US Equity Strategy

Rates spike and equities: what's next?

Equity Strategy

Americas

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P/E derating has been large amid surge in 10yr

As the US 10yr yield has risen ~100bp YTD, with a ~50bp spike in the last month, the S&P 500 NTM P/E has fallen 17% since Nov. The P/E derating is nearing recession/slowdown levels of 20%+ and is in line with the 1994 Fed cycle derating. While there have been many drivers of the 10yr rise, the shift from expectations of Fed cuts last fall to now pricing more Fed hikes has likely been the main driver, with 1y1y rates up ~180bp since Nov-Dec. SPX has rallied 10% on avg in the year following a rates spike with much stronger 18% avg rallies when the Fed did not raise rates >1pp within a year. Inflation expectations have been elevated but contained, which makes a benign Fed hike path and further SPX upside likely assuming no breakout in inflation/employment.

SPX path likely driven by Fed path post historic 10y yield spike

The US 10yr has surged to 5.2%, over 80bp above the 1yr moving average and a z-score of 1.6. The 10yr has cleared +1.5 stdev above its 1yr moving average only seven times in 40 years. Many catalysts will affect the path of rates (oil, employment, inflation prints, midterms), but 10y yields did not meaningfully decline for 2+ months post this stage of10 yr spikes, and yields increased further in full Fed hiking cycles.

- **Fed hikes moderate -> equities rallied**. When the Fed hiked <100bp within a year of rate spikes in the 2013, 2016, 2021 and 2023 episodes, the 10yr yield settled at elevated levels for ~2mo on avg before falling. After treading water those ~2mo, SPX rallied ~10% on avg the next 6mo and 18% the next year.
- **Fed hiking cycles -> equities weak**. When the Fed hiked by 100+bp within a year of the 10y surge in 1994, 1999 and 2022, SPX returns were negative or flat over the following year. The 10y also took 100 trading days on avg to reach the peak after crossing the +1 stdev threshold (vs 43 for other cases), and took much longer to get back to the moving average (288 days versus 197).

Equities have greater asymmetry to fall in rates, vs downside from higher rates

SPX forward sales growth expectations and CFROI have also increased 2-3pp since Nov, pushing the implied SPX P/E >24x vs ~20x currently, even with the surge in rates (link). The beta of SPX P/E to forward sales growth CAGR is nearly 2x that of bond yields. Our baseline is that valuations+returns remain well supported amid strong EPS growth, with notable upside if higher growth and/or lower rates do get priced. From a fundamental perspective, the rate sensitive part of the economy, housing and investment ex Tech, remains weak. While the jump in rates will be a headwind to activity, it should be less of a headwind than prior rate spikes when investment was strong. A fall in rates would be a much needed tailwind to investment ex Tech.

Strategy: position for period of elevated rates, and asymmetry to lower rates For a 2mo period of elevated but stabilizing rates, we highlight our High Growth+CFROI at a Discount basket while our High Leverage basket faces headwinds (link). We also see rising odds of a correlated rally into year end if rates pressures abate and earnings beat, making OTM SPX calls attractive. Comparing our Composite REVS scores to rates betas, top ranking subindustries Semis, Pharma, Refining and Div Banks remain attractive and appear less exposed to rates, in our view. We like pairing positive REVS subindustries with higher rates betas against low scoring rate sensitive industries:

- **High REVS and negative rates beta:** Biotech, Building Products, Consumer Finance, Trading Companies & Distributors, Hotels & Leisure and Regional Banks. Homebuilders have the highest rates beta and neutral REVS, though Building Products offers housing exposure, but scores well ahead on fundamentals.
- **Low REVS with negative rates beta:** Renewables, Automobiles, Construction Materials and Healthcare Facilities, alongside Auto Retail, Restaurants, Media and Application Software.

This report has been prepared by UBS Securities LLC. **ANALYST CERTIFICATION AND REQUIRED DISCLOSURES, INCLUDING INFORMATION ON THE QUANTITATIVE RESEARCH REVIEW PUBLISHED BY UBS, BEGIN ON PAGE 12.**

After 10y jump, SPX path likely driven by Fed path

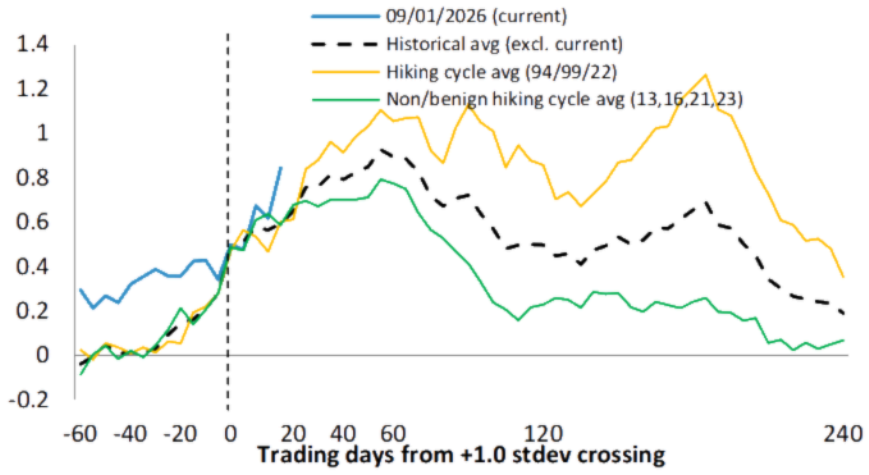
There are eight events since 1985 where the 10yr has increased by more than 1.5.stddev above the 1yr moving average, including now. Peak z-scores across the completed set range from 1.64 (2016) to 3.14 (2022). The key driver of what happens next is whether the Fed enters a full hiking cycle or adjusts rates moderately in our view. Three of the seven completed episodes began inside a Fed hiking cycle where the Fed rate increased by over 1pp within 1yr of the 10yr breakout (1994, 1999, 2022). The other four did not see larger Fed hikes (2013, 2016, 2021, 2023) .

The 10yr has jumped 1.5 standard deviations above its 1-year average only eight times since 1985, including the current episode.

Across all seven completed episodes, the S&P's average forward return from the +1 stdev crossing is roughly flat over the next 3mo (-1.2% at 3 months) before turning higher over 6–12 months (+4.9% 6mo, +10.0% 12mo). In hiking-cycle episodes, equities have historically been down 2.3% after 1 month and down 4.1% after three months. In the other instances, the S&P has been modestly positive over the first month and quarter, then compounding to +10.4% at six months and +17.7% at twelve. There was a ~18pp difference in performance depending on whether the magnitude of Fed rate increases over the next year.

In non/moderate hiking episodes, the S&P was positive at every horizon, modestly so early (+1.4% at one month, +1.0% at three) before compounding to +10.4% at six months and +17.7% at twelve.

Figure 1: US 10yr deviation from 1yr moving average for past rate spikes (in pp)



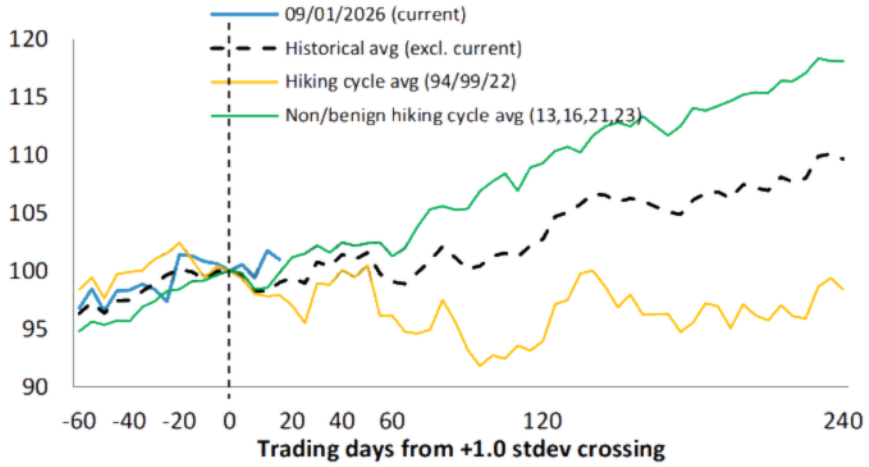
Source: Bloomberg, UBS

The 10yr is now over 80bp above the 1yr moving average, which is near the average of past rate spike episodes since the 1980s. History suggests rates are likely to stay elevated for at least 2-3mo.

In instances when the Fed hiked rates by >1pp within a year, the 10yr kept rising on avg, and took over 2x longer to reach the eventual peak compared to cases when the Fed path was more benign (102 vs 43 trading days).

~88bp of Fed hikes priced for the next year post the recent hike is borderline but more likely implies the benign path for rates vs what played out in larger hiking cycles.

Figure 2: S&P 500 performance around 10yr spikes



Source: Bloomberg, UBS

Across all seven precedents the S&P averaged –0.2% at one month, –1.2% at three, +4.9% at six and +10.0% at 1yr. Six of seven episodes were positive at both six and twelve months.

In non-hiking/benign episodes, SPX was positive at every horizon, modestly so early (+1.4% at one month, +1.0% at three) before compounding to +10.4% at six months and +17.7% at twelve

In hiking-cycle episodes, the S&P was negative at every horizon: –2.3% at one month, –4.1% at three, –2.5% at six and –0.2% at twelve. Not one of the three recovered within a year.

P/E de-rating has been large amid rise in rates

Figure 3: SPX forward P/E historical de-ratings



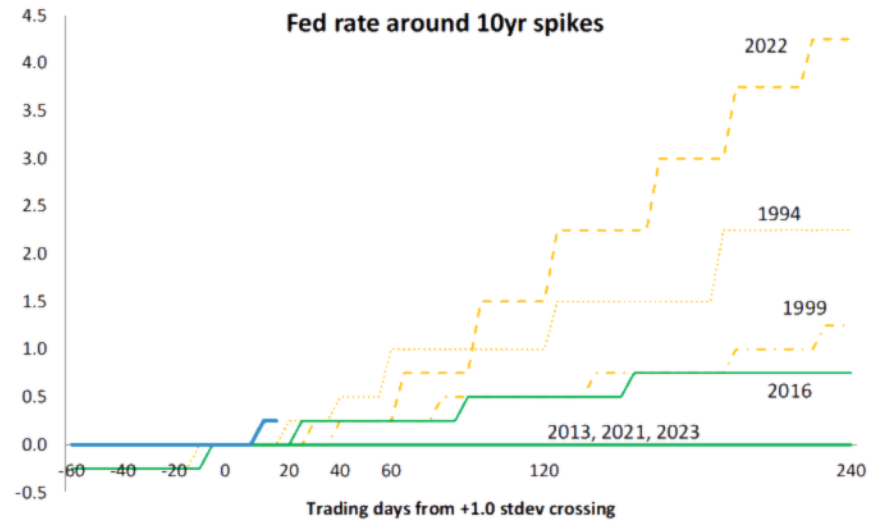
Source: FactSet, UBS

The S&P 500 P/E has fallen by 17% since the fall peaks, which is in line with the de-rating in 1994 during that Fed hiking cycle.

P/E de-ratings around recessions have been 20-30%, so the current multiple decline has already been large.

Fed path key to equity market trajectory

Figure 4: Fed rate increases around past 10yr yield spikes



Source: Bloomberg, UBS

There have been 7 instances of the US 10yr spiking 1.5stdev above the 1yr moving avg. Three instances saw the Fed hike rates by over 100bp within a year - 2022, 1999 and 1994. The other four instances saw no hikes (late 2023, 2021, 2013) or less than 100bp of hikes (2016-17).

With inflation expectations largely in check, particularly if oil stops rising/ falls, we see lower odds of a larger and longer Fed hiking cycle, which is reflected in market pricing. Thus, further rates pressure needs to come from more Fed hikes priced and/or higher inflation expectations - something to closely monitor.

Figure 5: Event analysis where US 10yr yields reach +1.5 stdev above 1yr MA

			S&P 500 Returns from +1 stddev date				10yr yield chg from +1 stddev date (bp)				Event # of days		
z=+1 date	z=+1.5 date	Peak date	1mo	3mo	6mo	12mo	1mo	3mo	6mo	12mo	MA to 1 Stddev	1 Stddev to peak	Peak to MA
02/24/1994	03/21/1994	05/09/1994	-0.8%	-2.4%	0.2%	3.7%	39	77	40	-30	15	53	209
05/07/1999	06/09/1999	08/10/1999	-0.8%	-1.7%	1.3%	6.7%	24	34	10	-60	18	68	169
06/10/2013	06/21/2013	09/05/2013	-0.1%	-0.2%	9.9%	15.7%	35	41	4	-60	26	65	170
11/14/2016	12/14/2016	12/15/2016	5.0%	6.0%	10.9%	19.3%	20	-2	-15	-40	5	23	172
02/12/2021	02/25/2021	03/19/2021	0.2%	5.5%	12.6%	10.0%	37	20	-39	-13	51	26	97
02/08/2022	03/21/2022	10/20/2022	-5.4%	-8.3%	-8.9%	-11.1%	-4	88	3	-5	35	184	112
08/03/2023	09/27/2023	10/19/2023	0.3%	-7.4%	8.1%	25.9%	-8	53	-34	68	58	56	40
09/01/2026	09/23/2026												
		Median	-0.1%	-1.7%	8.1%	10.0%	24	41	3	-40			
		Average	-0.2%	-1.2%	4.9%	10.0%	20	44	-4	-39			

Source: Bloomberg, UBS

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10yr breakout driven by real yields, not inflation

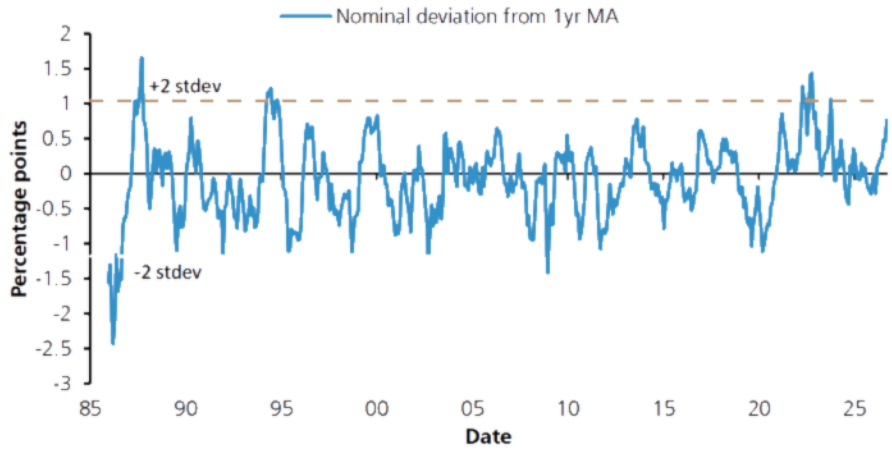
Figure 6: US 10yr nominal yield vs 1yr moving average



Source. Bloomberg, UBS

The US 10yr yield recently broke out of the trailing 3-year range and reached 5.2% vs a 1-year moving average of 4.4%, an ~0.8pp gap.

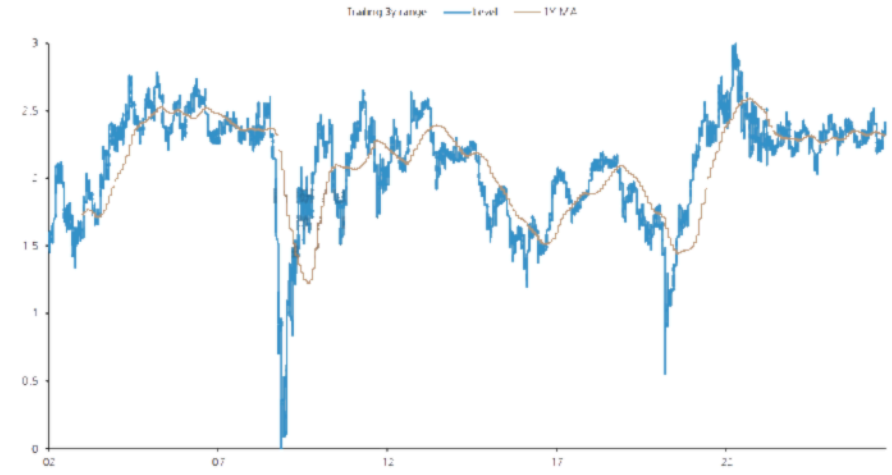
Figure 7: US 10yr nominal yield difference vs 1yr moving average



Source: Bloomberg, UBS

The US 10yr deviation from its 1yr moving average is a z-score of +1.64 and in the 93rd percentile vs history, putting it in rare company of 7 events since the 1980s that reached a >1.5 stddev.

Figure 8: US 10yr inflation breakeven vs 1yr moving average

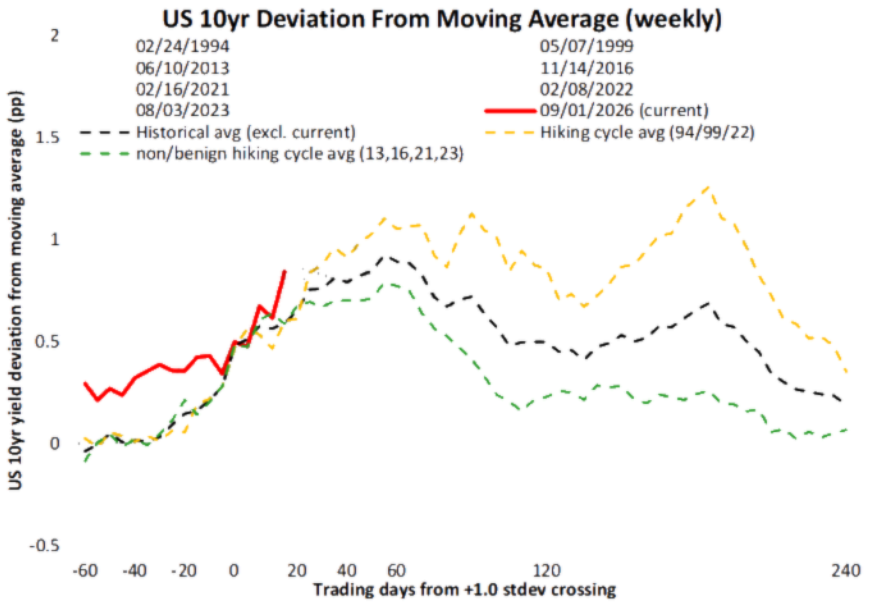


Source: Bloomberg, UBS

Inflation breakevens are in line with the moving avg (+0.01pp), noting that inflation expectations have not driven the increase in rates unlike other periods.

US 10yr and SPX around past rate spikes

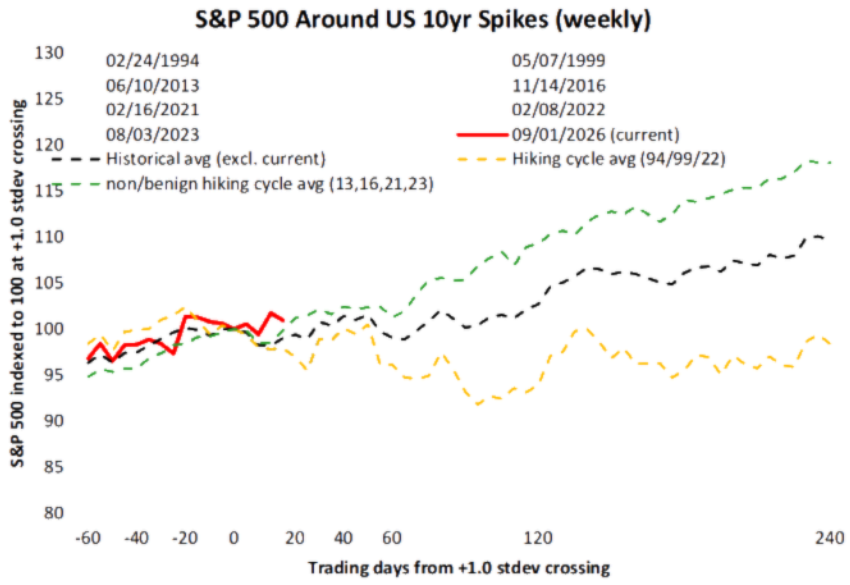
Figure 9: US 10yr yield around past rate spikes (deviation from MA in pp)



Source: Bloomberg, UBS

The US 10yr is up about 100bp YTD with ~50bp of the jump in the last month. The path of the 10yr following breakouts 1.5stdev above average has varied greatly with 2022 and 1994 seeing even higher 10yr rates amid Fed hiking cycles post recessions. Other instances saw the 10yr settle down at this stage.

Figure 10: S&P 500 performance around past 10yr yield spikes



Source: Bloomberg, UBS

The path for equities has largely depended on the path for Fed hikes post rate spikes.

A more benign Fed hike path and settling down of short rate expectations would pave the way for strong earnings and growth to drive further equity upside post the large P/E derating.

Valuations pricing higher rates and/or lower growth/margins

Valuations have fallen over the last 6-9mo as earnings have surged, profitability has improved and forward growth expectations have been revised up. Markets appear to be pricing slower growth, lower margins and/or higher rates. Given accelerating growth in many areas, the de-rating has been "early" and larger compared to past cycles, but discounting through cycle earnings/margins is a continued challenge.

With the SPX P/E to sales growth CAGR near 2008-12 lows, earnings should fuel further upside with valuations generally well supported.

There are many drivers of equity valuations but they can essentially be grouped into: 1) bond yields, 2) cyclical growth, 3) secular/terminal growth, 4) quality/uncertainty, 5) return of capital. Our forward sales growth CAGR is the most significant variable in the SPX valuation framework, on a univariate basis, while CFROI is the most significant variable in the broad P/E framework. The rise in fwd sales CAGR and CFROI has pushed the implied SPX P/E to >24x based on our framework. With ~21% upside to the implied P/E, the residual is at levels seen in 2020 and 2011-12. Our baseline is that valuations remain well supported amid strong EPS growth, with large upside if higher growth does get priced.

Leveraging our prior work, we develop a new SPX P/E framework incorporating more fundamental variables to account for the changes in growth and profitability for the S&P 500, in addition to macro variables.

Figure 11: Bond yields point to a lower P/E...



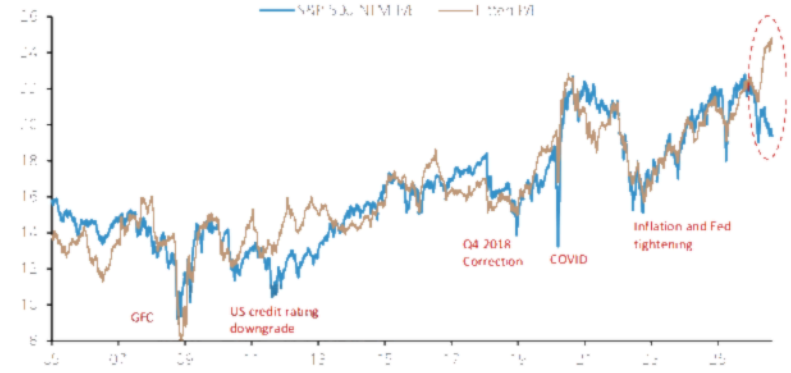
Source: Bloomberg, UBS

Figure 12: ...but higher sales growth supports a higher P/E



Source: Bloomberg, UBS. Note: Sales CAGR is avg of float and fundamental wtd.

Figure 13: S&P 500 NTM P/E is below our model implied value

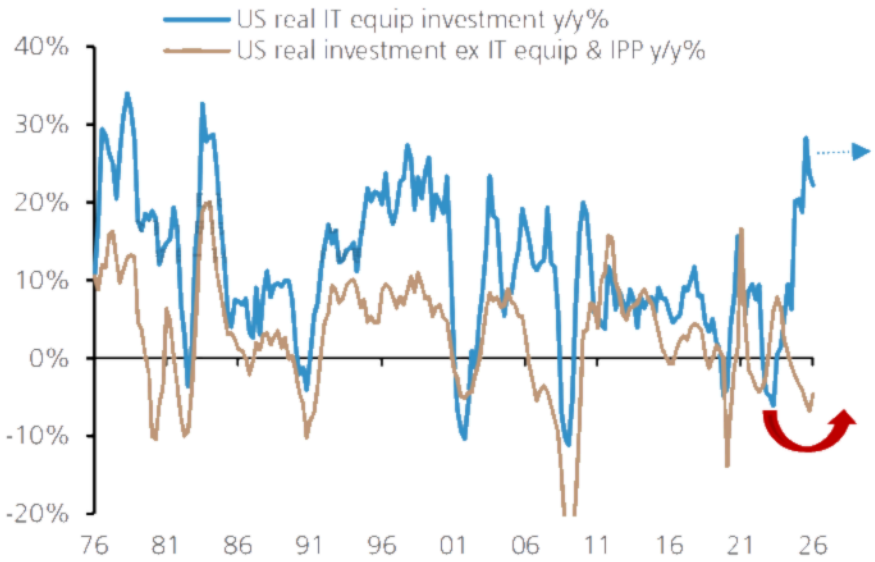


Variable	Beta	t-stat	Current level	Contribution
US 10yr + IG OAS	-1.19	34.5	5.5	-6.5
Economic surprises	0.89	7.8	0.1	0.1
US 1yr minus Fed rate	-0.04	0.7	0.4	0.0
Sales growth - 3-5yr CAGR	1.48	20.8	3.6	5.4
Cash flow ROI	0.76	26.8	8.1	6.1
Equity vol / rates vol	-4.80	9.6	0.2	-1.0
Sales growth inflection	0.19	10.4	-1.9	-0.4
Dividend payout	0.11	11.3	21.8	2.4
Intercept				18.5
Implied P/E				**24.5**

Source: FactSet, Bloomberg, UBS

Sensitivity of growth to rates should be lower

Figure 14: US real non-residential investment vs US real investment ex IT equip & IPP (y/y%)



Source: BEA, Haver, UBS

US real investment outside of Tech has been weak for years after the Fed hiked rates in 2022-23 with further declines over the last year-plus. While higher rates will be a headwind for growth activity, the beta of rate sensitive investment to higher rates should be lower given weak levels of activity currently.

Figure 15: New and existing home sales are already at very weak levels



Source: Bloomberg, UBS

In particular, housing activity is most sensitive to higher bond yields. But existing home sales are running at GFC levels already, while new home sales have also dipped and remain weak.

Subindustry rate sensitivity vs fundamental attractiveness

Not every rate-sensitive business is equally worth owning amid rates uncertainty. To better assess the relative strategy setup, we leverage our Composite REVS scores at the subindustry level against the beta to change in rates, separating groups where duration exposure is backed by improving fundamentals from those where a lower 10yr may be the only catalyst.

Top scoring subindustries that are rates neutral include Refining, Semis, Diversified Banks, Diversified Financial Services, Construction Machinery and Pharmaceuticals as they all carry a low beta to rates in our analysis. Owning the best fundamental momentum does not require taking a duration view.

Higher scoring fundamentals with negative rates beta can pair duration exposure with fundamental momentum. Consumer Finance, Trading Companies & Distributors, Biotech, Building Products, Hotels & Leisure and Regional Banks all rank in the top quartile of the composite REVS while screening negative to rates. Building Products in particular offers the housing exposure that Homebuilding does, but with fundamental momentum 38 places higher.

Negative REVS industries with higher rate sensitivity can be a source of funds and includes subindustries such as Renewables, which screens among the worst on REVS and carries a negative rates beta. Automobiles, Construction Materials and Healthcare Facilities are next among worst scoring subindustries with high rates betas. Auto Retail, Restaurants, Other Retail, Healthcare Equipment, Media and Application Software are in the same quadrant.

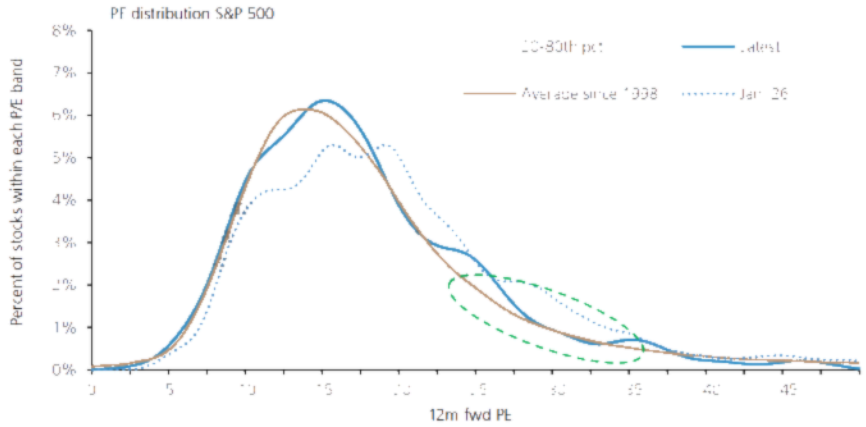
Figure 16: Subindustry REVS composite scores vs beta to interest rates



Source: UBS

S&P 500 stock valuations have 'normalized' since Jan as EPS has risen well above trend

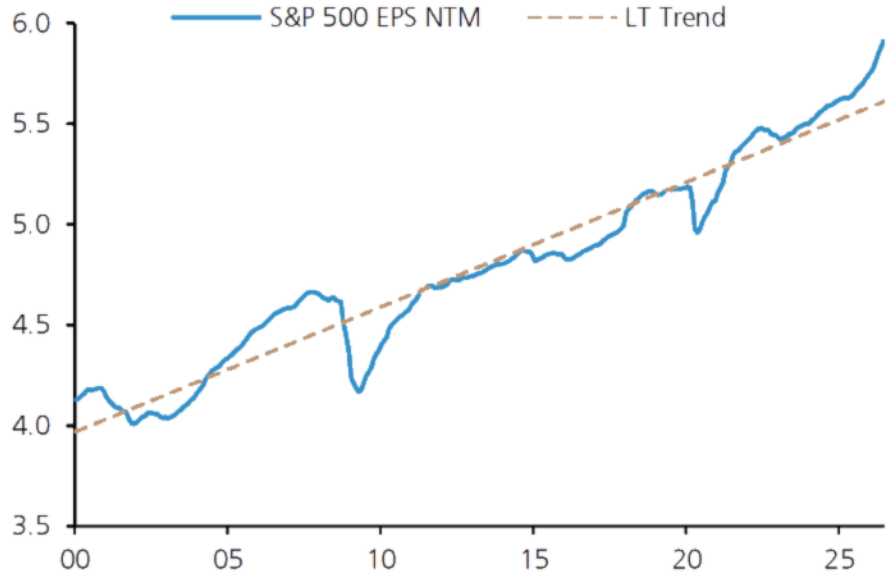
Figure 17: Distribution of Valuations in the S&P 500 have normalized significantly



Source: FactSet, UBS

The average NTM P/E of 19.4x and median of 16.6x are in line with historical averages, while the typical stock trades at only the 40th percentile of its own history. Both measures have fallen meaningfully since January.

Figure 18: SPX earnings are now well above trend



Source: FactSet, UBS. Note: EPS in log term

The SPX LTM P/E had a beta of -0.12 to the % difference between EPS and the historical trend based on our trailing P/E model (link).

The 1yr jump in EPS well above trend would have pointed to a ~3x de-rating, all else equal.

However, expected sales growth and CFROI are a lot higher which would support a higher multiple.

Valuation Method and Risk Statement

Equity market returns are influenced by corporate earnings, interest rates, risk premia, as well as other variables influenced by the business cycle. The outlook for any and all of these variables is subject to change.
Risks include macroeconomic variables (such as GDP growth rates and inflation), economic slowdown, a weakening currency, global economic events, and government policy changes. Our quantitative models rely on reported financial statement information, consensus earnings forecasts and stock prices. Errors in these numbers are sometimes impossible to prevent (as when an item is misstated by a company). Also, the models employ historical data to estimate the efficacy of stock selection strategies and the relationships among strategies, which may change in the future. Additionally, unusual company-specific events could overwhelm the systematic influence of the strategies used to rank and score stocks. Past performance is not a guarantee of future performance. Valuation methods across sectors include DCF, SOTP and multiples analysis.
Options, structured derivative products and futures (including OTC derivatives) are not suitable for all investors. Trading in these instruments is considered risky and may be appropriate only for sophisticated investors. Prior to buying or selling an option, and for the complete risks relating to options, you must receive a copy of "The Characteristics and Risks of Standardized Options." You may read the document at http://www.theocc.com/publications/risks/riskchap1.jsp or ask your salesperson for a copy. Various theoretical explanations of the risks associated with these instruments have been published. Supporting documentation for any claims, comparisons, recommendations, statistics or other technical data will be supplied upon request. Past performance is not necessarily indicative of future results. Transaction costs may be significant in option strategies calling for multiple purchases and sales of options, such as spreads and straddles. Because of the importance of tax considerations to many options transactions, the investor considering options should consult with his/her tax advisor as to how taxes affect the outcome of contemplated options transactions. All options discussed in this report are OTC options.