



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.

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

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.

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Source: Deutsche Bank

Pension expense at S&P non-financials is likely to fall more than an increase in borrowing costs as long-term yields rise, particularly through 2015. The improved pension funding we expect at 2013 end should provide a ~\$2 benefit to S&P EPS in 2014. If yields rise another 100bp at 2014 end it would eliminate deficits and provide another ~\$2 S&P EPS boost in 2015 (not in our estimates). Pension expense declines would likely stop at this point even if yields climbed higher because of likely shifts in pension asset allocations. This would cause some pension drag from lower ROA assumptions, but all considered lower pension expense should offset higher long-term borrowing rates.

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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