future performance. Further information is available upon investor's request. All third party data (such as MSCI, S&P & Bloomberg) are copyrighted by and proprietary to the provider.

For Investors in Canada: No securities commission or similar authority in Canada has reviewed or in any way passed upon this document or the merits of the securities described herein and any representation to the contrary is an offence. This document is intended for discussion purposes only and does not create any legally binding obligations on the part of DWS Group. Without limitation, this document does not constitute an offer, an invitation to offer or a recommendation to enter into any transaction. When making an investment decision, you should rely solely on the final documentation relating to the transaction you are considering, and not the [document – may need to identify] contained herein. DWS Group is not acting as your financial adviser or in any other fiduciary capacity with respect to any transaction presented to you. Any transaction(s) or product(s) mentioned herein may not be appropriate for all investors and before entering into any transaction you should take steps to ensure that you fully understand such transaction(s) and have made an independent assessment of the appropriateness of the transaction(s) in the light of your own objectives and circumstances, including the possible risks and benefits of entering into such transaction. You should also consider seeking advice from your own advisers in making this assessment. If you decide to enter into a transaction with DWS Group you do so in reliance on your own judgment. The information contained in this document is based on material we believe to be reliable; however, we do not represent that it is accurate, current, complete, or error free. Assumptions, estimates and opinions contained in this document constitute our judgment as of the date of the document and are subject to change without notice. Any projections are based on a number of assumptions as to market conditions and there can be no guarantee that any projected results will be achieved. Past performance is not a guarantee of future results. The distribution of this document and availability of these products and services in certain jurisdictions may be restricted by law. You may not distribute this document, in whole or in part, without our express written permission.

For investors in Bermuda: This is not an offering of securities or interests in any product. Such securities may be offered or sold in Bermuda only in compliance with the provisions of the Investment Business Act of 2003 of Bermuda which regulates the sale of securities in Bermuda. Additionally, non-Bermudian persons (including companies) may not carry on or engage in any trade or business in Bermuda unless such persons are permitted to do so under applicable Bermuda legislation.

© 2023 DWS Investment GmbH, Mainzer Landstraße 11-17, 60329 Frankfurt am Main, Germany.
All rights reserved.

as of 3/13/23; 095012_1 (03/2023)