CIO View
Americas CIO View

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Marketing Material

Send in the optimists: If the bond market rain stops, equities can shine

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IN A NUTSHELL

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If Treasury yields stabilize around 3.0% this summer, optimists can boost PEs

May was another tough month of many in 2022 so far, for both bond and equity investors. However, the last days of May and first days of June brought a strong rally for both asset classes off their worst year-to-date (YTD) levels. While the equity bounce was broad based, both in the US and abroad, across sectors and style, leadership remains narrow. It's just Energy being driven upward by a continued oil price rally. Despite commodities grinding higher and the dollar retreating from its recent highs, investors apparently got fatigued with all the inflation pessimism and focused instead on the peaking thesis and decided to give the U.S. Federal Reserve (Fed) and the supply-side a bit more benefit of the doubt. Some pointed to the many signs of economic slowing, a still healthy but more disciplined labor and housing market, and that inflation this high leaves plenty of room for it to fall. We'd agree with much of this, but it's really too early to tell and maybe it was simply investor goodwill around Memorial Day weekend. So much feels like the 1970s lately, perhaps Top Gun in the theatres again gave us a 1980s moment.

S&P fell 19% at its low, isn't that enough?: Depends on interest rates and growth

The S&P price-to-earnings (P/E) ratio fell from about 21x our forward earnings per share (EPS) estimate at year start to about 17x at its May 19-20 low and is currently about 18x the midpoint of our 2022E EPS of $225 and 2023E EPS of $235. Our yearend and 12-month S&P target of 4400 is 19.5x trailing EPS.

However, we don't think the S&P will exceed 4400 until we get closer to the end of Fed hikes and while we see 4000 as reasonable immediate long-term attractive fair value, we think risk is to the downside until commodities, the dollar and interests rates plateau. We've argued for many years that a fair S&P PE is anything between 18-21x, if long-term real interest rates stay close to 0% and if there is confidence in healthy long-term real S&P EPS growth. It's the latter that we want to elaborate on and quantify in this note. But if our S&P EPS estimates hold-up and 10yr Treasury yields stabilize around 3% with inflation expectations or breakeven in a 2.5-3.0% range and 10yr Treasury Inflation-Protected Securities (TIPS) yield in a 0-0.5% range, then we'd be more confident in our S&P price and PE target, even with some upside, provided a healthy expansion endures. Because of ifs, we use a higher than normal Equity Risk Premium (ERP).

S&P PE driven by real interest rates, risk premiums & long-term real EPS growth

Our fair S&P PE and intrinsic valuation framework is based on capitalizing accounting quality adj. S&P EPS by an estimated fair real return on long-term S&P 500 ownership. Our estimate of such fair long-term real return or S&P cost of equity (CoE) is based on our outlook for long-term real Treasury or TIPS yields plus a fair ERP. We expect 10yr TIPS yields to approach, but not exceed 0.5%, but because we are uncertain in this outlook we use a 4.75% S&P ERP. Inflation affects the outlook for real interest rates and real growth and thus the ERP. If inflation exceeds the Fed's target, then real interest rates are likely to be above the neutral real interest rate (which we estimate at roughly 0%) until inflation slows. If inflation is materially above real gross domestic product (GDP) growth, it usually brings poor real S&P EPS growth and also poor accounting quality from inadequate depreciation. Thus, although inflation isn't one of the three primary PE drivers, it affects all three of them. High inflation, but also commodity deflation and dollar strength hurt. Golden cycles help.

EPS should rise more than inflation due to reinvested profit not paid as dividends

The steady-state S&P PE formula that we use is PE = 1/ real CoE. It assumes: long-term S&P EPS growth = (1 – dividend payout ratio) x real CoE + inflation. Such that reinvested profits earn a fair real return, and earnings also rise with inflation. This healthy or steady-state equivalent EPS growth rate is also the nominal cost of equity less the dividend yield, when S&P is priced at steady-state. Thus, in order for an about 20 S&P PE to be fair, the fair real CoE must be about 5%. And if inflation is 2.5%, then S&P EPS growth is about 7.5% (i.e. nominal CoE = 5% +2.5%) less the dividend yield.

What about optimism?: PEs above the steady-state PE for economic profit growth

While we use a steady-state PE to guide our S&P 500 fair value estimates, PEs should be different for sectors, industries and especially companies not at steady-state. Our adjustments from steady-state values are small by sector, but we note that unless real interest rates climb a lot, the S&P 500 overall has no economic profit growth optimism built into its current valuation. It's not an optimistic market despite the still high S&P PE vs. history. That said, our market emotion indicator (PE/VIX (CBOE Volatility Index)), cannot tell if this market is skeptical or in denial about the health of the 2020s.

GLOSSARY

Breakeven rates provide a useful measure of average inflation expectations derived from inflation linked sovereign bonds

The CBOE Volatility Index (Vix) is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index. It is a popular measure of the volatility of the S&P 500 as implied in the short term option prices on the index.

Cost of equity (CoE) is the return (often expressed as a rate of return) a firm theoretically pays to its equity investors, to compensate for the risk they undertake by investing their capital.

Deflation is a sustained decrease in the general price level of goods and services.

In relation to currencies, depreciation refers to a loss of value against another currency over time.

The dividend yield is the dividend that a company pays out each year divided by its share price.

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.

Equity risk premium is an excess return earned by an investor when they invest in the stock markt over a risk-free rate. This return compensates investors for taking on the higher risk of equity investing.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

The neutral real interest rate is the official interest rate, adjusted for inflation, which is estimated to allow an economy to grow at its trend rate.

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

The real interest rate is the nominal interest rate adjusted for inflation as measured by the GDP deflator.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Treasury Inflation-Protected Securities (TIPS) are a form of U.S. Treasury bonds designed to protect investors against inflation. These bonds are indexed to inflation and pay investors a fixed interest rate as the bond's par value adjusts with the inflation rate.

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

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