CIO View
Americas CIO View

October 10, 2022
Marketing material

DWS

# Real yields rise into pre financial crisis range; must recalculate fair PEs

David Bianco
Americas Chief
Investment Officer

IN A NUTSHELL

— PEs stand on the shoulders of the bond market, which fell to its knees in 2022
— How bad might it get? Is this high inflation period just starting or nearly finished?
— We don't expect the 1970s to repeat, but we think this bear market is justified
— We cut 2022E S&P EPS by $5 and 2023E by $15: $227 & $235 to $222 & $220
— Fed aims to push real rates well above 0%, but for how long and what's normal?
— We raise S&P real CoE from 5.50% to 5.75%, lower fair PE from 18.5 to 17.5

## PEs stand on the shoulders of the bond market, which fell to its knees in 2022

At 3Q end, the S&P 500 was down 25% year-to-date and the US bond market down 15%. Bonds suffered more than the 1994 bond bear market and equities the worst decline outside of an evident recession except for the October 1987 crash. 10yr Treasury yields started 2022 at 1.5% and climbed to 3.8% at 3Q end with brief visits to 4.0%. 10yr Treasury Inflation-Protected Securities (TIPS) yields, which indicate long-term real interest rates, climbed from -1.0% at year start to 1.7% at 3Q end. Inflation expectations, per 10yr Treasury vs. TIPS breakeven, went from 2.5% at year start to 3% in spring down to 2.25% now. Thus, the climb in Treasury yields YTD is now entirely from real yields. Owing to the U.S. Federal Reserve (Fed) vowing to break high inflation by hiking rates to at least 2% above their 2% inflation target. Bond investors now believe inflation will return to about 2.5% from a Fed Funds rates over 4%, but how much over 4% and for how long is debated.

## How bad might it get? Is this high inflation period just starting or nearly finished?

Investors ask, "how bad might it get?" The answer to this anxiety ridden question is that it depends on whether this period of high inflation is just starting or nearly finished. The 1982 S&P bear market was a 27% decline, similar to the current bear market so far. 1982 brought a recession that ended the high inflation period. Inflation was 15% in 1980, 3% in 1983. However, the 1974 S&P bear was a 48% fall as the harsh recession brought inflation from 12% down to only 5%. Down, but still too high. The S&P suffered 10 years of 0% real return from 1973 start to 1982 end in a decade plagued by high inflation. While S&P earnings per share (EPS) growth kept up with inflation over the decade, producing a total return with dividends in line with inflation, no real return was earned because the PE compressed from about 19x in early 1973 to about 9x in 1982. This price-to-earnings (P/E) ratio compression was driven by surging interest rates, no real EPS growth, and earnings quality deterioration from inadequate depreciation expense.

## We don't expect the 1970s to repeat, but we think this bear market is justified

It would take repeated bad policies and economic conditions at home and abroad to repeat the 1970s, most of which can be avoided if leaders today understand past mistakes. The Fed's resolve to fight inflation today, even if it requires risking and tolerating a moderate recession, shows that they understand their 1970s policy mistakes. Do other policy setters?

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.

While we don't expect a 1974 bear market or lost decade of real returns, as through 1982, we think this bear market is a justified reset of S&P fair value owing to higher 2023 interest rate expectations and lower EPS estimates. The 15% decline in bonds YTD (20%+ at Treasuries) and about 10% decline in 2022 S&P EPS expectations YTD, suggests a 25% bear market is justified.

## We cut 2022E S&P EPS by $5 and 2023E by $15: $227 & $235 to $222 & $220

We expect trough quarterly S&P EPS of $52 in 1Q23, down 5-10% from the 1Q22 peak ex. Energy and down 10% from the 2Q22 peak of $58 with Energy for 4 main reasons: 1) small recession expected for US and Europe over the next couple of quarters followed by slow growth, causing a 5% dip or near $3 hit to 1Q23 EPS from $55 in 1Q22, 2) dollar strength that hits S&P EPS from 1Q22 levels by $1-$1.50 quarterly through 2023, 3) minimum book profit and buyback taxes of near $3 annually in 2023, 4) energy profits $2-3 above 1Q22 levels quarterly in 1H23. Our new 2023 quarterly EPS estimates are: 52+55+56+57=$220. We also cut 3Q22 and 4Q22 S&P EPS estimates from $56 to $55 and $58 to $54. Our new 2022 quarterly S&P EPS estimates are: 55+58+55+54=$222. This puts 4qtr trough EPS at $216 vs. $221 4qtr peak. These estimates assume a 3.5% inflation in 2023, unemployment not over 4.5% and stability in long-term interest rates and asset values from here. Because recessions usually hit S&P EPS much more, risk remains to the downside for our estimates.

## Fed aims to push real rates well above 0%, but for how long and what's normal?

The Federal Open Market Committee (FOMC) guidance and market indicators put the Fed Funds rate at 4.25-4.5% at yearend. Futures price a 75bp (basis points) November hike and 50bp December. This 425bp of hiking in 9 months, since March, exceeds the average hiking cycle of 300bp over 15 months. FOMC guidance suggests the Fed is likely to maintain these rates or higher through 2023 even if a small recession hits. This pushed 10yr TIPS yields upward recently to levels that suggest the Fed might maintain positive real interest rates around or over 1% for several years. We doubt that the real Fed Funds rate or 10yr TIPS yields will stay over 1.5% over the next few years, but we now believe the Fed and the bond market will sustain an at least 1% real risk-free rate for the next two years to lower inflation and help prevent it from rising again.

## We raise S&P real cost of equity (CoE) from 5.50% to 5.75%, lower fair PE from 18.5 to 17.5

Our intrinsic valuation model puts S&P fair value at 3750 at 2022 end. If 4Q23 EPS is $57 with inflation near 3% and 10yr Treasury yields under 4%, we think the S&P will be over 4000 at 2023 end. We change our Next 5%+ S&P price move from Down to Balanced Risk (Neutral).

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.

## Glossary

Technically, a bear market refers to a situation where the index's value falls at least 20% from a recent high.

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

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.

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 Federal Funds rate is the interest rate that banks charge each other to borrow or lend excess reserves overnight

The Federal Open Market Committee (FOMC) is the committee that oversees the open-market operations (purchases and sales of securities that are intended to steer interest rates and market liquidity) of the U.S. Federal Reserve.

A futures contract is a standardized, contractual agreement to trade a financial instrument or commodity at a pre-determined price in the future.

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.

The real return is the nominal return adjusted for inflation.

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.

A share buyback involves a company buying back its own shares.

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.

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.

## 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.

© 2022 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.
© 2022 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.
© 2022 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.
© 2022 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.
© 2022 DWS Investments Australia Limited

as of 10/10/22; 092484_1 (10/2022)

## 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 products(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.

© 2022 DWS Investment GmbH, Mainzer Landstraße 11-17, 60329 Frankfurt am Main, Germany.
All rights reserved.

as of 10/10/22; 092487_1 (10/2022)