What to do with small caps and higher beta after this rally?

David Bianco
Americas Chief Investment Officer
DWS

US. equities have priced in a patient Fed and path to an eventual trade deal

The S&P is up 11.5% year-to-date and 18.9% since the Christmas Eve trough. In late December, we advised investors not to panic because the blatant market protest of dissent in the last days of 2018 would force the U.S. Federal Reserve (Fed) to realize that they should bluntly signal a much more cautious stance on future hikes as the Fed Funds rate enters its arguable neutral range and the economy slows. We acknowledged then and now, that U.S.-China trade deal and Brexit risks remain, but we expect time to be provided to find solutions that avoid severely adverse outcomes to the economies of the parties negotiating. While full resolutions are still unlikely in the near-term, more time is likely.

Small outperformed large caps significantly across all sectors in this rally

The Russell 2000 is up 17.8% year-to-date and 25.4% since its Christmas trough, significantly outperforming its large cap counterparts as the outperformance is across all sectors. It's typical for small caps to outperform when exiting recessions or bear markets. But now that both the S&P 500 and Russell 2000 are within shouting distance from their previous peaks, an examination of the macro backdrop, earnings growth outlook, balance sheets and valuations causes us to reduce our small cap exposure from 5% back to the 4% or small underweight we had before late 2018's sell off. We reduce our total equity allocation to 64% from 65%, still overweight (OW) equity vs. fixed income, but raise fixed income to 31% from 30%, by raising investment grade credit to 4%.

Five reasons why large Growth stocks and Banks have better risk-reward

First, on a rolling 5-year basis, the relative performance of small vs. large is near the high end again for this cycle. Second, a continuing slowdown in U.S. gross domestic product (GDP) at least through 2020 should continue to make it hard for R2 to deliver superior earnings growth than S&P 500. The S&P is more exposed to global GDP, but its higher quality businesses should grow more if global growth is decent. Third, if the market continues to rally from here, good news from trade talks and Brexit should be important drivers and large caps will benefit more; yet if the market pulls back on bad news small caps likely suffer more, especially if levered. Fourth, despite more tax cut benefit, R2 failed to deliver stronger earnings per share (EPS) growth than the S&P in 2018. 4Q18 was another disappointing quarter with R2 EPS growth at 10.4% ex. companies with negative earnings, which compares to 15% at S&P. Fifth, while the valuation premium of R2 vs. S&P 500 is off its prior highs (the relative price-to-earnings ratio (PE) of R2000 vs. S&P 500 is back to average of this cycle) the relative PE is still above average since 1976 if excluding companies with negative earnings. These levels of valuation would not be concerning if the R2000 was delivering EPS growth at least on par with the S&P 500, but because the R2 didn't in 2018 it seems unlikely rest of cycle and R2 leverage is higher.

DWS strategic views: Global equities near fairly priced and overweight EM

For the next 12 months through March 2020, global equities should deliver better returns (4-9%) than fixed income. Our 12 month total return estimates by equity regions are: Emerging Markets (EM) (9%), EM Asia (7%), US (5%), Europe (4%) and Japan (4%). Our CIO View is over-weight EM and neutral on the relative preferences among the other regional equity markets.

Our EM over-weight is based on the view that several headwinds should be fading: 1) no sharp USD gains are likely now that the Fed plans to move more slowly; 2) the negative impact of semi-conductor profit reductions, severely impacting 2019 Taiwan & South Korea EPS, should soon lapse; 3) new structural reforms or stimulus programs in Brazil and China are in progress; 4) low inflation rates should allow monetary easing in several EM countries; 5) while relative PEs of EM to developed market (DM) are not depressed, we expect EM to show the best EPS momentum over the coming years. Sector-wise, our CIO view is over-weight Financials, particularly big U.S. Banks, and neutral on all other GICS sectors on a global basis. In the US, we advise a preference for Growth stock sectors as they tend to outperform in the latter years of long lasting expansions. We point to U.S. and EM Asia as having high growth stock compositions. Our CIO view is that U.S. 10 year Treasury yields will climb gradually to 3.0%, and U.S. investment grade (IG) credit spread will remain tight, but the high yield (HY) spreads widen slightly. Euro is expected to be stable at 1.15 and USD/CNY (U.S. dollar and Chinese yuan) to weaken to 7.0. West Texas Intermediate (WTI) oil is expected to rise to $60/barrel (bbl).

Contributor: Ju Wang, Investment Strategist & Portfolio Analyst

Contact Information
David Bianco 212 250-8169, david.bianco@dws.com
Ju Wang 212 250-7911, ju.wang@dws.com
Jamie A. Serio 212 454-0554, jamie-a.serio@dws.com

Definitions

One basis point (bp) equals 1/100 of a percentage point.

Bear market is a condition in which securities prices 20 percent or more over a sustained period of time.

Brexit is a combination of the words "Britain" and "Exit" and describes the possible exit of the United Kingdom from the European Union.

Earnings per share is calculated as a companies' net income minus dividends of preferred stock all divided by the total number of shares outstanding.

An emerging market (EM) is a country that has some characteristics of a developed market in terms of market efficiency, liquidity and other factors, but does not meet standards to be a developed market.

The euro (EUR) is the common currency of the Eurozone states and is the second most important reserve currency in the world after the U.S. dollar.

The federal funds rate is the interest rate at which banks actively trade balances held at the Federal Reserve.

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.

High-yield (HY) bonds are high-paying bonds with a lower credit rating than investment-grade corporate bonds, Treasury bonds and municipal bonds.

An investment-grade (IG) rating by a rating agency such as Standard & Poor's indicates that a bond has a relatively low risk of default.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

A particular security is overweight in a portfolio when it is held in an excess amount in comparison with the security's weight in the underlying benchmark portfolio.

The price-to-earnings (P/E) ratio or multiple measures a company's current share price relative to its per-share earnings.

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

This index measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

The S&P 500 Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Small cap firms generally have a market capitalization of less than $2 billion.

The U.S. Federal Reserve (Fed) implements U.S. monetary policy.

West Texas Intermediate (WTI) is a grade of crude oil used as a benchmark in oil pricing.

Yuan (CNY) is the basic monetary unit of China.

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