Deutsche Bank
Research

Global
North America

Strategy
Asset Allocation

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Strategy Update

Taking Stock of The Selloff

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- *We see the selloff in US equities as having further to go. Equity positioning has been cut sharply, but only from near max overweight to slightly underweight levels. With trade policy uncertainty likely to continue to weigh, at least until April 2, we expect positioning to continue to unwind. A move to the bottom of the positioning band which is where it went to in the last trade war, would take the S&P 500 down to 5250.*
- *The fundamentals have been weakening. Both consumer and corporate confidence have fallen sharply. Capex intentions have been slashed and the decline in CEO confidence is likely to arrest the budding recovery in manufacturing that had begun. Consensus GDP growth forecasts for Q1 have not been cut yet and downgrades likely to come. Earnings estimates for Q1 have been downgraded somewhat more than is typical, but in our reading do not yet factor in any slowing in macro growth, and we look for downgrades to continue.*
- *Will the administration relent? A necessary condition in our view is a decline in Presidential job approval ratings which, after an initial honeymoon period, tend to align with measures of consumer confidence as was evident in the recent Biden and prior Trump terms. Compared to the level of consumer confidence, the current approval rating is high, implying plenty of room for downside with negative growth or inflation developments likely to speed the catch down. The net approval rating (approval-disapproval) has already fallen from 12 percentage points on inauguration day to turn slightly negative this morning. We expect the net approval rating has to turn more significantly negative, at least -5%, before the administration starts to consider responding.*
- *Too early to throw in the towel on our year-end target. If the slide in approval ratings prompts a credible plan to resolve tariff uncertainty, it will allow the business cycle to continue. Equities can bounce back sharply in such a scenario, catching back up to their longer-run uptrend channel, as they did after the Phase 1 deal in 2019, so while the risks have grown, for now we maintain our year-end S&P 500 target of 7000.*

Taking Stock of The Selloff

Selloff in US equities has further to go

- So far, the S&P 500 has sold off (peak to trough) by 10%. This is still in keeping with other corrections that have been more frequent since the GFC, without marking the beginning of a bear market.
- Part of the selloff reflects the unwind of large-cap momentum, which began with Walmart's cautious guidance 3 weeks ago and continued with Nvidia's earnings release. Traditionally cyclical sectors like Materials, Industrials and Financials have in fact outperformed the S&P 500 so far since the February peak. In our reading, a potential broader economic slowing stemming from trade uncertainty is not yet priced in. How much further can the selloff go?
- Viewing the selloff through the lens of equity positioning, from the post-election peak in December near the top of its long-run historical band (0.77, 92nd percentile), positioning has been cut sharply, but only to modestly underweight levels (z score -0.36, 26th percentile). Discretionary positioning has fallen to near neutral (z score -0.05, 41st percentile), while systematic strategies positioning has been slashed (z score -0.48, 24th percentile) as trend signals flipped negative and vol rose. Realized equity vol has risen sharply but is not extreme and the implied vol premium in the VIX about average, leaving room for both to rise further, which would pressure systematic strategy positioning. 2022 is a good example of escalating policy uncertainty, then emanating from the Fed, driving vol higher and positioning lower.
- With trade policy uncertainty likely to continue, at least until April 2nd, we expect positioning to continue to unwind. A move to the bottom of the positioning band which is where it fell to in the last trade war would take the S&P 500 down to 5250. Equity inflows have so far been supportive, but any reversal, either as risk appetite wanes or flow seasonality turns unfavorable past peak bonus and tax refund season, could mean further downside.

The clock is ticking: fundamentals are weakening

- While hard data has not weakened, survey data has begun to. Both consumer and corporate confidence have fallen sharply. We see CEO confidence as key to prospects for corporate spend, hiring, capex and the business cycle. Readings on corporate confidence are scant over the last 6 weeks, but the CEO Magazine monthly survey which had indicated a jump in CEO confidence after the election, reported this week that CEO confidence has now plummeted to levels last seen in 2012 around the European financial crisis. The Business Roundtable survey also dipped albeit modestly. A wide swath of business surveys point to companies slashing plans for capital spending back to the anemic levels seen for most of the last 2½ years, completely reversing the rebound seen after the election.
- Consensus GDP growth forecasts for Q1 and for 2025 have not been cut yet and downgrades are likely to come. CEO confidence tends to lead ISMs and suggests the budding recovery in manufacturing is likely to stall. On the earnings side, estimates for Q1 have been downgraded a bit more than is typical, but in our reading do not yet factor in any slowing in macro growth, and we look for downgrades to continue.

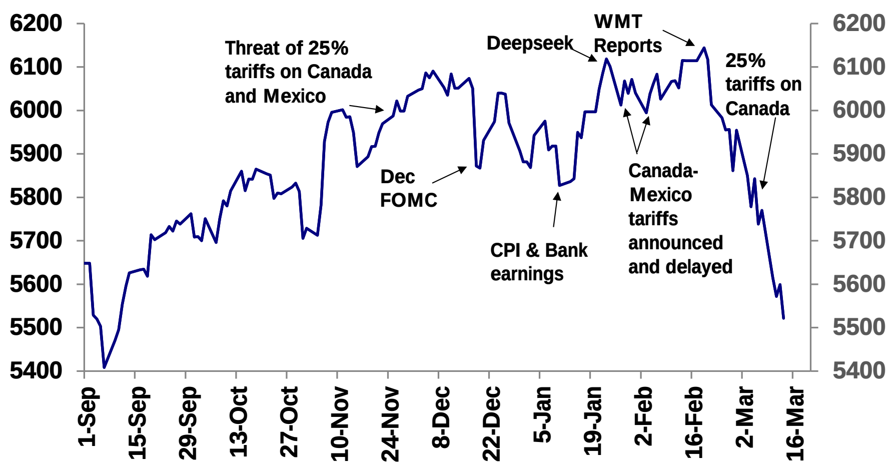
Will the administration relent?

- While the market selloff and potential economic weakness are clearly important, the key consideration is political, and we believe a notable decline in approval ratings is a necessary condition for a credible relent on trade policy.
- The administration is currently enjoying the typical "honeymoon" period granted all new presidents, after which approval ratings tend to align with what's happening in the economy and in particular consumer confidence. This was evident clearly in the recent Biden and prior Trump terms. The collapse in President Biden's approval ratings in the summer of 2021 is widely attributed to the US withdrawal from Afghanistan but looks in fact to have followed declines in consumer confidence as inflation spiked. His approval ratings then remained tied to consumer confidence for the remainder of his term. A similar pattern was evident in President Trump's first term.
- As noted, consumer confidence has begun to fall over the last 2 months. While consumer confidence is not a good predictor of consumer spending, it is a significant driver of Presidential approval ratings. Compared to the level of consumer confidence, the current approval rating is high, and while that's not unusual at this stage, it implies plenty of room for downside. Any negative developments on growth or a pickup in inflation are likely to speed the catch down to consumer confidence. The net approval rating (approval-disapproval) has already fallen from 12 percentage points on inauguration day to turn slightly negative this morning. We expect the net approval rating has to turn more significantly negative, at least -5%, before the administration starts to consider responding. The polling average is presently negative for all subcategories, including handling of the economy, inflation and foreign policy with the sole positive approval being on immigration.

Too early to throw in the towel on our year-end target

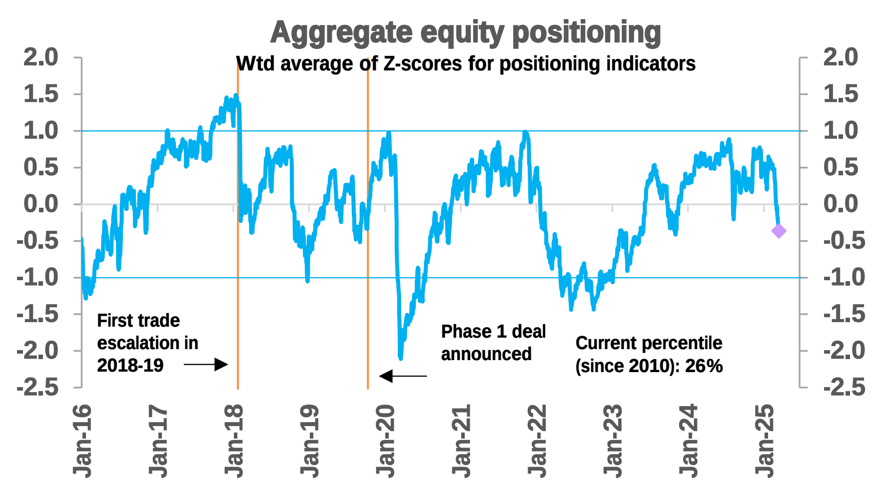
The declines in consumer and corporate confidence, in the equity market, and in Presidential approval ratings so far have been unusually sharp. In the near term, we expect the trends to continue, putting additional pressure on equities, with Apr 2 being flagged as a key date for a tariff plan. If the slide across a wide swath of economic, market, and political indicators prompts a credible plan to resolve tariff uncertainty in response, as is our baseline, it will allow the business cycle to continue. Equities can bounce back sharply in such a scenario, catching back up to their longer-run uptrend channel, as they did after the Phase 1 deal in 2019, and while the risks have grown, for now we maintain to our year-end S&P 500 target of 7000.

Figure 1: The S&P 500 has fallen -10% since the February peak



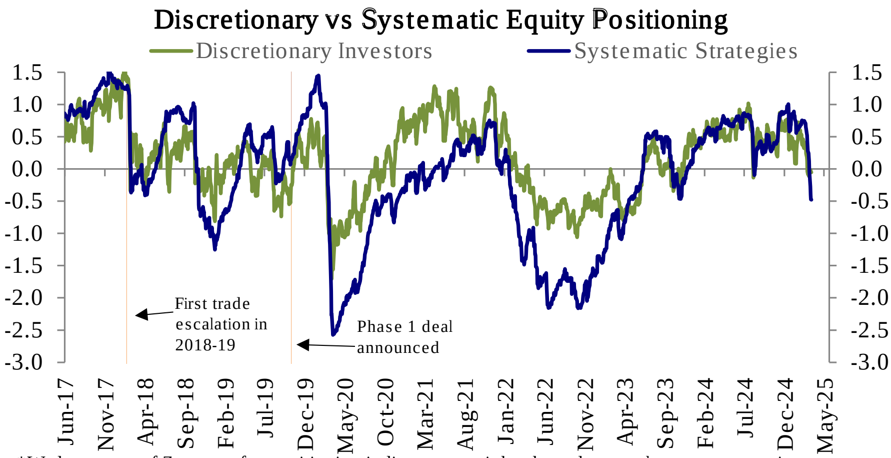
Source : Haver, Deutsche Bank Asset Allocation

Figure 2: Equity positioning has declined from near the top of its historical band to modestly underweight



Source : Deutsche Bank Asset Allocation

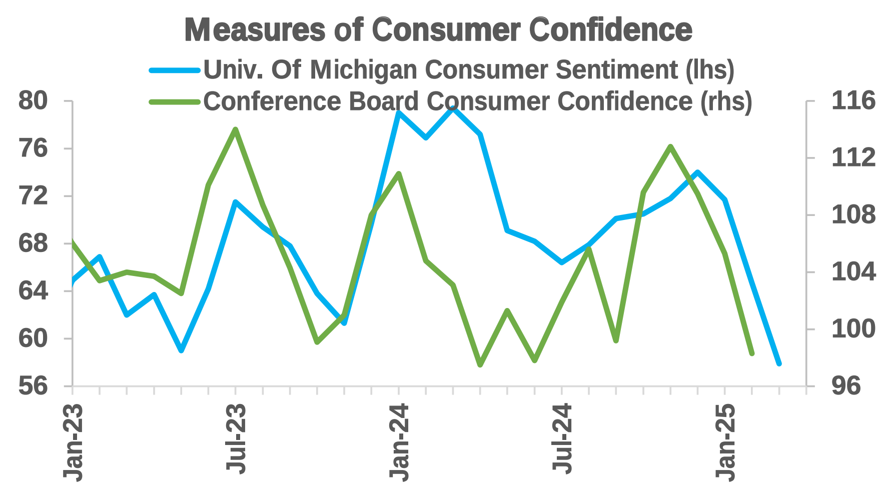
Figure 3: Discretionary as well as systematic strategy positioning has been cut



*Wtd average of Z-scores for positioning indicators, weights based on explanatory power in regression of equity performance on indicators

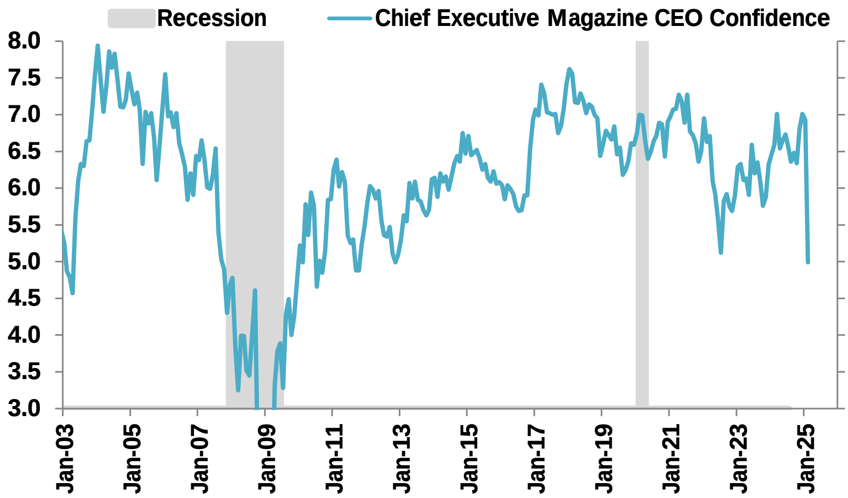
Source : Deutsche Bank Asset Allocation

Figure 4: Consumer confidence has fallen sharply …



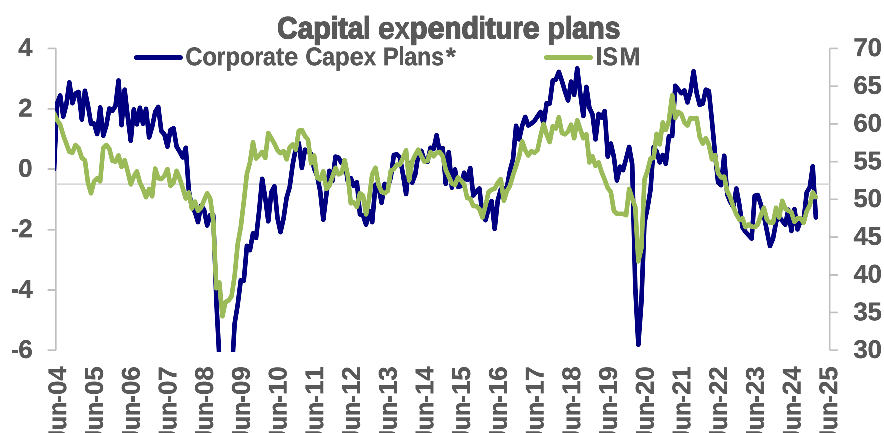
Source : University of Michigan, The Conference Board, Deutsche Bank Asset Allocation

Figure 5: … as have measures of corporate confidence



Source :Chief Executive Magazine, Haver, Deutsche Bank Asset Allocation

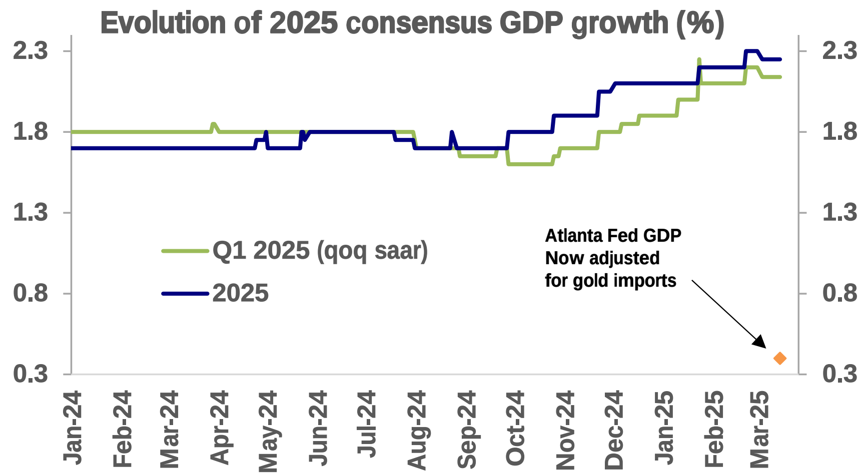
Figure 6: 7: Businesses are slashing capital spending plans



*** The first principal component of the capex intentions components of Philly Fed Outlook, Empire State Mfg, Richmond Fed Mfg, Kansas City Mfg, Texas Mfg, and the NFIB surveys**

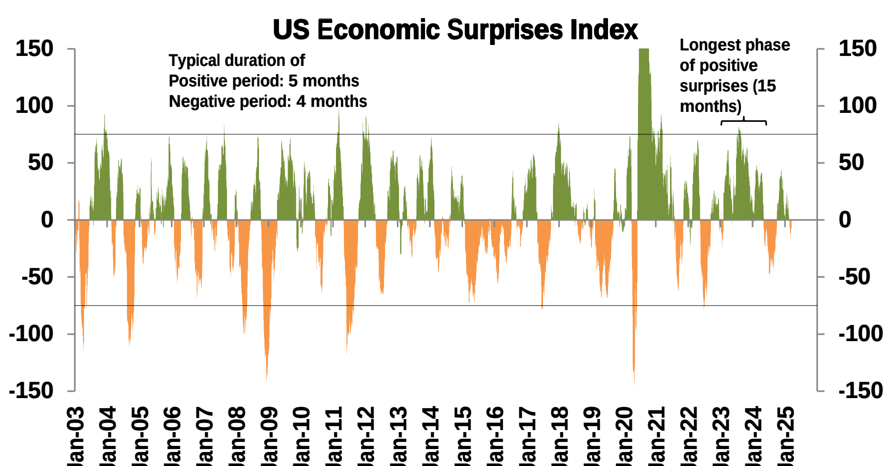
Source : Haver, Deutsche Bank Asset Allocation

Figure 8: Consensus GDP growth forecasts have not been downgraded yet



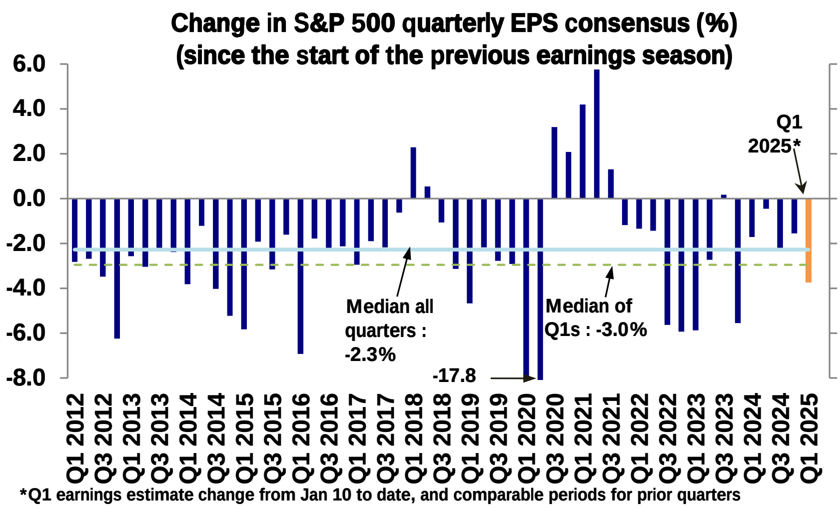
Source : Bloomberg Finance LP, Deutsche Bank Asset Allocation

Figure 9: Data surprises have just turned negative and typically such phases last 4 to 5 months



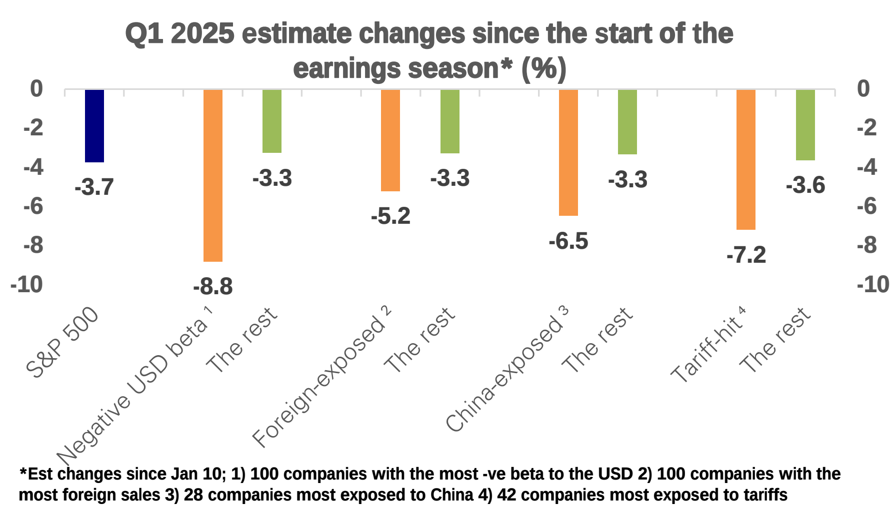
Source :Citigroup Economic Surprises, Haver, Deutsche Bank Asset Allocation

Figure 10: Consensus earnings estimates have been cut, by a little more than is typical in Q1s



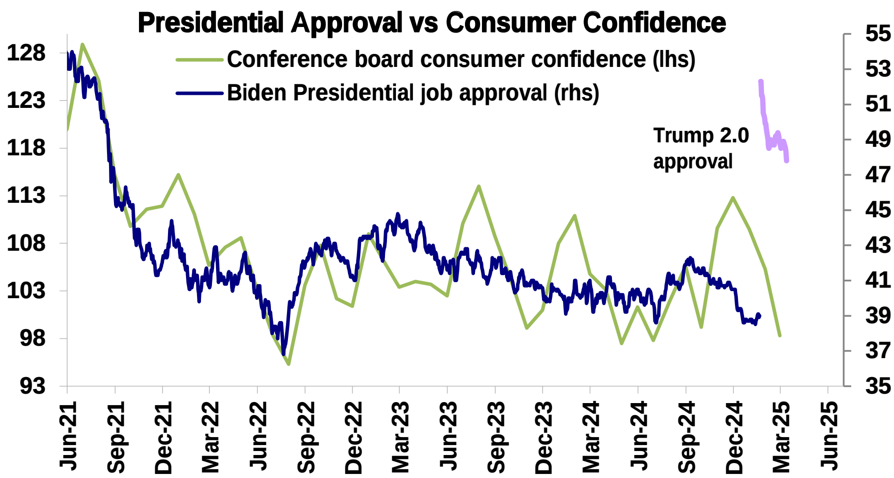
Source :Bloomberg Finance LP, Deutsche Bank Asset Allocation

Figure 11: In our reading, most of the decline in EPS estimates so far reflects the direct impacts of a higher dollar and tariffs, and not a broader economic slowdown



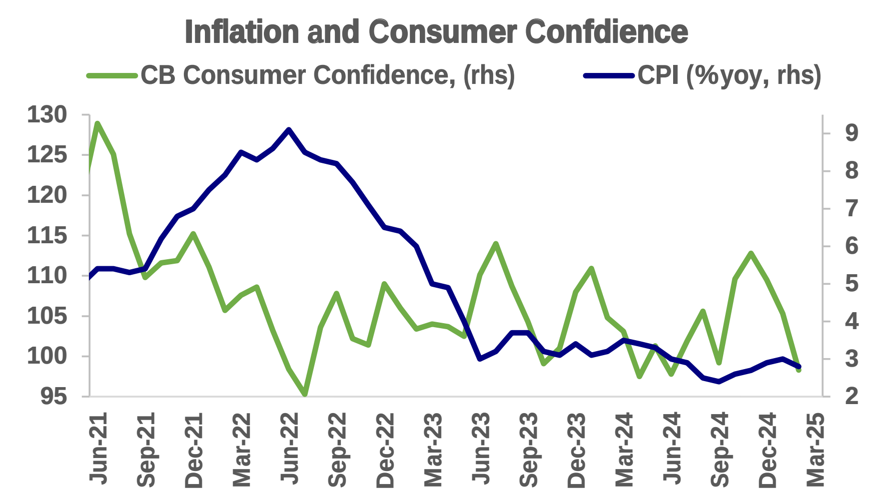
Source : Bloomberg Finance LP, Deutsche Bank Asset Allocation

Figure 12: The collapse in President Biden's approval ratings around the Afghanistan withdrawal actually closely followed that in consumer confidence



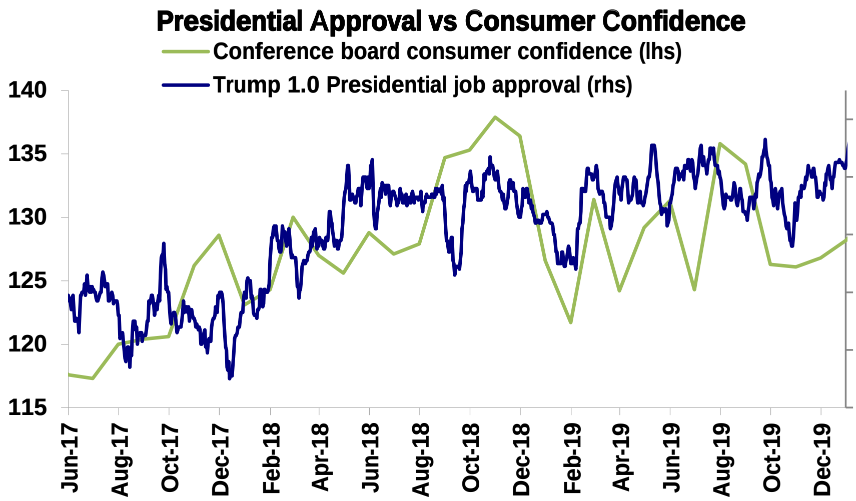
Source : Bloomberg Finance LP, Deutsche Bank Asset Allocation

Figure 13: The primary driver of falling consumer confidence looks to have been higher inflation



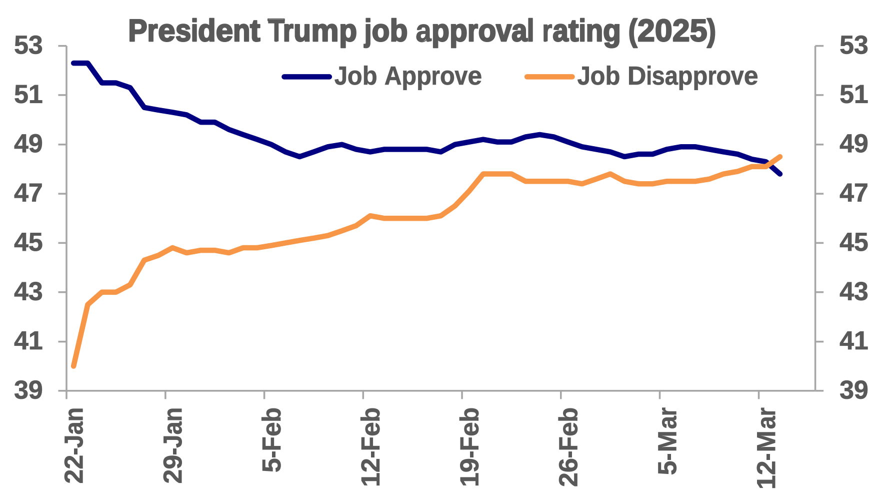
Source : Haver, Deutsche Bank Asset Allocation

Figure 14: During the last Trump term, approval ratings were similarly tied to consumer confidence



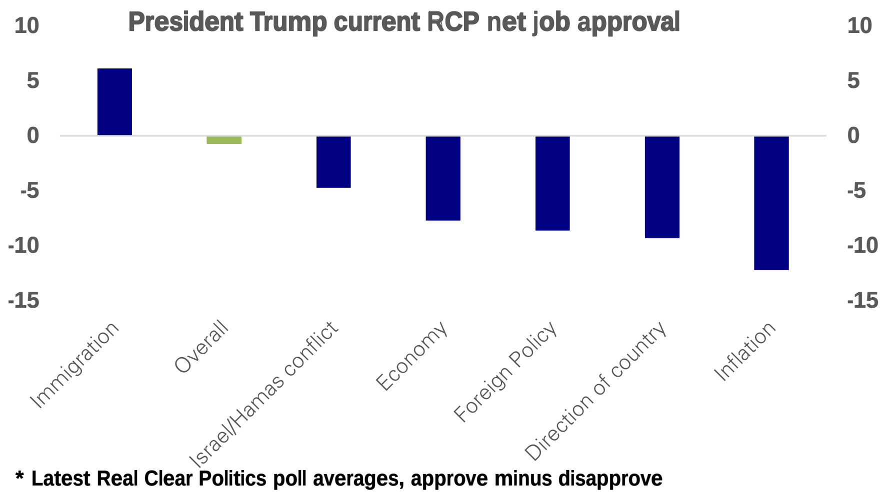
Source : Bloomberg Finance LP, Deutsche Bank Asset Allocation

Figure 15: Starting from elevated levels, the President's job approval rating has been declining and is now slightly underwater



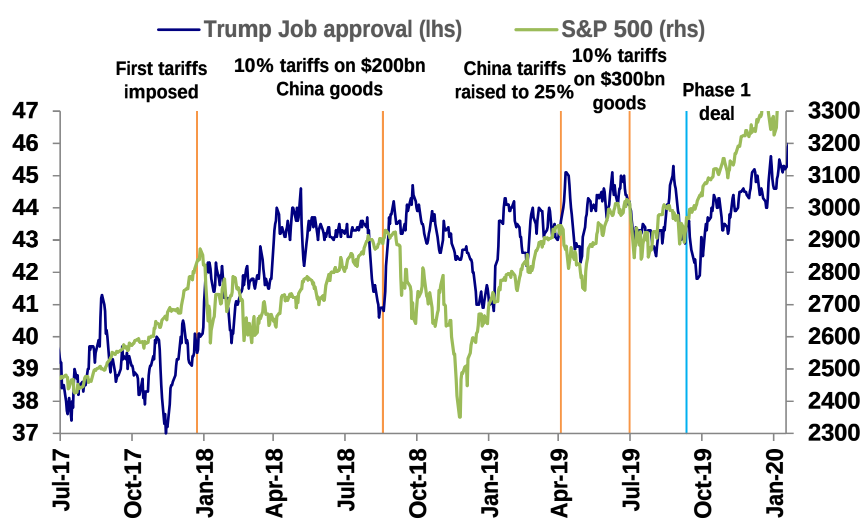
Source : Real Clear Politics, Bloomberg Finance LP, Deutsche Bank Asset Allocation

Figure 16: Net job approval is negative for most sub-categories of Presidential job approval



Source : Real Clear Politics, Deutsche Bank Asset Allocation

Figure 17: The combination of a series of sharp market selloffs and weak approval ratings prompted the end of the last phase of the trade war with the Phase 1 trade deal with China



Source : Real Clear Politics, Bloomberg Finance LP, Deutsche Bank Asset Allocation

Appendix 1

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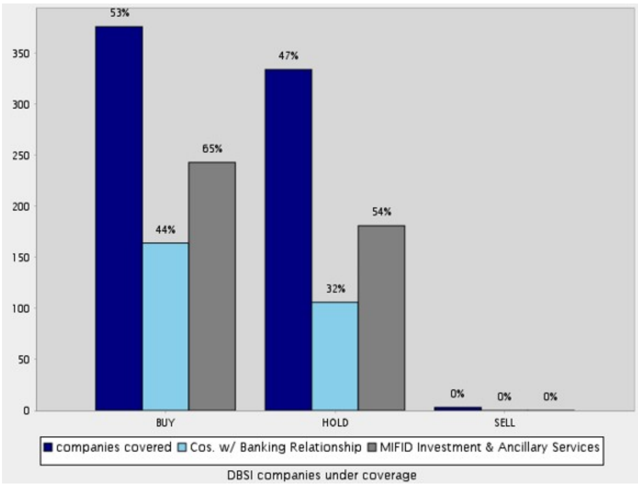
Equity rating dispersion and banking relationships



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