Constructive on S&P EPS, but tactically cautious on PE

David Bianco
Americas Chief Investment Officer
DWS

S&P EPS beat high expectations in 2Q on sales growth and operating strength

2Q earnings season is wrapping up with 93% of S&P earnings reported. 75% beat on earnings per share (EPS) with a weighted average beat of 3.9% compared to consensus estimates at June end. Bottom-up 2Q S&P EPS is $40.68, up 24.7% y/y for current S&P constituents. Bottom-up 2Q pre-tax income growth is 14.9%, buybacks contributed 1-2% of EPS growth, so the implied tax cut benefit is about 8%. Sales growth in 2Q was very strong at up 9.7% y/y. The non-globally accepted accounting principles (non-GAAP) net margin rose slightly again to a new high of 12.4% in 2Q, 13% ex Energy, impressive considering the reset from 11% in 2017 to 12.2% in 1Q from the corporate tax cut.

We raise 2018E S&P EPS from $160 to $161, up 21% vs. 2017. What about 2019?

Despite an unenthusiastic market response to very strong earnings during 1Q reporting, albeit after a strong January rally, the S&P rose by ~5% this earning season, since June end, despite escalating trade conflict. We appreciate that the S&P is now generating ~$162 of annualized EPS and that the 10yr Treasury yield remains capped at 3%, but it seems to us that investors are underestimating trade risks to 2019 S&P EPS. Tariffs and weakened global trade could strain healthy but decelerating countries like China or be the straw that breaks the back of weak countries like Turkey. Given strong first half results, we raise our 2018E S&P EPS from $160 to $161. We also raise our 2019E EPS from $170 to $171 or still up 6%, but this could be cut if tariffs lead to further dollar gains, commodity weakness or materially slower global growth.

It's important that S&P EPS growth stay above 5% in 2019 with a 2% dividend yield

We think it important for S&P EPS growth to not fall below 5% in 2019 for the PE to stay near 18. An aging cycle, Fed hikes, flattening curve, will demand clear signs of continued healthy EPS growth to prevent PE contraction. Furthermore, the S&P PE is likely limited in its upside until PEs abroad begin to climb. As 2Q earnings are behind and as the summer fades, we expect the S&P to trade on expectations for 2019 S&P EPS and the growth rate will influence the price to earnings ratio (PE).

Tariff risks are on the rise. Is a dangerous domino chain being set?

So far, the damage to markets from escalating trade conflict has been contained except at the center of the storm, China; hitting both China stocks and its currency. But the newly announced higher tariff on Turkey, seems to have caused a chain reaction. Turkish Lira has plummeted, down 25% in August and 40% year to date. This raises concerns for Italian and other European banks and businesses exposed to Turkey. At a time when Italy faces its own fiscal problems. This week the Euro fell to its lowest level since July 2017 and global stocks declined. Further tariffs on China might cause a greater than expected slowing, currency depreciation or more financial market strains. Given the greater importance of China to the world economy things wouldn't need to be like Turkey to have an adverse global affect. Our base case scenario is still that US and China will seek ways to de-escalate the trade war instead of pushing it further, but we think investors should be mindful that trade risks are not fully priced into U.S. equities despite the negative reactions in foreign equities. So far there are no apparent tariff-linked cuts to US profits estimates, but also no cuts made to China profits estimates either (cuts only in $ terms). We think it better to tilt toward Emerging Market Asia stocks to be rewarded for trade conflict de-escalation than overweight US global cyclical value stocks in Energy, Industrials, Materials.

Watch FX: A gradually stronger dollar is ok, but a surge in dollar is detrimental

Since April, the DXY dollar index has risen 8% on the U.S. Federal Reserve (Fed) reiterating its intention to maintain the pace of hikes and from escalating trade conflicts. DXY has entered the 95-100 range seen in 2015-2016 when dollar strength and oil weakness caused a profit recession for S&P 500 companies. If the dollar stabilizes and stays at current level or rises only slightly higher, which implies no full-fledged trade wars, then we think the impact on S&P profits is limited, both from direct foreign exchange (FX) and the trade tariff. However if DXY surges above 100 quickly, then it would be double whammy to multinational companies with high foreign profits. Oil prices will likely come under pressure and threaten the nascent recovery in commodity related capital expenditure (capex) spending. If the dollar surges on Fed hikes occurring despite global economy and disinflationary threats, raising real interest rates, then the valuation of risk assets abroad and the U.S.. may be pressured.

We are tactically cautious and take on a more defensive stance

The S&P 500 usually has weak performance in August and September, especially during mid-term election years. Since 1960 the average S&P price return in August and September is 0.1% and -0.6% respectively, and -0.6% and -1.8% in mid-term election years. Uncertainties around party changes in Congress and speculation on subsequent policy add to the seasonal risks. We keep our "Next 5%+ S&P price move" call as "Down" and we adjust our sector tilts to reflect a more defensive stance. We raise Real Estate and Utilities from underweight (UW) to overweight (OW). We still prefer Growth over Value. The Value we like are big Banks and defensive Value (Real Estates, Utilities). We continue to OW Tech and Health Care and UW Energy, Industrials, Materials and Consumers. Detailed sector/industry allocation and macro tilts are on page 11.

Contributor:

Ju Wang, Investment Strategist & Portfolio Analyst

Strategist Spotlight: Stefanie Holtze-Jen on RMB

Stefanie Hotlze-Jen
Direct Director
Chief Currency Strategist

The renminbi devaluated versus various currencies in the past months. After strengthening beforehand.

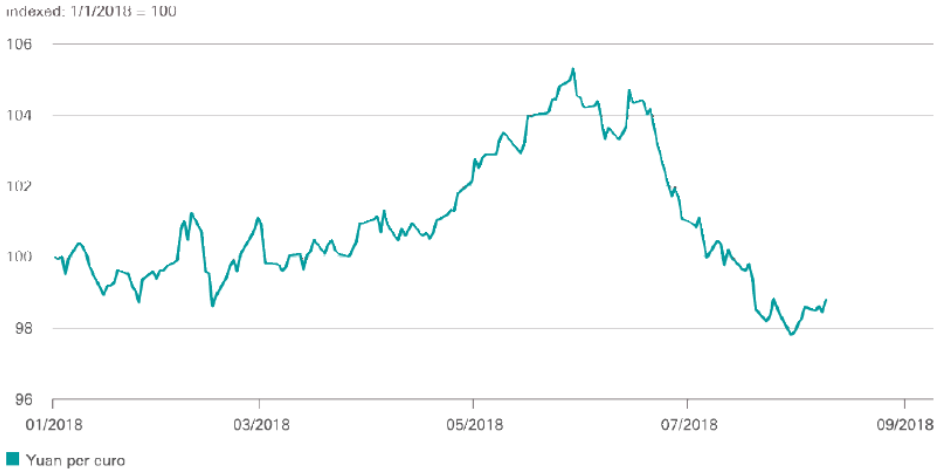
The Chinese renminbi took some beating in the course of 2018. The peak depreciation against the dollar was almost 10% - within four months, after a strong start to the year. This raises two questions: Is this perhaps an indication that China wants to use monetary policy to counter the slowdown in its economy? Or is Beijing deliberately using its currency to send signals to Washington?

The answer is far from clear. For one, the weakening of some economic signals from China coincided with the trade talks between Beijing and Washington. Furthermore, when you look at the price development of only one currency in a currency pair, you can miss which of the two currencies was the driver.

Our "Chart of the week" shows that although the renminbi has recently weakened strongly against the euro, it has only (over)compensated for the previous strong appreciation. Compared to the beginning of the year, the renminbi thus depreciated by less than 2% against the euro. Whether China deliberately weakens its currency remains a question of time perspective anyway. While the renminbi has depreciated against the dollar since 2013, it had gained around 35% against the greenback in the ten years prior to that. However, a glance at the purchasing power parity shows that this is not enough to speak of a "normal" exchange rate. According to OECD calculations, a dollar should not cost 6.8 yuan, but around half, 3.5 yuan.

However, our expectation that the renminbi will not devalue further in the medium term has little to do with purchasing power parity. But it has to do with day-to-day politics instead. Our Chief Currency Strategist, Stefanie Holtze-Jen, says: "The renminbi's descent really picked up speed in mid-June, which we believe was what Beijing wanted. The weaker economic data were certainly a good reason for this. However, we do not consider it a coincidence that the stronger devaluation began at the very moment when the talks with Washington had collapsed and the punitive tariffs were implemented. However, we also believe that Beijing has now given a clear signal that it is not interested in a further devaluation that Washington would see as an escalation of the trade conflict".

CIO View



Sources: Bloomberg Finance L.P., Deutsche Asset Management Investment GmbH as of 8/9/18

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

Capital expenditure (CapEx) are funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment.

The Chinese yuan (CNY) is legal tender on the Chinese mainland and the unit of account of the currency**, Renminbi (RMB).**

The DXY (U.S. Dollar Index) is an index (or measure) of the value of the United States dollar relative to a basket of foreign currencies consisting of U.S. trade partners' currencies.

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.

FX or foreign exchange is 'literally foreign money — used in the settlement of international trade between countries

Net margin is the percentage of revenue remaining after all operating expenses, interest, taxes and preferred stock dividends (but not been deducted from a company's total revenue**.**

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

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

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