The correction revisits: Still bullish, still favor Growth & Banks

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Keep watch on trade conflicts: Escalation risk is higher, but compromises are possible

New U.S. tariffs drew retailiation plans from China and rethoric from both sides shook global markets. Trade conflict risk is rising; but, we view executive-ordered US tariffs as a tactical move to demonstrate a resolve to urge China and others to take more significant steps to open their markets and respect international property rights. What happens from here is two-sided. We think all nations should back away from hostile trade rethoric and focus on negotiating updated agreements to improve the fairness and balance of trade without any nation obsessing on specious nominal trade balances. It's understood that no one wins a trade war, but this tension might relieve grievances and promote compromises for more popular and prosperous trade.

DWS Global CIO View for March 2019: Bond yields, U.S. dollar and global equities up

While acknowledging heightened trade risks, DWS Global CIO View extended its forecasts for healthy global economy growth through 2019 at its quarterly CIO Day last week. US GDP growth is estimated at 2.6% in 2018 and 2.5% in 2019, with global GDP rising 3.9% both years. The Fed is expected to hike to 2.25-2.5% in March 2019 upon continued growth, falling unemployment and inflation near 2%. The 10yr Treasury yield is expected to be 3.25%. Higher interest rates should moderately strengthen the dollar, but not stop stocks from rising. we raise our 12-month S&P 500 price target to 2850, which aligns with about 2800 for year-end.

We expect Growth to outperform Value again in 2018: But with less FANG dominance

Russell 1000 Growth outperformed Value with a total return of 30.2% vs. 13.7% in 2017. The trend continues in 2018 with a -0.1% total return for Growth and -5.2% for Value as of Mar 23. This note examines earnings growth, valuation, and leverage metrics of these two style groups. We still think Growth beats Value in 2018, but with less "FANG" or FAANG (FB, AMZN, AAPL, NFLX, GOOGL, GOOG) dominance at Growth and stronger gains at Banks in Value. Growth and Banks appear most attractive in this correction.

FANG is a strong driver of market gains and profit growth, but elsewhere is good too

Many overly attribute the S&P 500's strong gains and revenue/earnings growth to FANG stocks. S&P's total return in 2017 was 21.8%, but still 19.4% ex-FAANG. These five companies have become a big part of the S&P. FAANG was 5% of S&P 500 earnings and 7% of market cap when FB had its IPO in May 2012. Since then, their share of earnings has doubled to 10% and share of market cap risen to 11%. Earnings Per Share (EPS) growth at these five companies has been superior, averaging 27.8% vs. 5.7% for the overall S&P 500 in 2013-2017. But even ex-FAANG, S&P EPS increased 5.3% on average during the period, which is good considering the profit recession from 2Q15-2Q16.

EPS growth at Growth is higher than Value this cycle even excluding FANG

Since 2013, compounded EPS growth at Russell 1000 Growth is 6.0% versus 4.3% at Value. Even if comparing Growth ex FANG to Value ex Financials, the former's EPS growth is 4.7% vs. 4.3% of the latter. EPS growth for the full Russell 1000 Growth over the next 12 months is expected to surpass Value. EPS growth at Value was flattered last year versus the slump during the 2015-16 profit recession. Furthermore, even after the strong outperformance of Growth over Value, the price-to-earnings (PE) premium of Growth to Value just got back to its long term average and it is still slightly below its historic average when comparing Growth ex-FANG to Value ex-Financials.

Stronger balance sheets at Growth should help it fare better around the Fed rate hikes

We look at different leverage metrics and they all show that Growth stocks have lower leverage and better coverage ratios than Value stocks. This should keep any negative impact from climbing interest rates small. Net Debt/Mkt Cap and Net Debt/EBITDA (Earnings before interest, tax, depreciation and amortization) are 10% and 1.24 at Russell 1000 Growth, much lower than the 26% and 2.2 at Value. EBITDA/Gross Interest Expense is 11.1x at Growth vs. 8.4x at Value. And Growth has 4.3x as much cash as short-term debt, while Value only 1.9x. Pelase refer to our last note on Mar 16 "U.S. corporate debt climbing, but so are assets" for the discussion on the overall impact of higher interest rates on corporate earnings and their ability to cover their debt.

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Definitions:

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

EBITDA – earnings, before interest expenses, taxes, depreciation and amortization – is an accounting measure calculated using a company's net earnings, before interest expenses, taxes, depreciation and amortization are subtracted.

Gross domestic product (GDP) is the monetary value of goods and services produced within a country’s borders in a specific time frame.

Price-to-earnings ratio (P/E) compares a company’s current share price to its per-share earnings.

The Russell 1000 Growth Index tracks those stocks in the Russell 1000_ Index with higher price-to-book ratios and higher forecasted-growth values. Index returns do not reflect fees or expenses and it is not possible to invest directly into an index.

The Russell 1000 Value Index is an unmanaged index that consists of those stocks in the Russell 1000® Index with less-than-average growth orientation. The Russell 1000 Index is an unmanaged price-only index of the 1,000 largest capitalized companies that are domiciled in the U.S. and whose common stocks are traded.

The Standard & Poor’s 500 (S&P 500) Index is an unmanaged, capitalization weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Index returns assume reinvested dividends, do not reflect any fees or expenses and it is not possible to invest directly into an index

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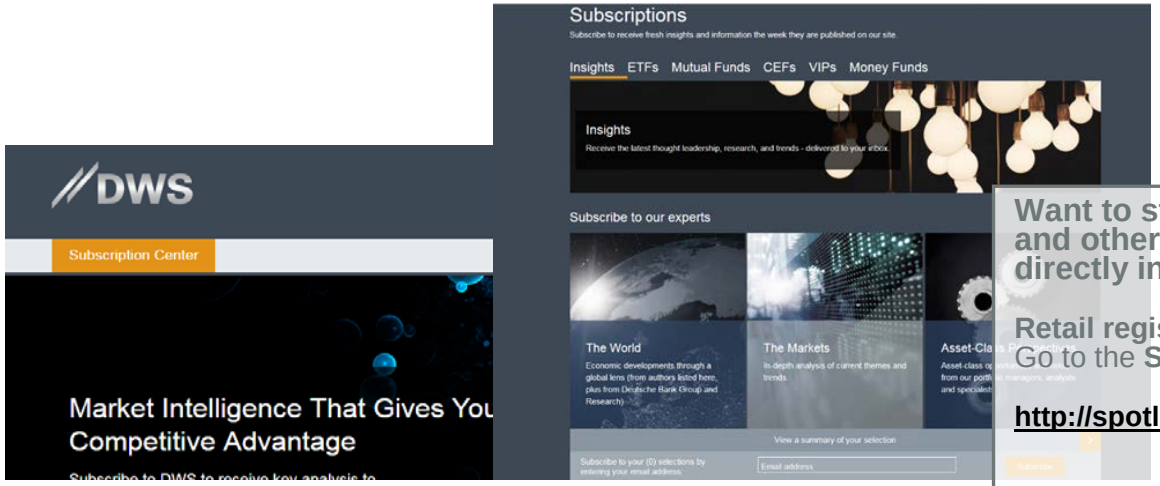

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