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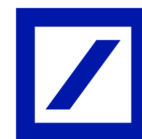

Global

Strategy
Asset Allocation

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10 November 2017

Strategy Update

After The Long Rally: S&P 500 Outlook

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- The duration of the equity rally without a typical 3-5% pullback has been very unusual, and the rally is on track to become the longest since WWII. But the speed and the size of the rally have not been unusual and the S&P 500 is well within its trend channel of this economic recovery defined back in 2010-2011 during the big pull- and snap-backs then. The rally has been driven by earnings while the multiple has been in a narrow range over the last year. While multiples are high relative to their historical averages they are in line with their historical drivers.
- Who bought the dips and why? Mutual- and long-short equity fund positioning has risen steadily from cycle lows following the dollar and oil shocks to a 6-year high presently. But equity positioning increased in tandem with the improvement in cyclical growth indicators such as the ISMs. Who did not buy? Most notably, there have been no inflows into US equities this year while asset allocation funds have turned significantly underweight.
- We see S&P 500 EPS growth of 11% in 2018, supported by stable robust US growth, a pickup in global growth and assuming a range bound dollar. This would put the level of earnings back up in line with their long run trend or normalized levels. We see the multiple as essentially remaining flat with offsetting impacts from the drivers. Our earnings ($146) and multiple forecasts (19.5x) point to an S&P 500 target of 2850 for 2018. We expect more regular (3%-5%) pullbacks to resume next year.

S&P 500 targets and EPS forecasts	
2017 target	2600
2018 target	2850
2017 EPS	$131
2018 EPS	$146

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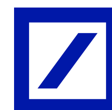


After The Long Rally: S&P 500 Outlook

The duration of the equity rally without a pullback has been very unusual

As we have noted previously, the S&P 500 has historically pulled back by 3-5% every 2-3 months on average. The current rally, in its 12th month, is the second longest since WWII and is on track in 2 weeks to become the longest. Have the speed and magnitude of the rally also been unusual? What drove it? Who bought the dips and why? Are positioning and inflows extended? We discuss these questions before presenting our outlook and S&P 500 target for 2018.

The speed and the size of the rally have not been unusual

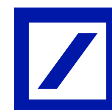
The 15% rise in the S&P 500 year to date is above the median 13% rise outside of recessions historically but well within the distribution. Moreover, the S&P 500 remains well within the channel defined early in this recovery, back during the big pull- and snap-backs around the double-dip recession scare in 2010 and the US debt downgrade in 2011. The S&P 500's trend channel in this recovery has been characterized by a 12.5% annual trend with +/- 10% bands. The above average rise in the S&P 500 ytd reflects a move off of the bottom of the channel following the Presidential election and a move towards the middle of it though it remains in the lower half of it.

The trajectory of the equity rally has remained very closely tied to that of earnings

- **The trajectory of the S&P 500 has been extremely closely tied to that of earnings during the course of this recovery and remains so.** Following the ECB's move to negative rates in mid-2014 and the subsequent dollar and oil shocks, earnings growth first slowed then turned negative and equities became range bound for a year and a half. In the context of the trend channel, the range bound S&P 500 moved from the top to the bottom of the trend channel, falling briefly below during the Q1 2016 growth scare and the trough in earnings. Following the Q1 2016 bottom in earnings, equity prices began to rise, briefly breaking their 1½ year range to reach a new peak in mid-2016; then paused as is typical in the run up to close Presidential elections before rebounding strongly after.

- **The trajectory of the S&P 500 year to date has continued to closely track that of earnings.** Indeed the market rallied in the first half of the year only during earnings seasons which saw well above average beats and paused between reporting seasons. Trailing earnings were up 10% through Q3, held back in the quarter by the impact of the unusually severe hurricane season, while our estimate is for 12% growth through Q4.

- **The S&P 500 trailing multiple meanwhile fluctuated in a relatively narrow range of 3.5% until September before moving up by a modest 2%.** The rise in the multiple in late September though is consistent with the market simply looking through the impact of the hurricanes on earnings, ex which they would have grown for a third quarter in the solid double digits.



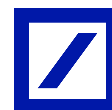
Multiples are well above historical averages but they are in line with their historical drivers.

A trailing multiple for the S&P 500 at 20x and a forward multiple at 18x are well above historical averages of 15.3x and 14.4x respectively. But as we have argued previously, the historical average is impacted disproportionately on the one hand by large and long negative episodes such as the Great Depression, World War II and the Great Inflation and on the other hand by the late 1990s equity bubble. We prefer, therefore, to look instead at the multiple relative to its historical drivers. The S&P 500 trailing multiple is historically well explained (71%) by payout ratios, earnings relative to normalized levels, interest rates broken up into inflation and real rates, and macro vol (Do Higher Rates Mean Lower Equity Multiples, Sep 2014). The steady climb in multiples since the bottoms reached during the financial crisis and again in August 2011 after the US debt downgrade were, as we have pointed out previously, a catch back up to fair value. As we noted in our outlook for 2017 back in December last year, with multiples having risen to near fair value, based on our outlook for the drivers, we expected them to be essentially flat as by and large they have been.

Who bought the dips and why? Mutual- and long-short equity fund positioning has risen to a 6-year high but moved in tandem with the improvement in cyclical growth indicators such as the ISM. Who did not? There were no inflows into US equities.

The extremely limited pullbacks raises the question of who bought the dips and why. We look at the rally through the lens of our demand-supply framework for US equities (Equity Supply and Demand, Nov 2010). The framework combines on the demand side inflows (mutual funds and ETFs) and changes in positioning with, on the supply side, new issuance and buybacks, to construct a demand-supply balance which has historically been well correlated (65%) with quarterly returns on the S&P 500. Looking at the components:

- **Buybacks continued to be a strong support.** Trailing buybacks, running currently at a massive $440bn on net have remained in line with their 3 year range, though they have shrunk as a proportion of market cap.
- **Overall short positioning has fallen to the bottom of its range in this cycle.** Speculative long future positions have risen and ETF short interest declined, while single stock short interest has increased slightly. Overall short interest as a proportion of market cap has fallen to the bottom of the elevated range it has been in during this cycle.
- **Equity positioning has risen steadily from cycle lows reached in Q3 2015 following the dollar and oil shocks to a 6-year high currently. But the rise in positioning has been in line with the improvement in growth indicators.** Following the dollar and oil shocks of 2014-2015, mutual fund positioning fell to a low for this recovery cycle. Mutual fund positioning has been rising since Q1 2016 as the impacts of the shocks began to recede. In our reading, mutual fund positioning is now the longest it has been since 2011. It is worth noting though that fund equity positioning tends to be highly cyclical and the increase has been in line with, even slightly short of, rising growth indicators such as the ISMs. Long-short equity hedge funds raised exposure at the beginning of the year but have kept it flat since March at well above average levels. Asset allocation funds on the other hand have sharply cut exposure since June and we estimate have turned significantly underweight equities. There is also evidence that investors have raised equity exposure in brokerage accounts with cash declining and margin debt rising.



- **Outflows from US equities.** While fund managers steadily raised their exposure, end investors have pulled money out of US equities since March, with net fund outflows for the year at -$11bn suggesting little exuberance. Flows instead rotated away from US equities into bonds and foreign equities. Into bonds as rates declined on slowing inflation and away from US equities as US data surprises disappointed relative to strong data surprises in the rest of the world. The recent sharp rise in US data surprises and bounce in rates from their early September lows has already seen inflows return back to US equities over the last 3 weeks and we see them as having further to go.

S&P 500 Outlook

We see S&P 500 EPS growth of 11% in 2018 ($146 vs $131 in 2017). Earnings growth for 2017 is on track to hit 12% despite the significant hurricane hits in Q3 and we expect only a modest deceleration in 2018. We model S&P 500 EPS in 3 blocks: ex FEM (Financials Energy and Materials); the Financials; and Energy and Materials:

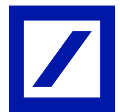
- **Ex FEM earnings are well explained (71%) by US growth, global growth and the dollar** (The Dollar, Earnings and Multiples, Feb 2015). We see the underlying drivers remaining very supportive in 2018 with stable robust US growth, global growth accelerating further and assuming a range bound dollar;

- **Financials earnings have been in a steady growth trend of 9% for the last 5 years despite range bound rates.** We model Financials earnings as continuing to grow at this trend. We though view this forecast as conservative and in our base case of rates rising much higher, growth could exceed the recent trend and indeed the bottom up consensus is at 15%;

- **For Energy, we see oil prices remaining within their range of the last 3 years and Energy earnings in turn rising only modestly.** We see downside risks to consensus estimates for Energy which are for 32% growth;

- **A move back up to 80-year trend levels explains double digit growth.** With S&P 500 EPS having fallen well below their trend or normalized levels following the dollar and oil shocks, our forecast for 2018 would put them right back up in line with it. The very clear 80-year trend has been of 6.5% growth at an annual rate. Starting from below, a reversion back up to trend levels requires growth above trend rates which is what we have seen in 2017;

- **Upside risks if history repeats.** It is worth noting that so far the current global economic recovery has been very unusual for earnings. Historically, earnings fall by an average 30% around recessions, then recover to trend levels. But they do not generally pause or stop there. They typically rise far above trend during cyclical expansions, ending 15-25% above in the last 4 cycles. This cycle has been very unusual in that following the great recession during which earnings fell by more than 40%, they recovered back to trend levels by end-2011. For the next 3 years trailing EPS essentially hugged the trend line. We attribute this to the negative impacts of first the European financial crisis; then the slowing and renormalization of EM growth; and finally earnings fell



below trend levels after the dollar and oil shocks. But each of these factors has now passed and with global growth finally becoming more synchronized, we could well see the typical "boom" or above-trend phase of the earnings cycle. The historical pattern repeating represents upside risks to our forecasts.

We see the multiple as essentially remaining flat with offsetting impacts from the drivers.

We see the historical drivers of the multiple pulling equity valuations in both directions. Higher inflation will be a drag on valuations as will higher macro vol in this late cycle phase. As earnings rise and approach trend levels, multiples should adjust modestly lower. But contrary to popular perceptions and in line with the historical pattern, higher real rates should provide a boost. We expect payout ratios to remain stable and be a wash for valuations. On net the multiple should derate modestly to 19.5x (versus our year-end target and EPS estimate for 2017 which imply a multiple of 19.8x (2600/131)).

Our earnings ($146) and multiple forecasts (19.5x) point to an S&P 500 target of 2850 for 2018.

Our baseline estimates do not factor in the impact of potential tax reform as we continue to see the prospects for passage as mixed. We see the proposed corporate tax reform in its current form as having a notable positive but temporary impact on earnings in the aggregate though our estimates tend to be on the lower side of the distribution of estimates as we see the effective tax rate (27%) as already much lower than the statutory rate (35%) (Tax Reform: With Nothing Priced In How Best To Be Long? Sep 2017). But with the gap between high and low payers at a 30-year wide we do expect large relative impacts.

We expect more regular (3%-5%) pullbacks to resume next year, exacerbated by positioning, especially in Momentum and Growth.

The duration of the rally without a 3% pullback (buying any small dip) partly reflected a catch back up after a 1½ year period of equities being range bound following the dollar and oil shocks. It reflected a steady increase in positioning from cycle lows as US and global growth indicators rose. In our reading, 3%-5% pullbacks happened historically when: (1) positioning is long (this is a solid check today); (2) macro data surprises are at the top of their band and there is good reason to believe they turn down (this is near a check on the US growth side; but we still see upside to global growth); often combined with (3) a clear and unexpected negative catalyst. Finally, muddying the picture in the current context is the absence of inflows into US equities until a couple of weeks ago. Flows into US equities have behaved in line with rates and macro data surprises and argue for more (inflows and upside) to come near term. Our baseline view is the market goes through our year-end target of 2600, before pulling back modestly over the last couple of weeks in December as happened last year on rebalancing.

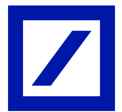
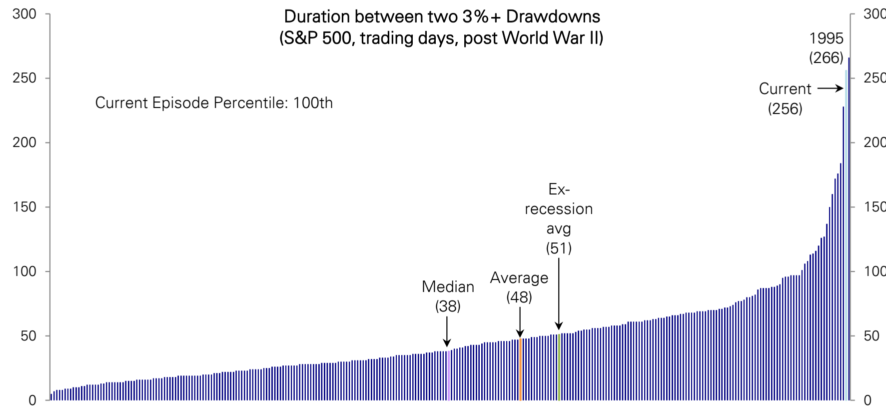
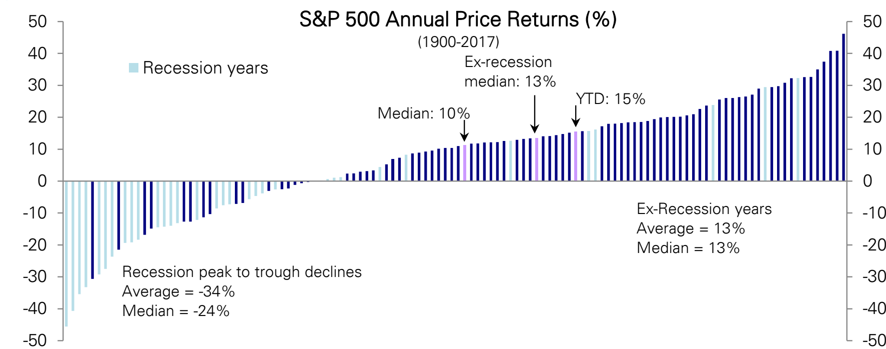


Figure 2: The duration of this equity rally without even a modest pullback has been very unusual and on track to be the longest since WWII



Source: Haver, Deutsche Bank

Figure 3: The size and speed of the rally are far from unusual



Source: Haver, Deutsche Bank

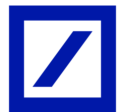
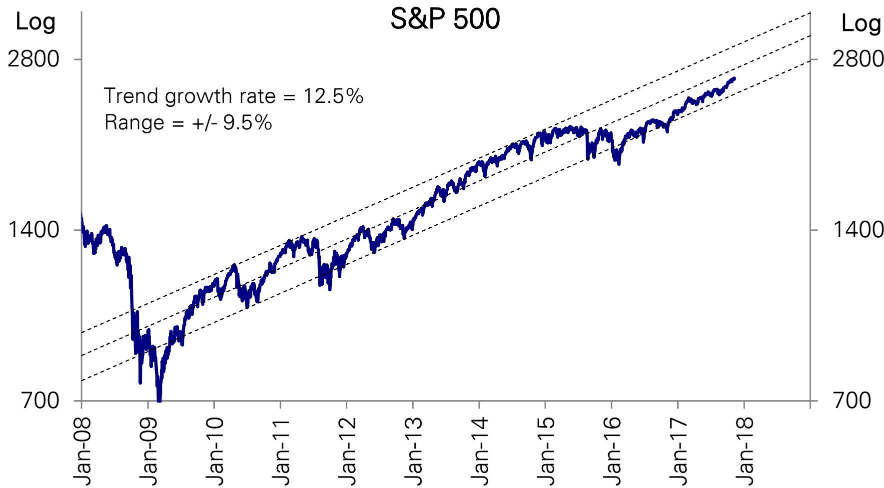
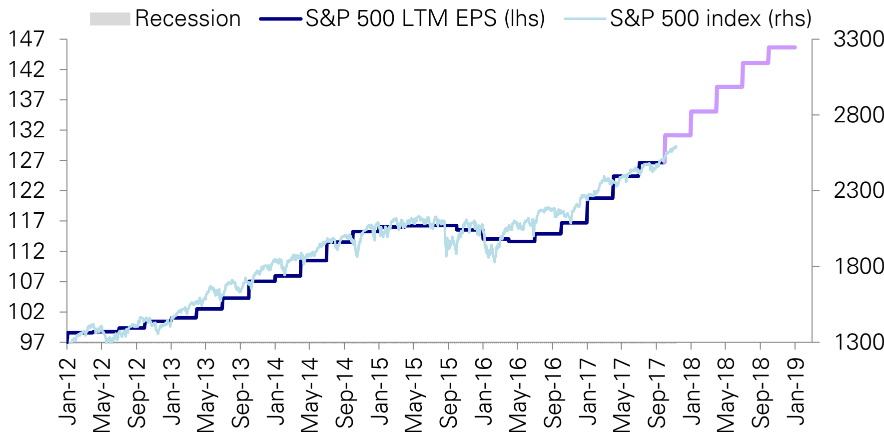


Figure 4: The S&P 500 remains well within the channel defined early in this recovery, back during the big pull- and snap-backs in 2010 and 2011



Source: Haver, Deutsche Bank

Figure 5: The trajectory of the equity rally has remained very closely tied to that of earnings



Source: Haver, Bloomberg Finance LP, Factset, Deutsche Bank

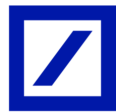
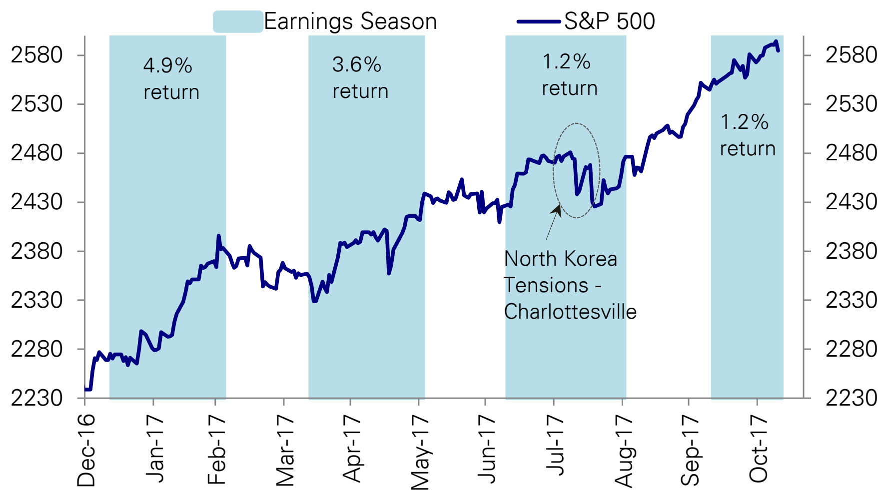
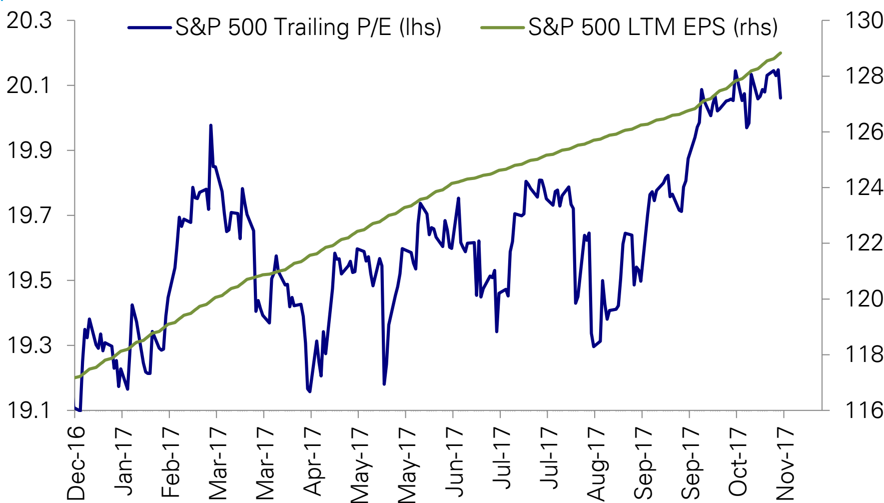


Figure 6: In the first half of the year, the S&P 500 rose only during earnings seasons and was flat outside of them



Source: Factset, Haver, Deutsche Bank

Figure 7: Both earnings and multiples have moved up this year



Source: Haver, Bloomberg Finance LP, Factset, Deutsche Bank

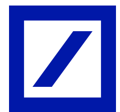
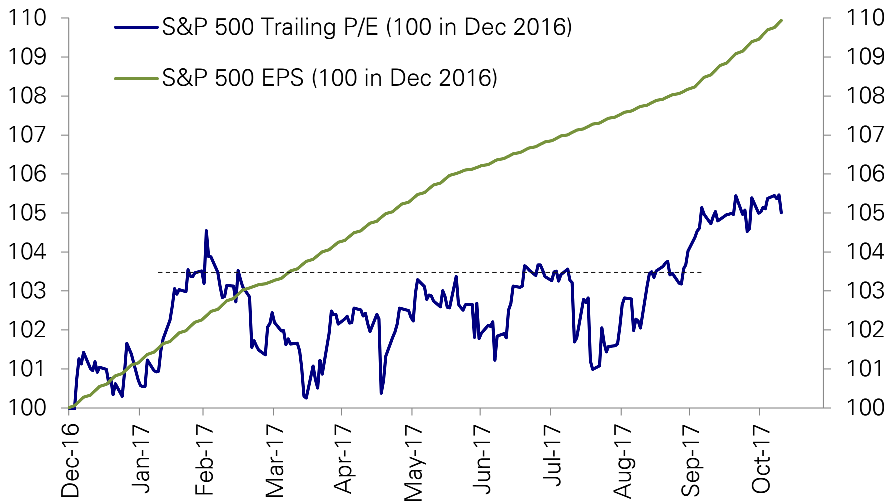
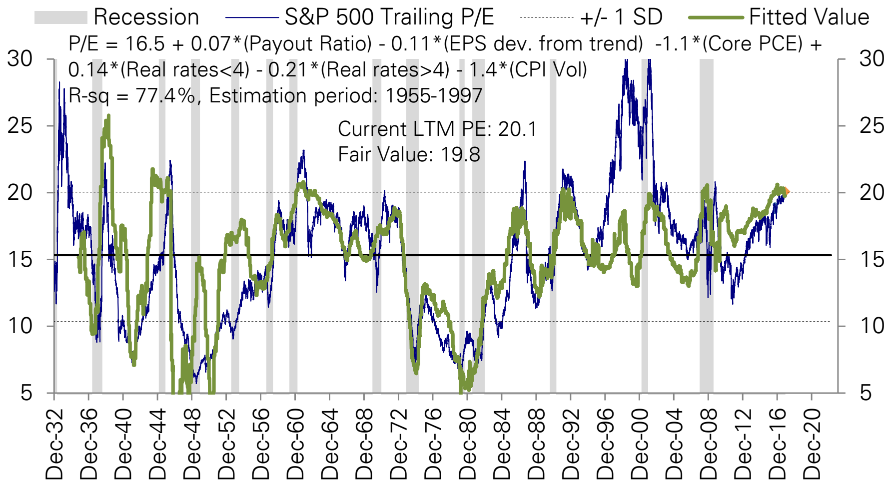


Figure 8: The bulk of returns have come from earnings growth (10% ytd and on track to hit 12% for the year) while the multiple has remained in a narrow range (3.5%) before moving modestly higher recently as the market looks through the impact of the hurricanes on earnings



Source: Haver, Bloomberg Finance LP, Factset, Deutsche Bank

Figure 9: Equity multiples are well above historical averages but in line with historical drivers



Source: BLS, BEA, Haver, Compustat, Factset, Bloomberg Finance LP, Deutsche bank

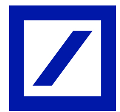
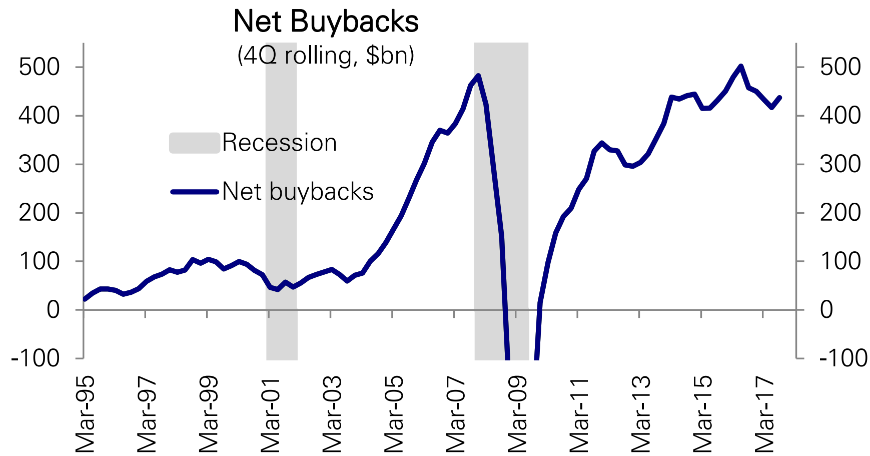
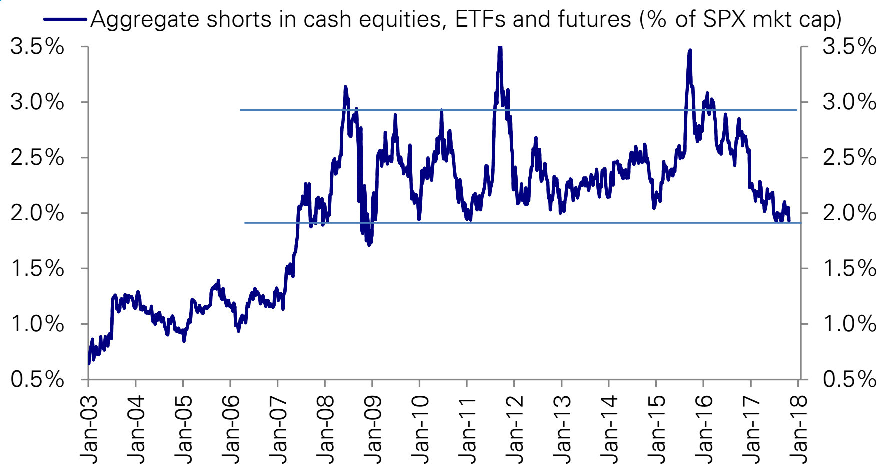


Figure 10: Buybacks have continued to be a strong source of support for equities



Source: Compustat, Deutsche Bank

Figure 11: Aggregate short positioning in equities has fallen to the bottom of its range in this cycle



Note: ETF shorts and Cash equities data as of Oct 31 and S&P Futures data as of Oct 31

Source: Compustat, Factset, CFTC, Haver, Deutsche Bank

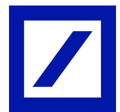
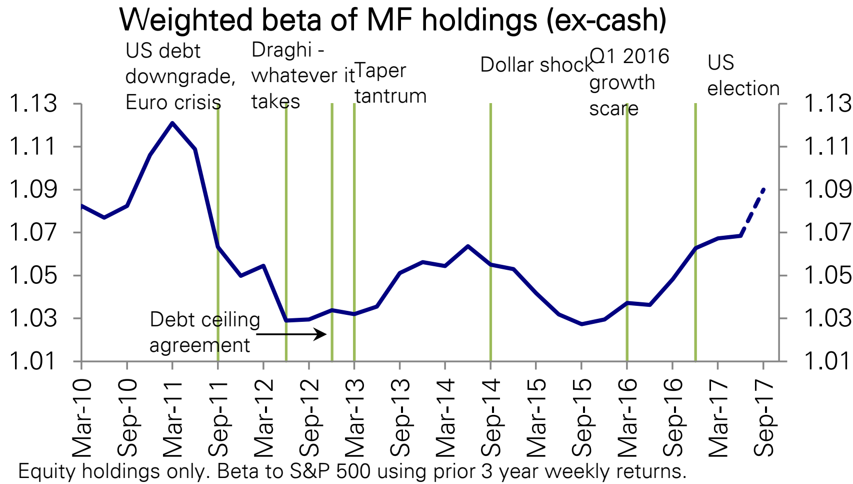
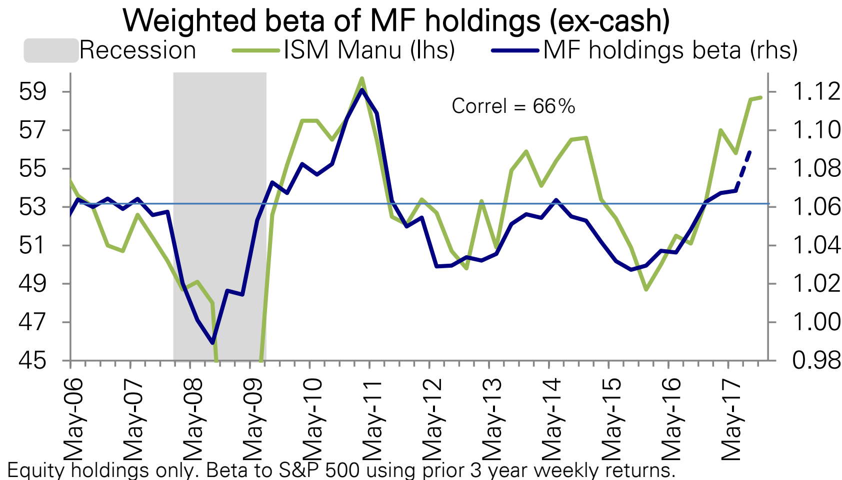


Figure 12: Mutual fund equity positioning has risen steadily from cycle lows reached in Q3 2015 following the dollar and oil shocks to a 6-year high currently



Source: Factset, Deutsche Bank

Figure 13: The rise in positioning has been in line with the improvement in growth indicators



Source: Factset, ISM, Haver, Deutsche Bank

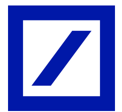
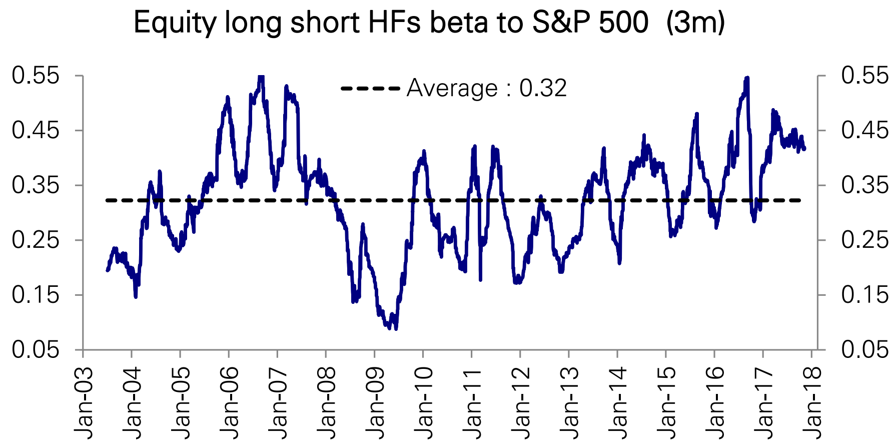
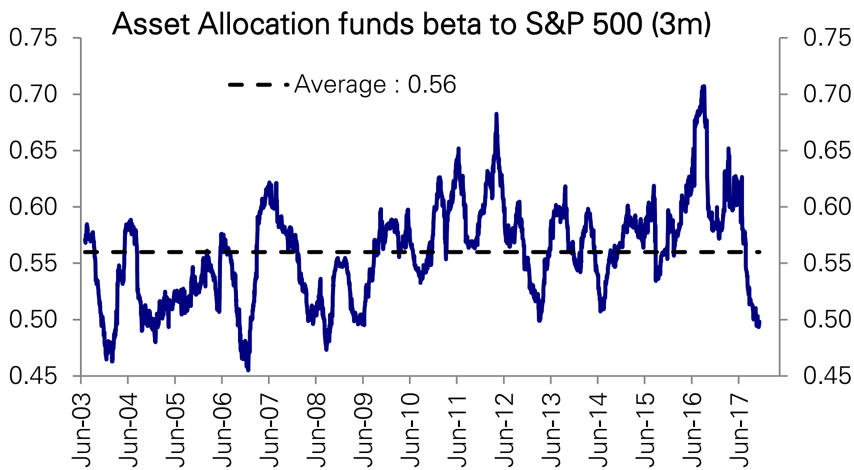


Figure 14: Long-short equity hedge fund positioning is overweight…



Source: Factset, Deutsche Bank

Figure 15: …but that of asset allocation funds turned significantly underweight equities



Source: Factset, Deutsche Bank

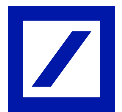
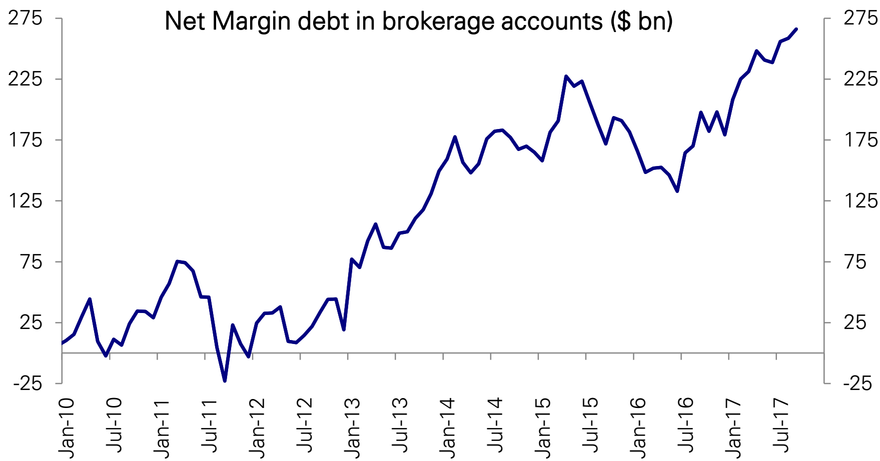
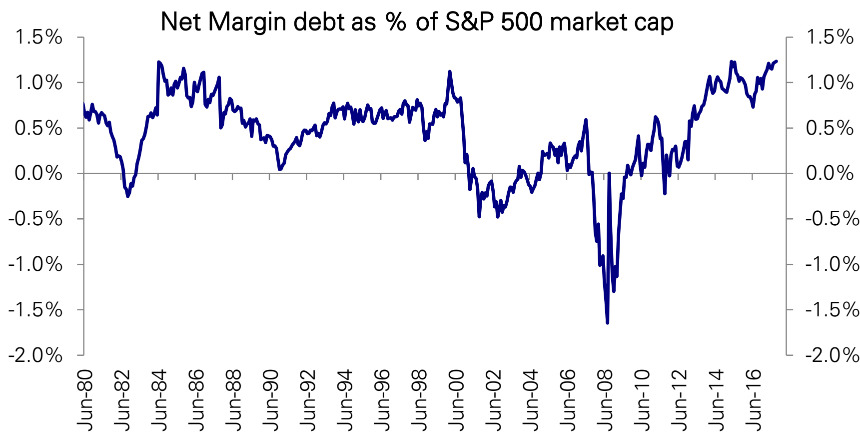


Figure 16: Margin debt in brokerage accounts has risen sharply…



Source: NYSE, Haver, Deutsche Bank

Figure 17: …and is elevated as a proportion of market cap



Source: NYSE, Haver, Deutsche Bank

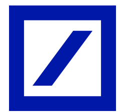
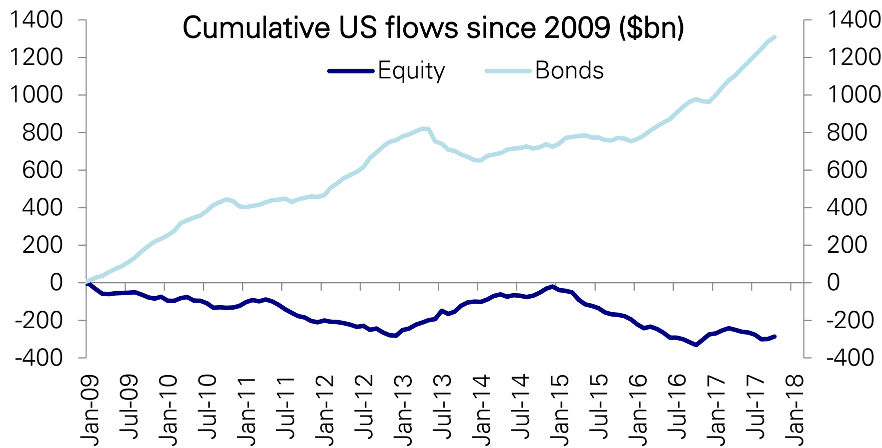
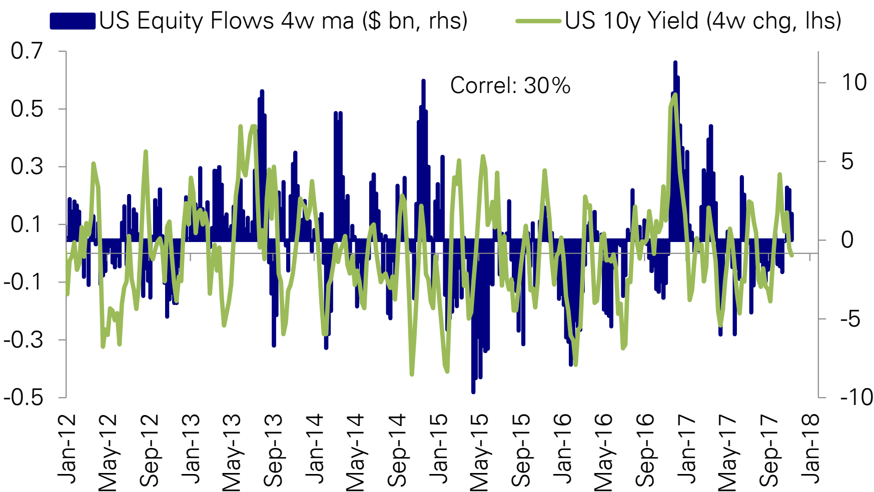


Figure 18: Flows have once again rotated away from equities and into bonds…



Source: EPFR, ICI, Haver, Deutsche Bank

Figure 19: … as rates declined on slowing inflation



Source: EPFR, FRB, Haver, Deutsche Bank

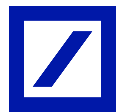
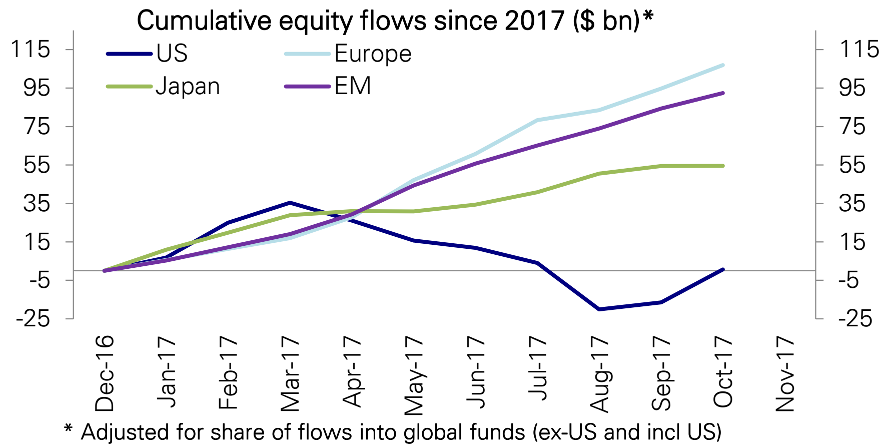
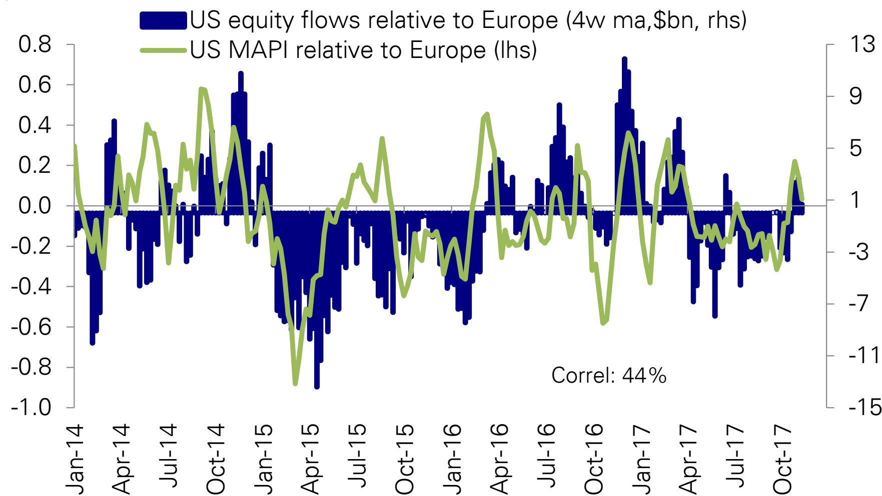


Figure 20: Within equities flows have rotated away from the US and into foreign equities…



Source: EPFR, ICI, Haver, Deutsche Bank

Figure 21: …as US data disappointed relative to surging data surprises in the rest of the world



Source: EPFR, Haver, Bloomberg Finance LP, Deutsche Bank

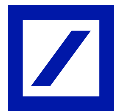
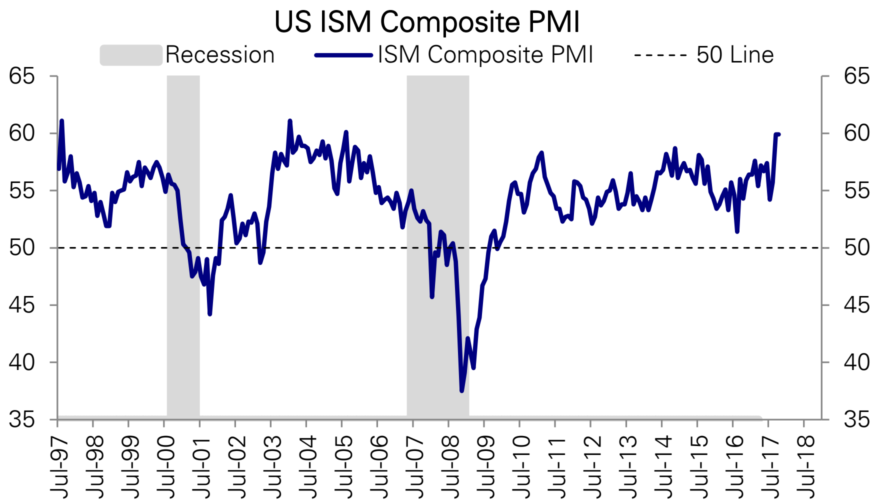
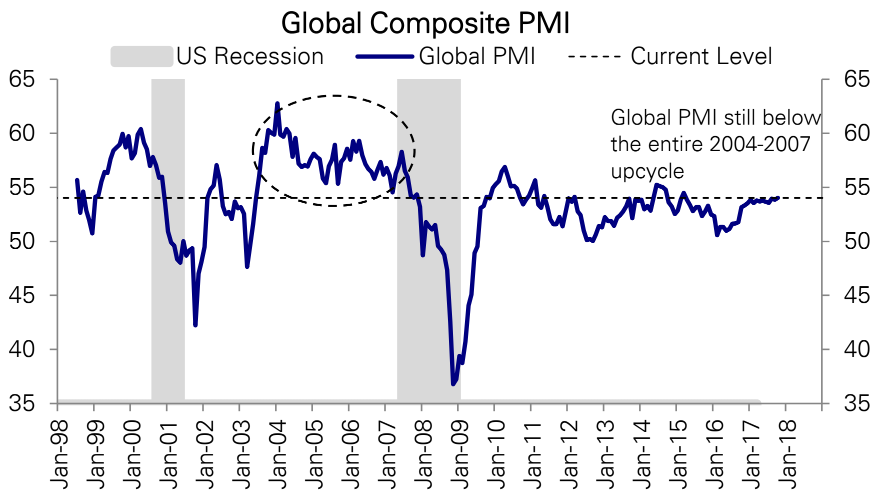


Figure 22: We see robust US growth…



Source: ISM, Haver, Deutsche Bank

Figure 23: …and accelerating global growth…



Source: Markit, Haver, Deutsche Bank

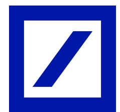
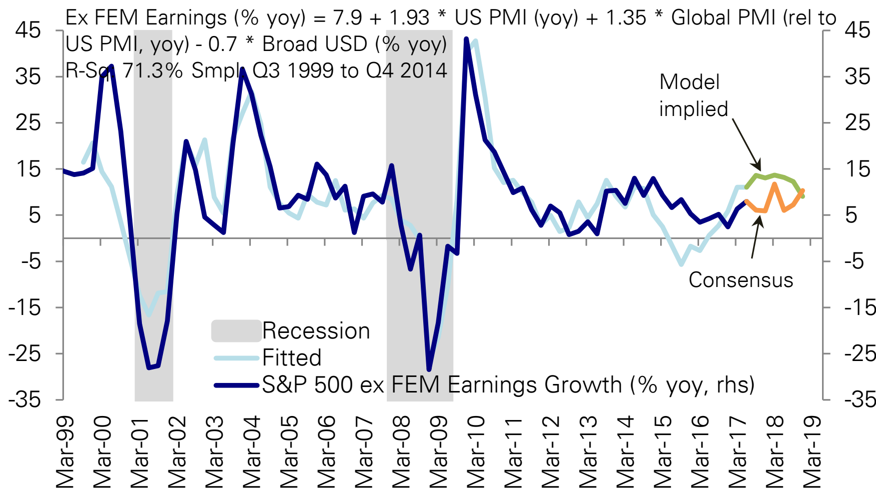
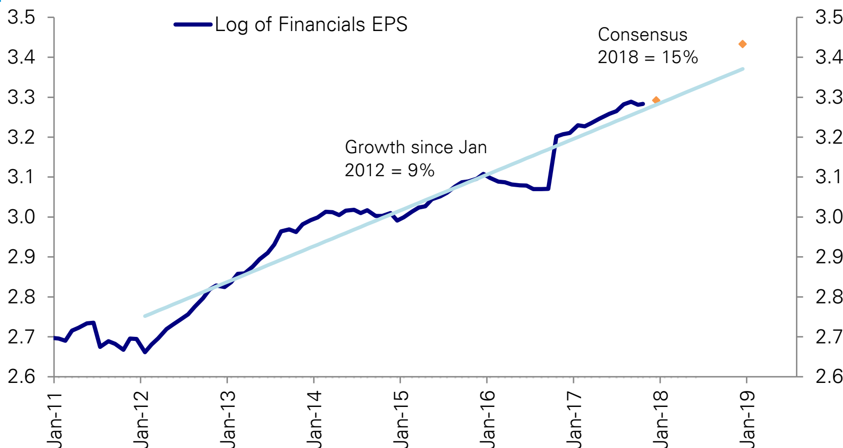


Figure 24: ...driving strong underlying US earnings growth



Source: ISM, Markit, FRB, Haver, Factset, Bloomberg Finance LP, Deutsche Bank

Figure 25: Financials earnings have been growing at a 9% trend rate for the last 5 years and we see that continuing but the risk is to the upside if rates rise sharply higher



Source: Factset, Haver, Deutsche Bank

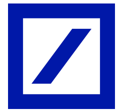
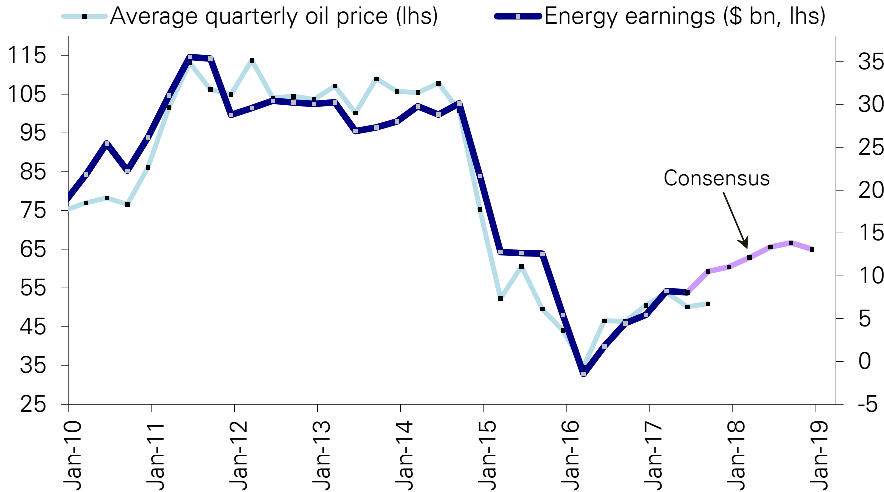
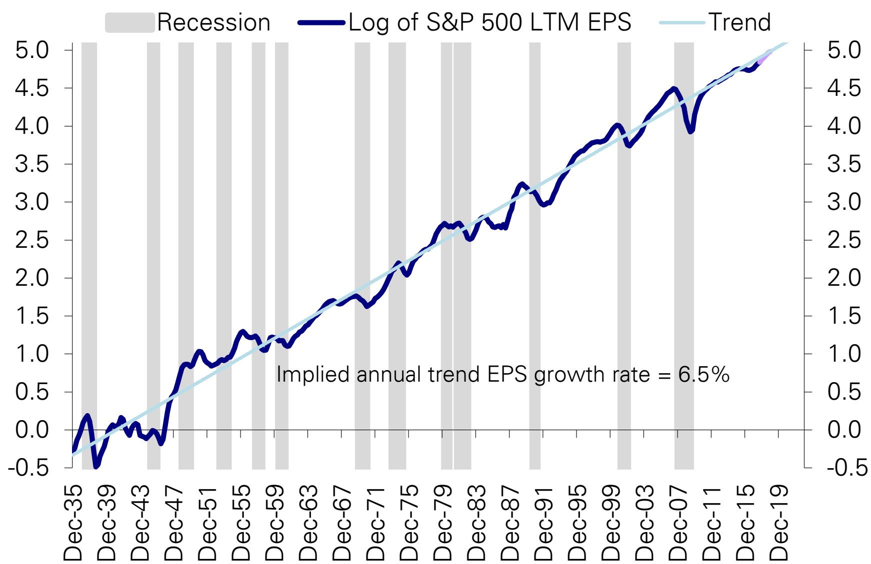


Figure 26: The consensus for Energy earnings growth looks aggressive if oil prices stay range bound as we expect



Source: Factset, Haver, Deutsche Bank

Figure 27: S&P 500 earnings have grown around a very steady 6.5% trend for the last 80 years



Source: Factset, Bloomberg Finance LP, Haver, Deutsche Bank

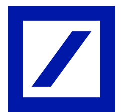
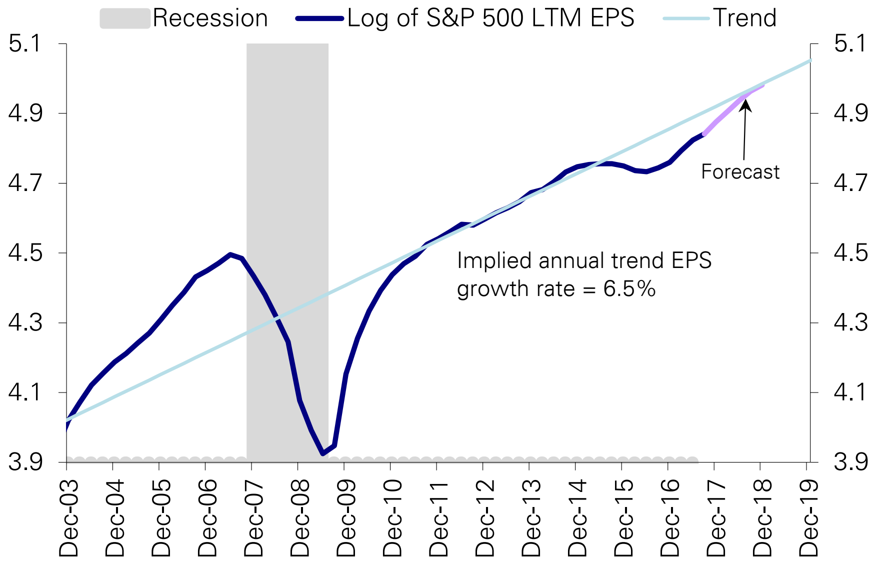
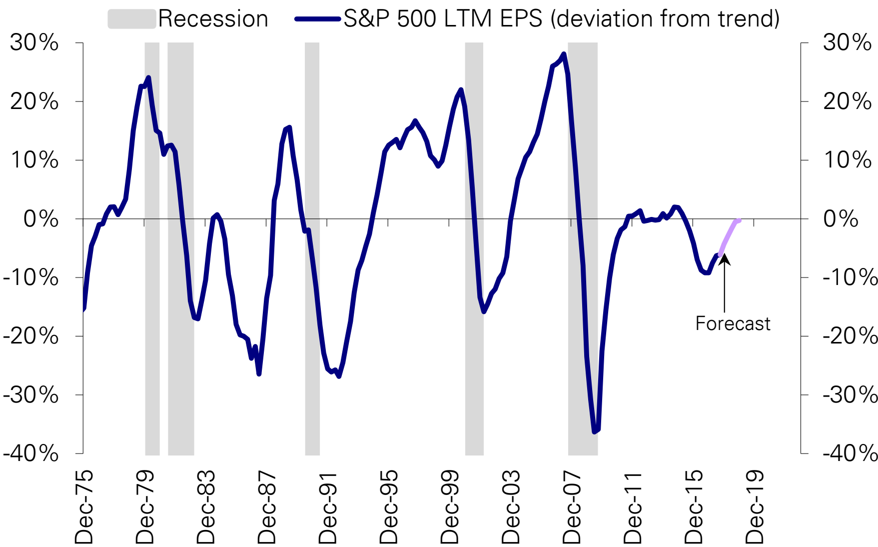


Figure 28: Our forecast for 11% growth for EPS in 2018 would put them back up in line with their long run trend or normalized levels

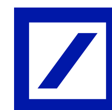


Source: Factset, Bloomberg Finance LP, Haver, Deutsche Bank

Figure 29: Historically earnings have ended up 15-25% above trend levels during cyclical expansions



Source: Factset, Bloomberg Finance LP, Haver, Deutsche Bank



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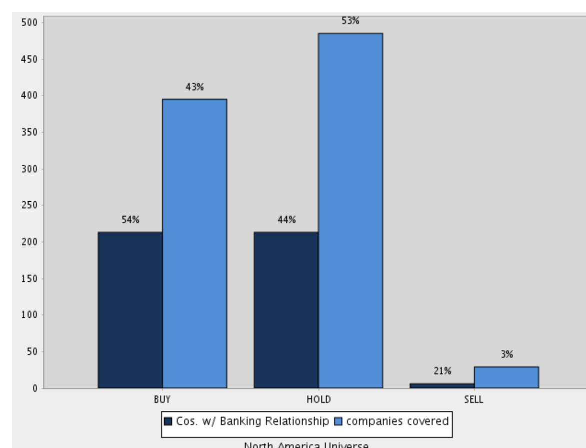

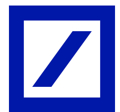

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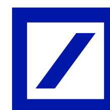

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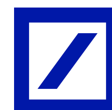

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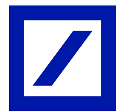

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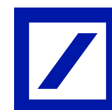

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