ELECTION AND VACCINE EQUITY STRATEGY: SAME STYLE, STILL CAUTIOUS

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IN A NUTSHELL

_ The recession is over and the recovery has begun: Will cyclical-value finally lead?
_ Should bulls go to value? If bullish S&P 500 >20x 2021E EPS, why not tech at 25x?
_ Vaccine is a "when," Republican Senate is an "if," yet other risks face cyclical-value.
_ Last cycle did not follow the playbook: global cyclicals to duration to digitalization.

THE RECESSION IS OVER AND THE RECOVERY HAS BEGUN: WILL CYCLICAL-VALUE FINALLY LEAD?

Valuations suggest that equity investors are confident in a steady recovery and a long lasting economic expansion to follow. Risks to this view aside, some think the best way to play this recovery is with a strategy from the classic playbook of being overweight cyclical-value stocks and underweight growth and defensive stocks. But we have been sticking with secular growth stocks and defensives and are likely to do so until at least the election.

SHOULD BULLS GO TO VALUE? IF BULLISH S&P 500 >20X 2021E EPS, WHY NOT TECH AT 25X?

Rotate to cyclical-value arguments: 1) cyclical-value tends to outperform in recoveries and early cycle years, 2) a new cycle brings new leadership and mean reversion is past due, 3) U.S. Federal Reserve (Fed) wants more inflation, so prefer real over nominal assets (fine, but intangible assets can pass forward inflation as well or better than physical assets), 4) a vaccine will come, 5) cyclical-value is cheaper than growth. Energy, industrials and financials are cheaper than growth if you assume 2019 earnings per share (EPS) is fully recovered by 2022, ignore election and policy risks, greater cyclicality and bruised balance sheets, and dismiss that low real interest rates boost fair price-to-earnings ratios (P/Es) at defensive and growth stocks far more than cyclical-value stocks.

VACCINE IS A "WHEN," REPUBLICAN SENATE IS AN "IF," YET OTHER RISKS FACE CYCLICAL-VALUE

If higher tax risk fades post-election, with responsible fiscal spending plans that do not explore the limits of debt monetization, and vaccine progress suggests this is the last winter of Covid-19, then we might overweight more "early-cycle" stocks of a blended value/growth nature found at consumer discretionary and communications. We think live entertainment, hotels, luxury/specialty retailers, even down in market-cap size, should do well with a vaccine and personal and corporate taxes kept low. For those willing to wait through the risks, but heed broken balance sheets, we suggest shifting from auto and housing to more of these post-vaccine consumer service / experience plays. However, we would not shift from health care or tech (which thrived pre Covid too), or even virtual office software / connectivity plays, which are productivity enhancers we think are here to stay.

Moreover, even if Covid is eradicated next year, we expect a long road to recovery for oil prices, industrial capital goods demand (especially American) and interest rates. We think most "late-cycle" cyclical-value plays in energy, industrial capital goods and some materials are facing a long recovery very dependent on a steady long lasting expansion. We fade infrastructure hopes, because we think the United States and China will prioritize advancing biotech, semiconductors, communications, agile defense over roads, bridges, airports, etc. Financials are historically early-cycle plays, but we expect their fundamentals to have a more late-cycle recovery; just like last cycle as overnight rates stay near zero for years. But we will monitor valuations to see how much they relieve the need for 2022 EPS growth.

LAST CYCLE DID NOT FOLLOW THE PLAYBOOK: GLOBAL CYCLICALS TO DURATION TO DIGITALIZATION

It took time for the nature and ultimate winning themes of last cycle to emerge. Transitions in leadership also came along the way. Leadership extremes in a prior cycle can end with a crash that hinders ability to lead for many years, but early-cycle leadership can also echo parts of last cycle until truly new leadership emerges. Our guess for true next generation leadership is biotech and semiconductors, but we will proceed here slowly and carefully.

Last cycle, China led the global recovery – intensified urbanization, infrastructure, global transport and commodity capex – and global cyclicals (usually late-cycle leaders) led the equity market (2009-2011) as they did in the prior cycle's late years (2005-2008). Early leadership was not playbook consumer, financials, technology. When leadership did transition from global cyclicals it went mostly to bond substitutes or duration, owing to still low interest rates despite an entrenched recovery (2012-2014). Then China slowed and a global capex and profit recession came (2015-2016). It was not clear if the expansion would continue or new leadership emerge, but it came with a burst of digitalization and mobility. An extended cycle and time for a big leadership transition was made by a surprise supply-side jolt that boosted consumer spending on tech and services and allowed U.S. interest rates to move up a bit. But the classic playbook of grabbing early cyclicals and prior cycle laggards and shunning defensives did not outperform in early or mid-cycle years last time.

Last cycle had many surprises and deviations from historical norms. The expansion set a new record in length and peacetime unemployment, yet inflation and interest rates stayed extremely low. Eventually oil supply surged and prices collapsed, dollar made king again, yet S&P 500 margins soared. U.S. stocks beat foreign and large beat small, both essentially without interruption full cycle, and growth eventually pummeled value in the late years as accelerating new economy innovation and scale more than offset decelerating China and old economy excess capacity. The longevity of macro trends (e.g. China from construction to services) suggests that growth could still lead for years, but we are also looking beyond the trillion dollar cap tech titans for the next exceptional growth stock opportunities.

GLOSSARY

A balance sheet summarizes a company's assets, liabilities and shareholder equity.

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

Consumer discretionary is a sector of the economy that sells non-essential goods and services.

Cyclical is something that moves with the cycle.

Defensive stocks are stocks from companies whose sales are expected to fluctuate less than the market average as the demand for their products are less tied to business cycles.

Duration is a measure expressed in years that adds and weights the time periods in which a bond returns cash to its holder. It is used to calculate a bond's sensitivity towards interest-rate changes.

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.

Fundamentals are data giving information about the general well-being of companies, securities or currencies and serving for the subsequent valuation of these as an investment opportunity.

Growth stocks are stocks from companies that are expected to grow significantly above market average for a certain period of time.

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

Market capitalization, in the context of an individual firms, is the number of shares issued multiplied by the value of the shares.

Mean reversion is a theory that prices and returns eventually move back toward the mean, or average.

In economics, a nominal value is not adjusted for inflation; a real value is.

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

In economics, a real value is 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.

The U.S. Federal Reserve, often referred to as "the Fed", is the central bank of the United States.

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm's stock price in relation to its earnings.

Value stocks are stocks from companies that are trading at prices close to their book value and that are therefore cheaper than the market average on that metric.

APPENDIX: PERFORMANCE OVER THE PAST 5 YEARS (12-MONTH PERIODS)

	08/15 - 08/16	08/16 - 08/17	08/17 - 08/18	08/18 - 08/19	08/19 - 08/20
S&P 500	12.6%	16.2%	19.7%	2.9%	21.9%

Past performance is not indicative of future returns.
Sources: Bloomberg Finance L.P., DWS Investment Management Americas Inc. as of 9/21/20

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