

Post G20: Existing tariffs stay in effect, lower S&P EPS outlook



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No agreement or timeline to cut 25% tariffs on half the imports from China

The post G20 summit between President Xi and President Trump produced many pictures and handshakes, but no framework or timetable to reduce existing tariffs. The recently hiked tariff rate from 10% to 25% on \$200bn of imports from China (effective essentially in June given the seaborne provision) and also China's retaliatory tariffs stay in effect indefinitely. Neither leader is in a rush to drop these tariffs. While they agreed to delay further tariffs for several months, postponement is not cancellation and U.S. Trade Representative Lighthizer continues with preparations to provide President Trump additional tariff options on China and others. We still think another round of China tariffs is unlikely, but no more unlikely than before the G20 given the U.S. Federal Reserve's (Fed's) more accommodative stance and strong financial markets.

We cut our 2019E & 2020E S&P EPS to \$165 & \$175 from \$169 & \$179

Because of the direct cost of tariffs and the related potential hits to demand and possible supplier disruptions, we reduce our S&P earnings per share (EPS) estimates for this year and next. This assumes that the existing two-way tariffs continue through most if not all of 2020, but that companies find ways to mitigate some of the costs and disruptions in 2020. We continue to monitor the side effects of slower trade, slower investment, slower manufacturing and slower global growth from this trade conflict; which includes risk of a stronger dollar and lower oil prices. We think it likely that the Fed cuts by 25bp on July 31, but we don't expect a series of Fed rate cuts over the coming year. We do think that Powell's dovish pivot curbs dollar upside risk and oil price downside risk to S&P EPS. We expect a stable dollar, despite the Fed's dovish stance, because very few central banks would welcome their currency appreciating vs. the dollar. However, lower U.S. interest rates have lowered our Financials EPS outlook.

S&P EPS cuts at Financials, Tech, Industrials, Energy and Consumer

We have repeatedly argued that continued tariffs will negatively affect Industrials, Technology hardware, Energy and certain Consumer industries and that lower interest rates weaken the profit outlook for Financials. We previously published that if existing tariffs continue through this year, we would cut our S&P EPS estimate by \$3-5. Today, we cut both our 2019 & 2020 S&P EPS estimates by \$4: About \$1.50 from Financials, \$1.00 from Tech, \$0.75 from the Consumer sectors, \$0.50 from Industrials and Energy each. The recent rally in oil prices prevented a larger cut to Energy. Our new 2019 quarterly S&P EPS estimates are: \$39, \$41, \$42, \$43 = \$165.

S&P 500 sector strategy adjustments: Energy raised to equal-weight

Given the recent rally in oil prices and our reduced earnings outlook for Financials, we close out our long standing preference for the Financials sector over Energy. We now put both equal-weight. We still find the valuations and dividend growth potential more attractive at Financials, but Energy could outperform, especially short-term, if oil rallies further. We remain constructive on big Banks given undemanding valuations, benign credit costs and dividend payout ratio upside, but pressure on net interest margins from collapsed interest rates is a risk we must carefully monitor. We also raised Utilities to overweight from neutral to broaden our overweight of domestic bond substitutes. We lowered Industrials and Consumer Staples to underweight on weak EPS growth outlooks and demanding valuations. Our earnings estimates by sector and sector valuation and sector/industry allocations are inside.

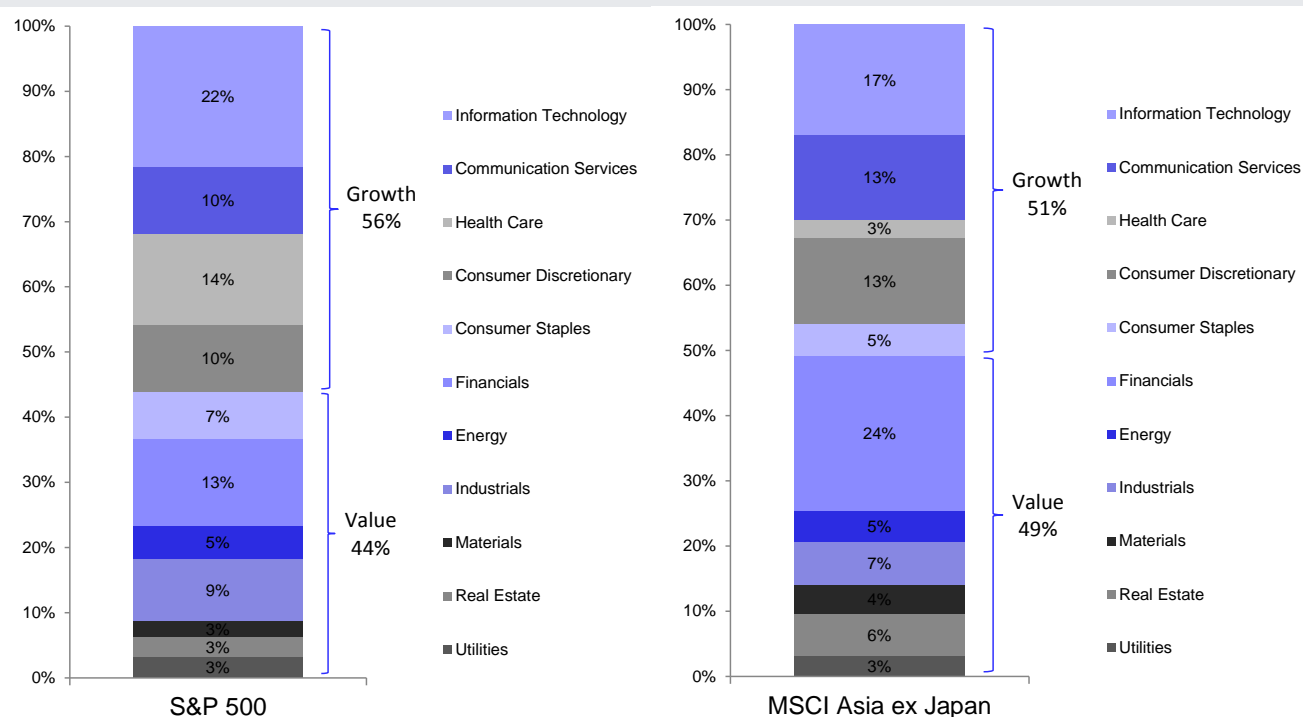
Seek shelter at bond substitute domestic equities and IG corporate credit

We continue to expect the S&P to fall to or below 2800 this summer as the continuation of existing tariffs causes companies to guide earnings estimates lower and a U.S. fiscal fight begins to brew for the autumn to posture for the 2020 elections.

We see greater risk from the continued trade conflict to the global cyclical sectors of the S&P 500 than to broad Emerging Market (EM) Asia or China equities. Tariffs on China imports will mostly be paid by the importing companies. China's listed companies are more exposed to domestic consumption and less exposed to export activity than China's economy. Because of fiscal and monetary stimulus in progress and also because exports are a much smaller driver of China's growth than a decade ago (only a quarter of China's exports are to the US) we expect China's economy and its currency to prove resilient. We also think the best short-term reward vs. the risk for any de-escalation of the trade conflict is EM Asia equities. We think U.S. investors should keep full and even a moderate over-weight to this region despite a likely volatile summer, while being under-weight developed market cyclical sectors. For summer, we suggest over-weights on solid secular growth stocks (Communications, Health Care) and domestic bond substitute defensives (REITs, Utilities). Yields on investment grade credit are low vs. normal, but the credit spread is attractive. Observed spreads should narrow if the 10yr Treasury yield settles at 2%.

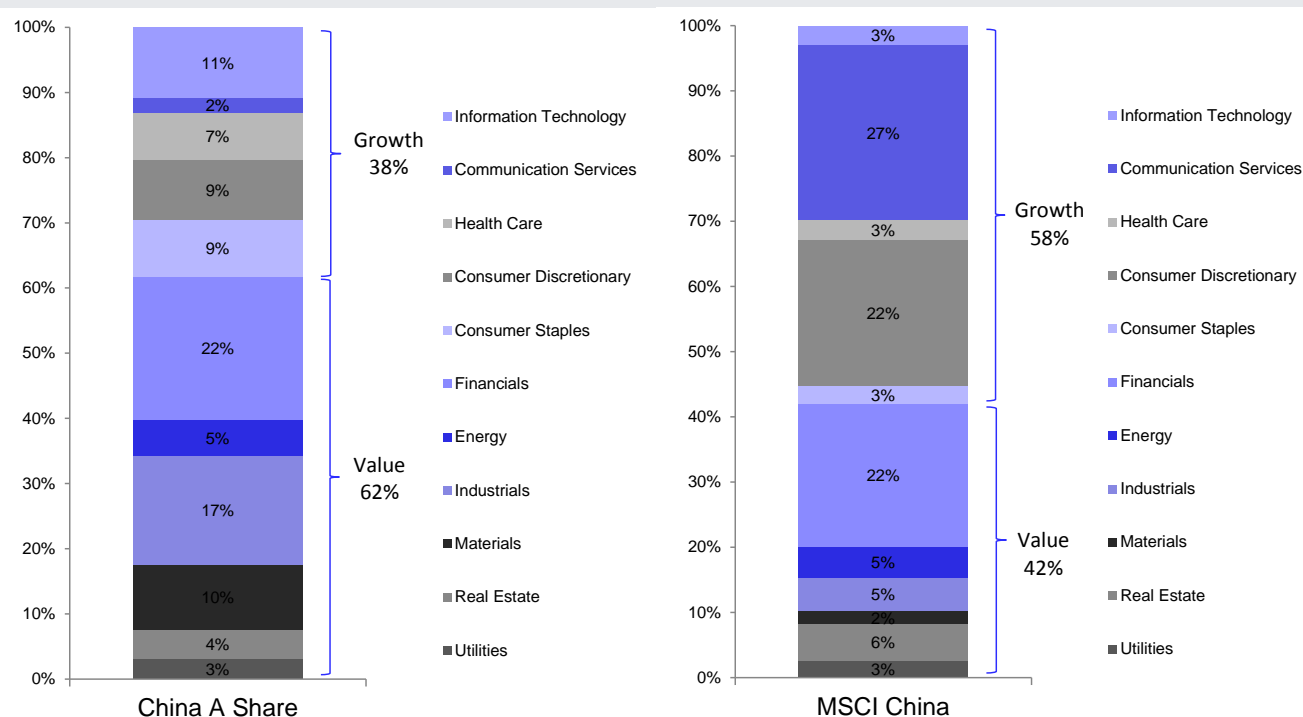
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Sector composition: S&P 500 vs. MSCI Asia ex Japan



Source: S&P, MSCI, DWS Investment GmbH as of May 2019. Past performance may not be indicative of future results.

Sector composition: China A share and MSCI China



Source: Bloomberg, Factset, MSCI, DWS Investment GmbH as of May 2019. Past performance may not be indicative of future results.

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Definitions

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

Consumer staples is a sector of the economy selling essential products.

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 Group of Twenty or G20 is an international forum of the governments and central- bank governors from 19 individual countries—Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi-Arabia, South Africa, South Korea, Turkey, the United Kingdom and the United States—along with the European Union (EU), founded in 1999 with the aim of promoting international financial stability.

The MSCI Asia ex Japan index measures the performance of stocks from the Asia/Pacific region, with the exception of Japan. The countries included are Australia: Hong Kong, New Zealand, Singapore, China, Indonesia, Korea, Malaysia, Philippines, Taiwan and Thailand.

The MSCI China Index captures large and mid cap representation across all China securities listed in China and Hong Kong as well as in the U.S. and Singapore. The index includes: A shares, H shares, B shares, Red chips, and P chips along with China securities (including ADRs) that are listed on the NYSE Euronext (New York), the NASDAQ, the New York AMEX and the Singapore exchanges.

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.

A real estate investment trust (REIT) a company that owns – and typically operates – income-producing real estate or real estate-related assets.

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

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

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