



## 3 reasons not to fear a 3%+ 10yr yield

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1600 should be good support even if 10yr treasury yields go a little over 3%. As discussed last week, we are increasingly tolerant of higher treasury yields given the coincident climb in the euro and oil prices. Treasury yield normalization poses little threat to S&P EPS provided euro and oil prices prove resilient. Our view that the chief risk to EPS from higher yields is via FX and commodity prices is sometimes challenged by investors who see other threats to EPS from higher interest rates, such as interest expense, or threats to the S&P's valuation. This note gives a few reasons to discount these concerns.

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Interest expense is relatively small and likely overpowered by pension swings. Net interest expense at S&P 500 non-financials is likely under \$150bn in 2013, which after-tax is roughly \$10 of EPS. Essentially all of the \$2trn in net debt at non-financials is now long-term debt because cash is more than double short-term debt and companies have been using more long-term debt in their debt mix. Usually 10-15% of long-term debt rolls over each year and much of it is still rolling to lower rates. But, if we assume that 15% of long-term debt rolls to a rate 100bp higher than the hit to 2014 S&P EPS would be ~\$0.25. If we assume that the effective interest rate rises 200bp on all non-financial net debt the hit to S&P EPS is about \$3, but if this occurs it would play out over several years.

### S&P 500 Key Forecasts

|                 |           |       |       |
|-----------------|-----------|-------|-------|
| Price           | 1660      |       |       |
| Next 5%+ move   | Uncertain |       |       |
|                 | 2013E     | 2014E | 2015E |
| Year-end Target | 1675      | 1850  | 2000  |
| EPS             | \$109     | \$115 | \$120 |
| Target P/E      | 15.4x     | 16.1x | 16.7x |
| Current P/E     | 15.2x     | 14.4x | 13.8x |
| DPS             | \$36      | \$40  | \$45  |

Source: Deutsche Bank

### Related recent research

| Related recent research                | Date        |
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| S&P 500 Pensions: End of cycles?       | 31 Jul 2013 |
| Multi-year path to PE expansion        | 14 Jun 2013 |
| How do interest rates affect stocks?   | 31 May 2013 |

Source: Deutsche Bank

### US Equity Strategy Baskets

| US Equity Strategy Baskets          | Bloomberg Ticker |
|-------------------------------------|------------------|
| Tech's Enduring Eight               | DBUSTECH         |
| Total Shareholder Return Stimulator | DBUSBBD1         |
| Dividend Dark Horses                | DBUSDFCF         |
| China Cyclical                      | DBUSCNCY         |

Source: Deutsche Bank

Financial earnings will likely benefit from higher treasury yields and eventually higher short-term interest rates. Thus, we see little threat to overall S&P EPS.

A ~15 forward PE wouldn't be threatened until 10yr yields were well over 4%. Assuming a fair S&P 500 equity risk premium of 4% (historically 3-4%), it would likely require a 10yr treasury yield of ~5% or a 10yr TIPS yield over 2% to threaten the fairness of a ~15 forward PE on normalized S&P EPS. However, such an increase in long-term interest rates would significantly amplify US fiscal risk. Thus, it is important that any such climb in yields be slow and over multiple years, while the deficit is further tamed and housing strengthened.

Treasury yields now exceed the dividend yield, but won't grow like dividends. Dividend yields like earnings yields represent real yields. Expected inflation must be added to these observed yields in order to compare them to nominal interest rates. The 10yr TIPS yield provides a comparable real interest rate, which at 0.75% suggests that EPS and DPS yields remain very attractive. The S&P's indicated dividend yield is 2.1% and we expect DPS growth to be ~15% next year and at least 6% thereafter. This suggests an offered long-term nominal return on S&P ownership over 8% with the ability of that offered nominal return to adjust for inflation variations over the long term.

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