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Rising bond yields challenge US equity valuations

Nicole Bullock

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The long-running US equity bull market has received support from a long period of slumbering bond yields.

Into a seventh year, the equity bull certainly looks mature and while the S&P 500 loiters just shy of record territory, it stands less than 2 per cent higher for the year. More troubling is how, since early February, the market has been confined to a rather narrow range, batting back and forth between 2,050 and 2,100.

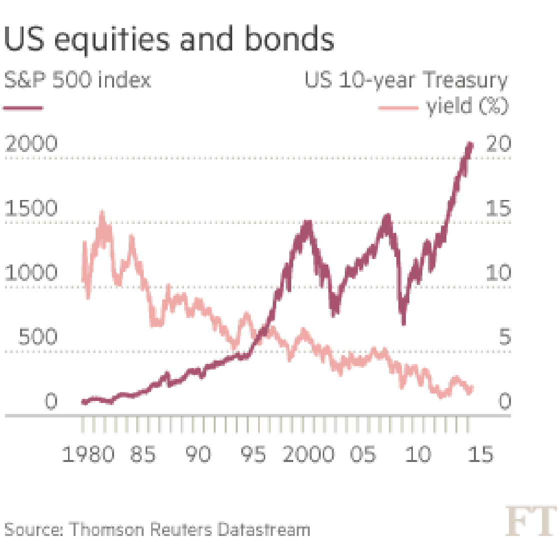
As equities have spun their wheels, attention in recent weeks has concentrated on rising US Treasury bond yields against the backdrop of global government debt significantly underperforming as investors sell their holdings.

Last week, Fed chairwoman Janet Yellen made two statements about financial markets. She said valuations in the stock market were "quite high" and she warned that there was a risk of a "sharp jump" in longer term bond yields when the Federal Reserve raises short-term rates.

Some see a link between bonds and equities and worry that lofty share prices look vulnerable.

"The problem markets face just now is that sovereign interest rates are rising," says Nicholas Colas, chief market strategist at Convergex. "But there is no incremental confidence that macro growth will support a higher assumed level of earnings growth."

Rates are a key component of one of the simplest ways to price financial assets — taking the present value of the future stream of earnings or cash flow of a business and discounting by a certain rate. That is usually the risk-free rate, or the yield on the 10-year US Treasury, plus a risk premium to account for the risk of buying stocks versus bonds.



"Basic financial theory says that as you lower the discount rate, people are willing to pay more for a dollar of earnings," says Russ Koesterich, global chief investment strategist at BlackRock.

The reverse is also true, which explains why price-to-earnings multiples fell to single-digits in the late 1970s and early 1980s when 10-year bond yields soared.

“Now p/e’s are in the teens, which is not illogical because you have low interest rates,” says Tobias Levkovich, chief US equity strategist at Citigroup.

Currently, the S&P 500 trades at 16.8 times forward earnings, above the long-term average of 15.9 times going back 15 years, according to FactSet.

Underpinning high share prices are rock bottom interest rates, and once yields climb companies will require stronger earnings growth to support their current valuations. And although US companies have achieved earnings growth, it has been in many cases through cost cutting and record high operating margins, while revenue growth has proved elusive.

“The feedstock of higher earnings is really revenue growth,” says Mr Colas. “It would be hard from here to push margins higher.”

During the first quarter, S&P 500 companies beat bleak expectations to eke out a 0.1 per cent gain in year-over-year earnings, but revenues fell a worse than expected 2.8 per cent, according to FactSet.

“A lot of the gains we have seen in the stock market have come from multiple expansion versus revenue and earnings growth, which makes it more challenging,” Mr Koesterich says.

Much, therefore, depends on economic growth accelerating, pushing up revenues and paving the way for higher interest rates.

“If the Fed is raising rates because the economy is expanding then earnings and revenue should be going up,” says Mr Koesterich.

Mr Levkovich expects the early stages of higher rates to be an affirmation of sustainable economic development. While the risk-free rate is low, he sees the risk premium as fairly elevated by worries ranging from the stagnant economy to the situation in Greece and the next move for oil prices.

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- Russ Koesterich, global chief investment strategist at BlackRock

“The risk-free rate starts to edge higher, but risk premiums start to edge lower,” he says. “The risk premium aspect should initially offset the slightly higher rates.”

So far, lacklustre economic growth has characterised the years since the financial crisis, with first quarter US gross domestic product rising by a sluggish 0.2 per cent versus expectations for an annualised expansion of 1 per cent. For the second quarter, some of the early data, such as retail sales, have not boosted enthusiasm.

In turn, market expectations for a Fed rate hike have shifted towards the end of the year. That delay, against the backdrop of rising oil prices has fanned higher inflation expectations, pressuring the value of long-term bonds, pushing their yields higher. Such a shift in long-term yields has kept equity prices on the defensive and for good reason.

“What has been scary about the last couple of weeks is that rates have been rising without a clear improvement in the economy,” Mr Koesterich says. “That is a much more dangerous environment for stocks.”