

Deutsche Bank  
Markets Research  
North America  
United States  
Periodical

US Equity Insights

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

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.

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 shortterm

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 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.

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.

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.

Date

23 August 2013

David Bianco

Strategist

Ju Wang

Strategist

S&P 500 Key Forecasts

Price 1660

Next 5%+ move Uncertain

2013E

Year-end Target

EPS

Target P/E

Current P/E

DPS

Priya Hariani

Strategist

2014E 2015E

1675 1850 2000

\$109

\$115 \$120

15.4x 16.1x 16.7x

15.2x 14.4x 13.8x

\$36

\$40  
Source: Deutsche Bank  
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Interest expense is relatively small and likely overpowered by pension swings

Figure 1: S&P ex-financials net debt/market cap at 14% is considerably lower than historical levels

0%

10%

20%

30%

40%

50%

60%

70%

0%

10%

20%

30%

40%

50%

60%

70%

EPS hit from higher interest rates is likely to be very small and should be overpowered by pension swings.

If we assume that 15% of the \$2.8 trillion in long-term debt rolls to a rate 100bp higher the hit to 2014 S&P EPS would be ~\$0.25.

Pension expense is likely to fall by more and a 100bps increase in long-term rates should eliminate pension deficits.

Recession

Source: Deutsche Bank

Net Debt / Market Cap

Figure 2: Share of long-term debt (>1y) at S&P ex.

financials has increased to 85% from 75% in 2003

Figure 3: S&P ex-financial cash, current and long-term debt (\$ millions)

60%

65%

70%

75%

80%

85%

90%

Recession

Source: Deutsche Bank  
Long-term debt/ Total debt  
60%  
65%  
70%  
75%  
80%  
85%  
90%  
1,000  
1,500  
2,000  
2,500  
3,000  
500  
0

Current Debt  
Source: Deutsche Bank  
500  
1,000  
1,500  
2,000  
2,500  
3,000  
0

Long Term Debt  
Cash

Figure 4: S&P ex-financial interest expense/sales at 1.5%  
is the lowest level since 1970

100,000  
120,000  
140,000  
160,000  
40,000  
60,000  
80,000  
Interest Expense -LTM (\$bn, lhs)  
Interest Expense/Sales (rhs)

Source: Deutsche Bank  
1.0%  
1.5%  
2.0%  
2.5%  
3.0%  
3.5%  
4.0%

Figure 5: 10-15 year IG corporate bond yield is up 100bp  
from 1Q13 end but still below 2011 end.

10.0  
0.0  
2.0

4.0  
6.0  
8.0  
IG (10-15 years) Corporate  
Source: Bank of America Merrill Lynch, Deutsche Bank  
10 yr Treasury

0.0

2.0

4.0

6.0

8.0

10.0

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Figure 6: S&P 500 trailing PE and implied equity risk premium: PE is now close to long-term historical average but ERP is still 200bps higher than its average of 390bps.

10  
15  
20  
25  
30  
35  
0  
5

LTM PE (lhs)

Source: S&P, FRB, Deutsche Bank

Implied ERP (rhs)

Avg PE = 15.9

Overstated EPS from  
inflation distortions

0%  
2%  
4%  
6%  
8%  
10%  
12%

A ~15 forward PE wouldn't  
be threatened until 10yr  
yields are well over 4% or  
10yr TIPS exceed 2%.

Treasury yields now exceed the dividend yield, but dividends should grow double-digit for the next few years as the payout ratio rises from 33% now. 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 long-term DPS growth to be ~15% next year with at least 6% growth 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.

Figure 7: S&P Dividend yield, 10yr Tsy and TIPS yield

-2%  
0%  
2%  
4%  
6%  
8%  
10%  
12%

14%  
16%  
S&P Dividend Yield  
10yr TIPS yield  
Source: S&P, FRB, Deutsche Bank

10%  
12%  
14%  
16%  
-2%  
0%  
2%  
4%  
6%  
8%  
10yr Treasury Yield  
Figure 8: S&P 500 dividend growth (y/y % chg)

-25%  
-20%  
-15%  
-10%  
-5%  
0%  
5%  
10%  
15%  
20%  
25%  
Recession  
Trailing 4-qtr DPS growth (y/y % chg)

Source: S&P, Deutsche Bank  
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Equity rating dispersion and banking relationships

100

200

300

400

500

600

0

Buy

Companies Covered

Hold  
Sell  
Cos. w/ Banking Relationship  
North American Universe  
46 %  
55 %  
52 %  
46 %  
2 %35 %  
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