To the point!

Cross-Asset- and Strategy-Research

Soft tailwinds turned into stiff headwinds

LBBW_Research

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The stock market may have to fall further

Whether shares rise or fall has not just one, but several causes. The LBBW share valuation model focuses on three central factors that can describe the course of the market.

1. **Corporate earnings**. The profitability of the traded companies is, of course, a key factor in determining the fair value of a share.

2. **Relative attractiveness** of equities versus government bonds. Investors are always free to choose the asset class they consider more favorable. Higher interest rates make alternative investments more attractive.

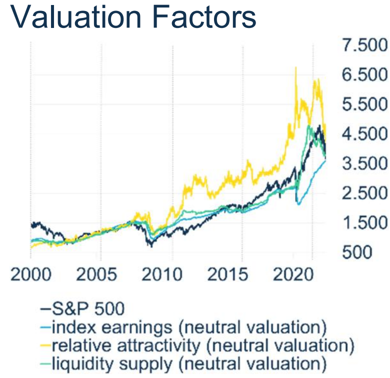
3. **Liquidity** has a significant impact on the demand for securities of any kind, including shares.

For each of the three factors mentioned above, we calculate a "neutral" index level, which we compare with the actual index value. Until the 2008 financial crisis, the three factors largely coincided in determining the "appropriate" price level for equities (see figure for the S&P500).

As central banks shifted to ultra-loose monetary policy, bond yields plunged ever lower, massively improving the relative attractiveness of equities (shown by the yellow line). The generous supply of liquidity (green line) and robust corporate earnings (blue line) also provided initial support.

With the outbreak of the Corona pandemic, share prices plummeted. Corporate profits were hit hard by the widespread lockdowns (blue line). But soon thereafter, share prices shot up again. Why? The relative attractiveness of equities rose rapidly because of the accelerated decline in bond yields (yellow line).

S&P 500 Stock Index: Valuation Factors



Source: Refinitiv, LBBW Research

Low interest rates propped up stocks for a long time

And with the unprecedented monetary expansion by central banks, immense excess liquidity was created, which sought investment opportunities (green line).

2022: Annus horribilis for equities

The combination of massive government support programs, strained supply chains and rising energy and commodity prices let inflation off the leash. Central banks have come under considerable pressure. Interest rates, especially at the long end, shot up. The relative attractiveness collapsed (yellow line).

Furthermore, liquidity supply is now in reverse gear (green line). Thus, the strong tailwind of the last ten years suddenly turned into a stormy headwind for equities.

The bottom has probably not (quite) been reached yet

With the rapidly weakening economic momentum, the outlook for corporate earnings (blue line) is also likely to dim soon. The last factor that has supported the stock market so far would then also weaken.

In this situation, the US S&P 500 - for which we have developed our model - has already fallen by more than 20% since the beginning of the year.

Multiplying the described fair values of the three model sub-criteria by their historically optimal weights results in a corridor in which the US leading index typically moves. The lower limit of this corridor is currently around 3,350 index points and therefore still leaves room for further declining prices.

Rising yields and liquidity withdrawal now weighing on equities

The economic slowdown will be reflected in earnings prospects

LBBW index targets	DAX	S&P 500
current	12.913	3.796
30.09.2022	12.500	3.450
31.12.2022	13.500	3.750
30.06.2023	14.500	4.100