Global Research Highlights

Stocks vs interest rates

Investment Strategy

22 July 2016

Global

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Top Macro reports

Deconstructing the Fed Model

Given the fall in bond yields, our US equity strategy team takes a look at the Fed model, which compares the earnings yield on stocks with bond yields. There have been many iterations of the Fed model over the years, but they all come to the same conclusion today: stocks are cheap relative to bonds. The bulls argue that the spread between bond yields and the earnings yield will normalize as equity valuations re-rate higher. But this is just one of the ways that the relationship can mean-revert – which it has failed to do over the last decade. The other two may not be as bullish – the spread can mean-revert if earnings were to collapse, or if interest rates were to spike. Thus, the Fed model may not be as clear cut a buy signal for equities. And critically, their analysis suggests that the various forms of the Fed model have far less predictive power than simply using a PE ratio.

Fiscal policy to the rescue

It has taken a long time, with monetary ammunition running low, but finally fiscal easing seems to be starting to kick-in globally. Recent news makes our Global Economics team increasingly confident that Japan will announce a large fiscal stimulus plan. In Europe, fiscal policy has already moved from tight to modestly easy. European Economist Gilles Moec expects policy makers in Europe to respond to Brexit by bringing forward a number of stimulus efforts. The likelihood of further easing has increased in the US as well, according to our economists.

S&P 500 Relative Value Cheat Sheet

Deconstructing the Fed model

21 July 2016 Corrected

Market valuations remain uncompelling...

Valuations were little-changed for the S&P 500 in June, with the forward P/E contracting just slightly to 16.6 from 16.7, still above its long-term average of 15.1x. Valuations remain elevated vs. history for the majority of metrics we track (Table 2), and is one reason we currently remain cautious on US equities. Notably, small caps are now trading at a discount to large caps for the first time since 2003.

...but opportunities abound within sectors

While valuations were little-changed for the S&P last month, big moves occurred within sectors. Amid the reach for yield, multiples expanded most for Utilities, Telecom and Staples last month, and contracted most for Tech, Financials and Discretionary. Utilities' P/E (nearly 19x) is its highest ever, and Staples' 21x P/E is its highest since 2000—and at a record vs. Health Care's 15x multiple. Meanwhile, Financials' P/E is in-line with the market multiple for the first time since the crisis, and Discretionary is trading at its narrowest premium to the market in 15 years. With industry valuation dispersion at a four-year high, we now see more alpha opportunity rather than just factor -based investing which had mattered more than anything in 2015. We recently introduced our sector outlook after an agnostic stance on sectors in the 1H. See our Sector Focus Point.

Special focus: The Fed Model

As equity markets make new highs, the bulls are grasping for new (or very old) ways to justify the rally. The latest to garner attention is the Fed model, which compares the earnings yield on stocks with bond yields. There have been many iterations of the Fed model over the years, but they all come to the same conclusion today: stocks are cheap relative to bonds. The bulls argue that the spread between bond yields and the earnings yield will normalize as equity valuations re-rate higher. But this is just one of the ways that the relationship can mean-revert – which it has failed to do over the last decade. The other two may not be as bullish – the spread can mean-revert if earnings were to collapse, or if interest rates were to spike. Thus, the Fed model may not be as clear cut a buy signal for equities. And critically, our analysis suggests that the various forms of the Fed model have far less predictive power than simply using a PE ratio.

Chart of the month: Sensitivity of multiple to chgs in ERP

Table 1: Sensitivity of multiple to 100bp decline in ERP and reversion to mean/median

ERP Model	Current	Historical Mean	Historical Median	Sensitivity to 100bp Decline	Reversion to Mean	Reversion to Median
Fed Model	4.4%	1.5%	1.0%	20%	92%	127%
Adj. Fed Model	5.9%	4.2%	4.1%	20%	40%	46%
FCF ERP	2.7%	-1.2%	-2.5%	30%	876%	616%
DDM ERP	7.4%	4.6%	4.0%	12%	45%	59%
Normalized ERP	5.0%	2.8%	2.6%	18%	49%	57%

Source: BofA Merrill Lynch US Equity & US Quant Strategy

Investment decisions should not be made prior to reading the research report, which includes important information and disclosures.

Click here for full report including important disclosures.

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An historical guide to sector & industry valuation

For those interested in examining relative value across and within sectors, we provide a "cheat sheet" that includes Price to Book (P/B), Price to Operating Cash Flow (P/OCF), and Price to Fwd. Earnings (P/E) of each sector and industry.

We present these as relative multiples vs. the S&P 500 and calculate implied upside based on where the sector/industry trades vs. its average. We also provide charts of sectors' absolute and relative multiples over time.

For our **tactical industry rotation** model, which is based on valuations, momentum and earnings revisions, see page 13.

Global Economic Weekly

Fiscal policy to the rescue

15 July 2016 Corrected

Global

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Global: Fiscal policy to the rescue

We expect both monetary and fiscal easing in Japan in the next couple months with at least some elements of coordination. This is part of a broader global pattern, with a number of key countries shifting from tight to modestly easy fiscal policy.

United States: Supermodels

The Atlanta Fed GDPNow, New York Fed Nowcast, and our in-house GDP tracking model take their own distinct approaches to "nowcast" current quarter growth. Our in-house model has been slightly more accurate on average than the two Fed models, though Bloomberg consensus tends to have the best forecast. While nowcasting models help, it is important to remember that there is plenty of scope for error with the first estimate of GDP as it is based on incomplete data.

Euro Area: ECB Preview: Wink-wink, nudge-nudge

In our view, resilient markets post Brexit vote will allow the ECB on 21 July to simply deliver hints at an imminent additional layer of stimulus. Together with the new inflation forecasts, we expect hard announcements for September.

Emerging Asia: A week is long time in politics

While counting continues, Australia's Liberal National Party has obtained the minimum 76 seats to form a majority government. It will take longer for an outcome in the Senate but it is likely that it will again be challenging for reform to be passed. While this event does not warrant a response from the RBA, we see that it supports our view of additional easing.

Emerging EMEA: Russia: reassuring trip feedback

Our meetings in Moscow show that risks to the existing disinflation and recovery trends remain low. Rising liquidity surplus on fiscal inflows and stagnating credit to continue to provide support to all forms of Russian debt. Duma elections should be a non-event for the market, as improvement in Russia's relations with the West is unlikely.

Latin America: The power grab

Brazil's interim President Michel Temer scored another political victory when the Lower House elected an ally, Rodrigo Maia, as the Lower House President. In Venezuela, it is the military that is taking a larger share of the political power. Inflation is also leading to tighter monetary policy in Mexico, Colombia and Argentina.

UK: Brexit 'perplexit'

BoE's decision to hold rates looks like a policy mistake to us: BoE has injected uncertainty into an already uncertain world. We now expect 25bp rate cut in August & see QE shouldering more of burden. Risk is BoE just less dovish than we had thought.

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