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US Equity Strategy

Are Rate Concerns Overblown?

Scott T Chronert[AC]

Patrick Galvin, CFA

CITI'S TAKE

Our view is that the traditional stock vs bond allocation decision has been somewhat negated by ongoing AI fundamental tailwinds, as well as structural changes in the underlying composition of equity ownership. Interest rates may matter more to expectations for economic trajectories but less to multiples and cross asset flows than commonly perceived. The good news is that the equity culture seems alive and well, for now. The bad news is that this raises the question of who's the incremental buyer.

Interest Rates and Multiples — The connection between interest rates and index multiples over the past 60 years is evident. Interestingly, though, it has varied by decade and weakened over time. Generally, interest rates have had a lesser impact on multiples since the early 2000s. Ultimately, rate impacts on macro conditions matter but cross asset valuation implications have structurally changed.

Fair Value Model Signals Stretched Sentiment — Our proprietary Fair Value model starts with the 10yr yield but then incorporates a series of macro adjustment factors. Currently, the S&P 500 trades at 22.4x versus the model's 17.1-22.1x range. We argue that stretched sentiment and complacent positioning factor into the current valuation.

Cluster Insights — Our work on S&P 500 via a Growth/Cyclicals/Defensives lens helps to interpret rate impacts. Cyclicals and Defensives have sold off since late August, influenced by traditional rate sensitivity. Yet Growth has been resilient as a function of expectations for an ongoing AI-related fundamental tailwind.

What's the Clearing Rate? Economic indicators point to a mixed macro message. In turn, this implies that some part of the recent interest rate back up is less of a function of an overheated economy, with more focus on the anticipation of incremental debt issuance. To the degree that the rate backup is supply driven, it is likely that different investor types will require varying cross asset valuation clearing rates to trigger a rotation from stocks to bonds.

Structural Investing Shifts — The notion of a growing "equity culture" seems to be at work across investor types. The shift from Defined Benefit to Defined Contribution is reinforcing investor proclivity for equities as pension funds' ownership imprint has lessened. Target date funds utilized by younger cohorts tend to overweight equities and lessen the cross-asset valuation connection. Foreign investment flows also increasingly bias to equities. These trends seem more predicated on persistent equity outperformance over time but do beg the question as to who's the incremental buyer.

See Appendix A-1 for Analyst Certification, Important Disclosures and Research Analyst Affiliations.

Cross Asset Dynamics Favor Equities

Freshening Our Rates Playbook

Given the backup in interest rates over the prior few months, the question arises as to why we have not seen a significant negative response in equity valuations and price action. This note updates our historical work on the equities vs rates connection. The high-level takeaway is that structural shifts in equity investor types and their ownership imprint may be influencing the conventional approach to the stock vs bond decision. The framework described herein is critical to an understanding of the rates to multiples connection and why the current cross asset divergence is rational.

Conventional wisdom is that the interest rate influence on equities has several components. These include: the underlying impact on future economic growth and, thus, fundamentals; the discounting effect on future earnings; and related, the portfolio rebalance channel instigating stock vs bond rotations. In our view, the interest rate to equity multiple connection mostly derives from these factors.

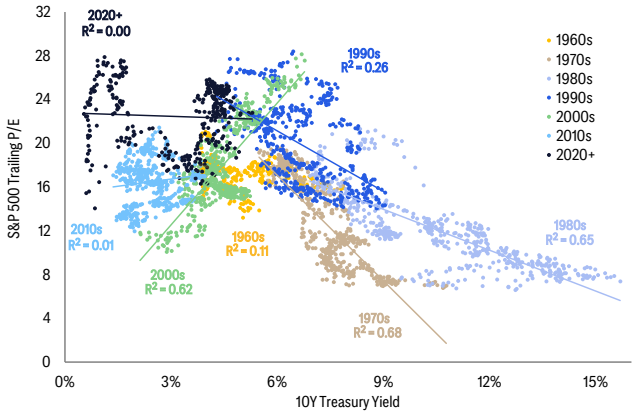
Historical Context

We have dug into this subject several times through our previous work and have found the rates to valuation connection to be complicated. Over longer time frames, the negative relationship between 10YY and index valuations is apparent, yet over shorter windows this relationship breaks down. In theory, equity prices reflect a discounting mechanism whereby higher interest rates should decrease the discounted value of future earnings, translated via multiple compression and/or lower stock prices. Through a different lens, the portfolio rebalance channel should work such that with finite shelf space in the investor portfolio, higher interest rates should entice investors on the margin to dial back equity exposure in favor of bonds. In practice, there can often be a significant divergence between actual index valuations and the index multiple implied from a given level of interest rates.

Intuitively, when investors expect strong forward earnings growth for the years ahead, the rational response is to pay more for a dollar of earnings today. As such, one driver of cross asset valuation imbalance is when a strong/overheated macro backdrop is the trigger for higher interest rates, as this backdrop should in tandem support the expectation for above trend forward earnings growth.

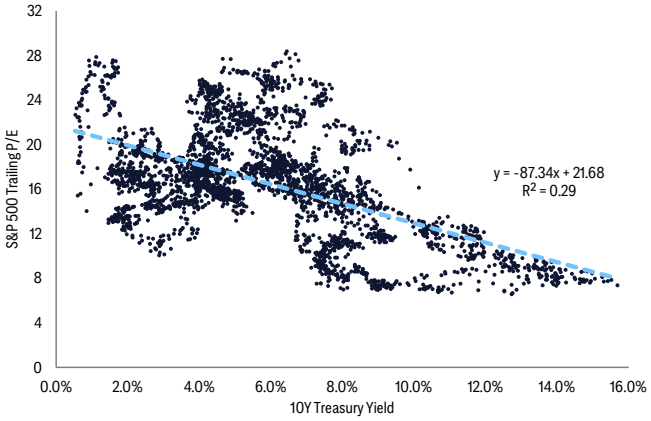
Still, the data in Figure 1 shows that the correlation between trailing PE and 10 yr yields has varied quite significantly by decade. The result is a decent r-squared on a 60 year look back, Figure 2, but where the path to it has not been consistent. Thus, we appreciate the longer-term context while recognizing that conditions change. It is also evident in Figure 1 that the post 2000 interest rate to multiple connection has weakened relative to the pre-2000 timeframe, an important point as relates to the retirement market structural shift we dive into later on.

Figure 1. S&P 500 Trailing P/E vs. 10YY, by Decade



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Source: Citi Research, Bloomberg

Figure 2. S&P 500 Trailing P/E vs. 10YY, Last 60Yrs



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Source: Citi Research, Bloomberg

In turn, our approach has led us down the path of modeling a fair index multiple to pay for a given level of interest rates. We start with the residuals in Figure 2, or the difference between actual index multiples and the 10YY implied index multiple from the regression line. We mapped these residuals to various macro factors to assess if there are factors that drive investors to pay more/less for a dollar of earnings historically, for a given level of interest rates. This framework is not perfect but does help partially explain divergences in cross asset valuations over time.

This residual model starts with the 10YY implied P/E and adjusts to a FV P/E range based on the macro factors below. Mainly, we found that for a given level of 10YY, the fair index multiple to pay increases with stronger one year forward earnings growth expectations, higher trend GDP growth, declining short term interest rates, positive curve slope, stable inflation and dollar regimes, and lower credit spreads.

Figure 3. Citi S&P 500 Fair Value Adjustment Factors

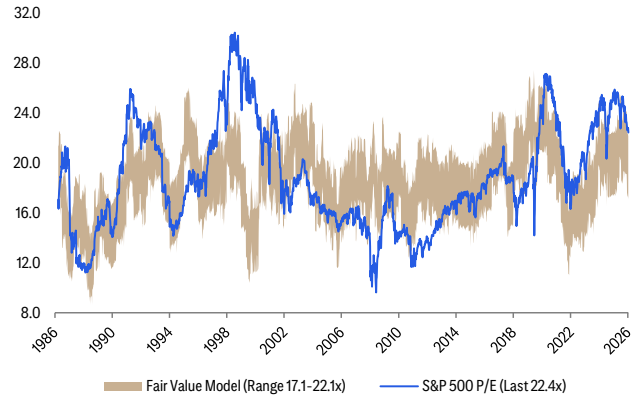
Model Base		
Long-term linear regression of S&P 500 trailing P/E vs. 10-year Treasury yield		
Residual Macro Variable	**Upward P/E Revision Level**	**Downward P/E Revision Level**
1Y Forward EPS Growth	> +15%	< -10%
CPI (YoY)	+2% to +3%	> +3%
1Y Change in CPI (YoY)	< +2%	> +2%
10Y Annualized Real GDP Growth	> +3.5%	< +2%
1Y Change in 2Y Treasury Yield	< -100bps	> +100bps
Moody's Baa Corporate Yield Spread	< 150bps	> 250bps
NY Fed Recession Probability Next 12Mo	< 25%	> 25%
2s10s US Treasury Yield Slope	0bps to +100bps	< 0bps
1Y Change in US Dollar Index	0% to +10%	< 0% or > +10%
6Mo Change in US Dollar Index	0% to +5%	< 0%

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This framework does not fully explain index multiples but does a better job than purely focusing on interest rates. After the recent backup in interest rates following

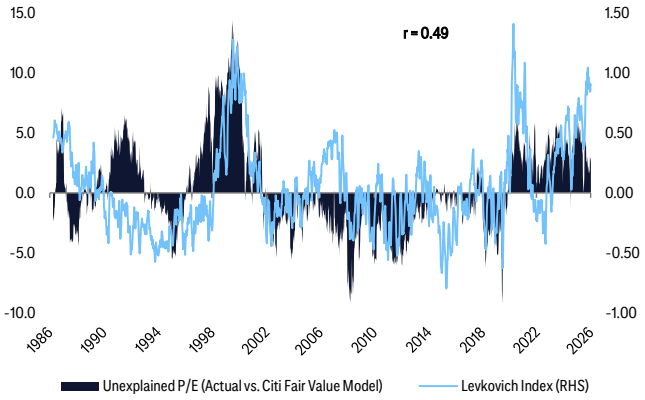
Jackson Hole, our fair value multiple range has pulled back, and index valuations sit above the top end of the FV range. Figure 4. A large part of this delta is the euphoric sentiment backdrop. If we look at the remaining unexplained portion of index valuations relative to our FV model implied multiple (midpoint of the range), the delta does stack up well against sentiment indicators such as our Levkovich Index. Figure 5. Thus, it is entirely possible that the cross-asset valuation imbalance today is simply a function of stretched sentiment or complacent positioning rather than rational resilience.

Figure 4. FV P/E Range vs. Actual Index Multiples



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Source: Citi Research, FactSet, Bloomberg, Haver Analytics

Figure 5. Unexplained P/E vs. Levkovich Index



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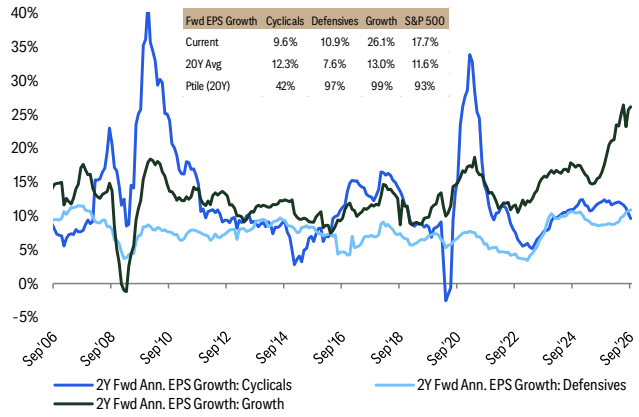
Cluster Insights

While the above is justifiable, we are cognizant that our models are not perfect and there may be more to the story. It is clear from our work thus far that some cross asset valuation imbalance is warranted if there is strong confidence in an above trend forward earnings growth trajectory. Undoubtedly, AI tailwinds are causing a portion of this cross-asset valuation imbalance. Whether or not this persists is a different question but there is an element of rational euphoria in the fear of missing out on unknown payoffs from transformational technology.

Still, index construction has evolved over the decades such that the S&P 500 is much more reliant on the "growth" component than it had been, say, 30 years ago. Per Figure 6, two-year forward earnings growth expectations are in the top decile for the Growth cluster. Concurrently, Figure 7 shows that the Cyclicals and rate sensitive Defensives portions of the market have in fact drawn down significantly alongside the recent backup in rates post Jackson Hole.

Thus, we would argue that, under the index surface, there is rational behavior whereby parts of the index conventionally impacted by rate direction are trading as one would expect while the earnings growth tailwinds of a significant portion of the index are less impacted, for now. Of course, this muddies conventional thought on cross asset behavior.

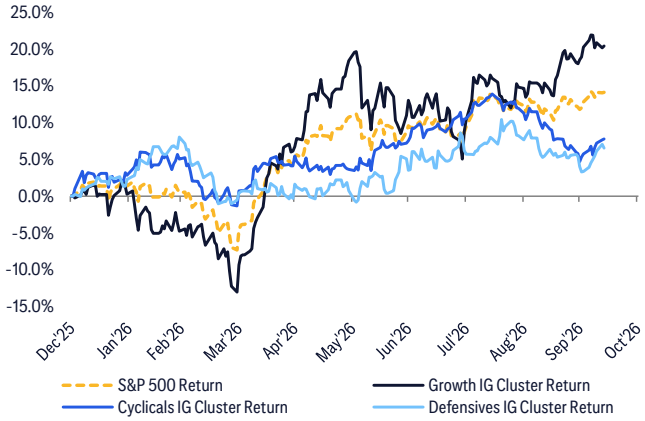
Figure 6. 2YR Fwd Earnings Growth CAGR by IG Cluster



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Source: Citi Research, Bloomberg, FactSet

Figure 7. YTD IG Cluster Performance



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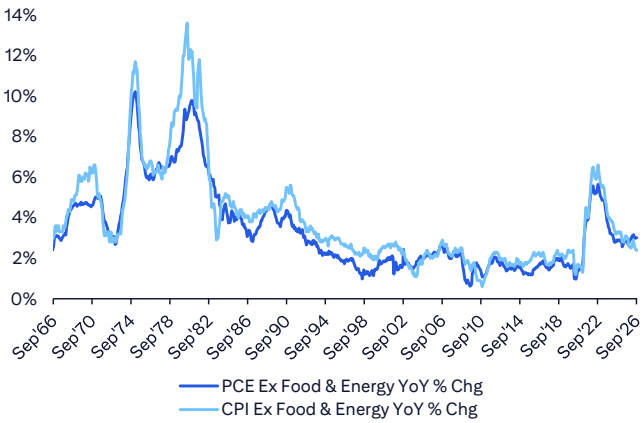
Source: Citi Research, Bloomberg, FactSet

Macro Matters

It is also possible that the backup in rates is being driven by more confidence in a strong macro backdrop that is not being picked up in our model adjustment factors but would warrant higher conviction in the forward earnings growth path and a higher fair multiple as result.

Among the host of indicators we track which have strong connections to index earnings, the picture does not suggest an overheated economy that warrants higher long end real yields and multiple hikes from the Fed. A subset of macro factors below paints a picture of neither an overheated nor a soft macro backdrop. This does not appear to be a primary driver of the cross-asset valuation imbalance. Rather, it would seem to lessen concerns of a new Fed rate hike cycle. Of course, we're still left with navigating an evolving Fed policy backdrop but it does open the door for a shifting market commentary on eventual rate impacts. As an example, the mid-90's analogy is becoming more frequent in client conversations, particularly as we move further away from the post-GFC dynamics.

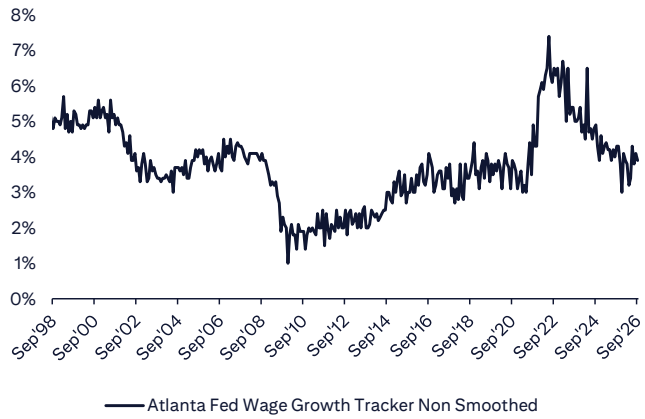
Figure 8. Core CPI & PCE



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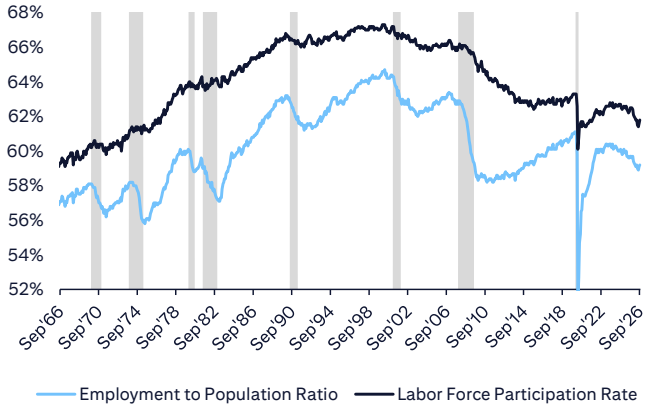
Figure 9. Wage Growth (Atlanta Fed)



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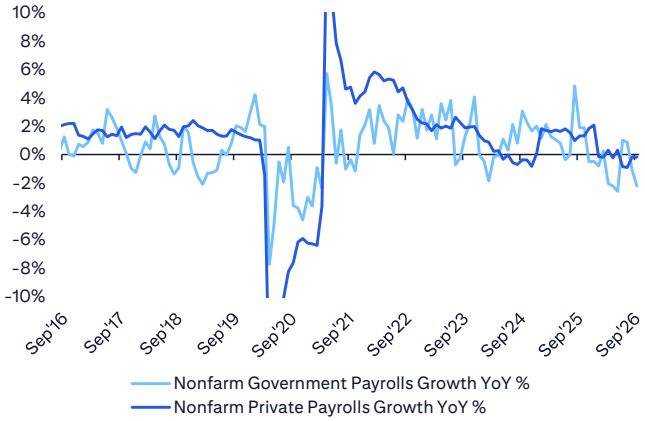
Figure 10. Employment to Population & LFP Rate



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Source: Citi Research, Haver Analytics

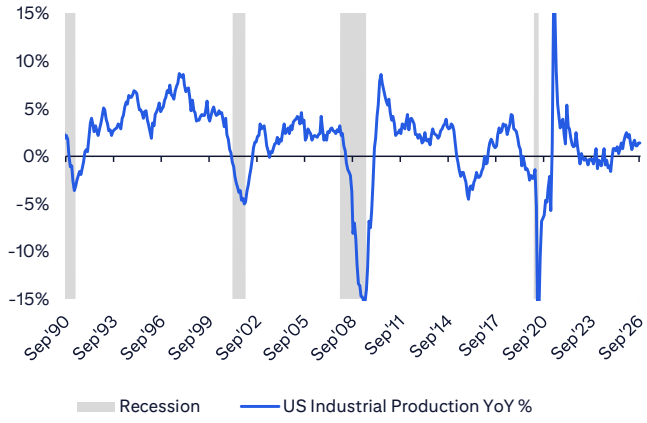
Figure 11. Private & Gov Payroll Growth



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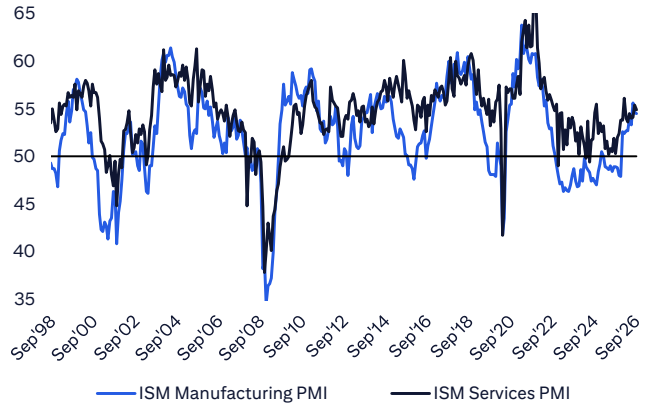
Figure 12. Industrial Production Growth



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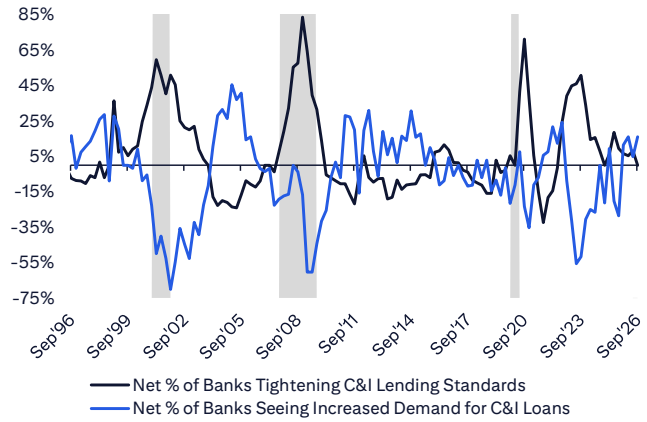
Figure 13. ISM Manufacturing & Services PMI



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Source: Citi Research, Haver Analytics

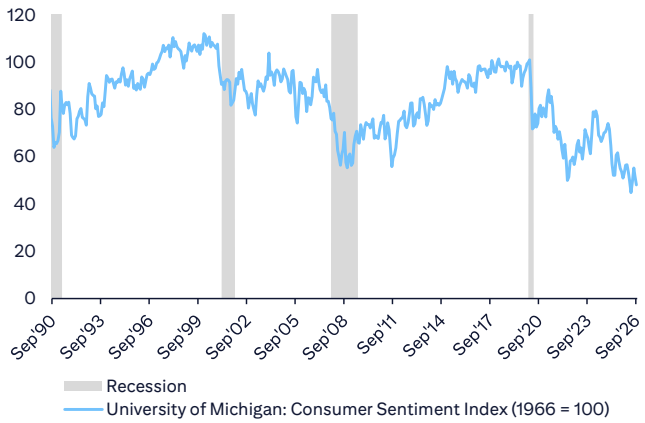
Figure 14. Net Tightening of C&I Lending Conditions



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Source: Citi Research, Haver Analytics

Figure 15. UMich Consumer Sentiment



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Equity Culture? Or A New Clearing Rate?

The supply side of the equation is something our framework doesn't consider and this could be an influential factor driving the delta between the fair index multiple and actual index valuations following this recent backup in rates. Treasury issuance continues to fund the deficit, while corporate debt issuance to finance the AI infrastructure buildout has added its own storyline.

If rates are moving higher because of deficit/Treasury & Corp debt issuance pushing term premium higher, our current framework would push the fair index multiple lower. In practice, with the coming wave of credit supply well telegraphed, we don't see the reason for an immediate response in lower equity multiples. Rather, the price/yield of Treasuries and Corporates needs to adjust to a level high enough to entice investors to sell equities and take down the bond issuance. While a real issue, it doesn't directly play into the conventional rate to multiple and cross asset discussion. Of course, this ignores the corresponding wave of equity supply which we leave for a different discussion.

In other words, supply factors are forcing cross asset valuations to balance at a new clearing rate. With finite shelf space in the holistic investor portfolio, incremental fixed income supply needs higher rates to justify more shelf space. This is difficult to do when earnings growth and sentiment related to equities is as constructive as it seems to be currently.

To be clear, we don't have our heads buried in the sand. But what we are suggesting is that if rates continue to move higher on supply concerns, we may not see the sharp de-rating and index drawdown that we saw in '22. Rather, equity valuations cap out and drift lower as each incremental investor weighs the decision tree as to whether rates are high enough to justify an equity to fixed income allocation shift. It is likely that this began at 5% on the 10YY and continues in tranches corresponding with psychological yield levels 5.5%/6%/etc. 10YY until a new cross asset valuation equilibrium is met.

The important factors here that differ from historical compares are that the AI sentiment/FOMO/elevated out year earnings growth expectations may make it more difficult to convince investors to dial back their equity exposure in favor of bonds. Additionally, financial advisors have had to justify offsides fixed income holdings made in '22, while defending subpar returns YTD. Thus, there is likely some hesitation in recommending an upsize to fixed income allocations when their clients may be questioning why they have owned bonds at all for the last 5yrs, relative to equities.

In our view, those easiest to convince to dial back equities at this juncture in favor of bonds are the 55+ cohort of near retirees, and the US pension funds that have ridden the bull market in equities over the last few years and now find themselves in a compelling place to dial back risk and immunize liabilities.

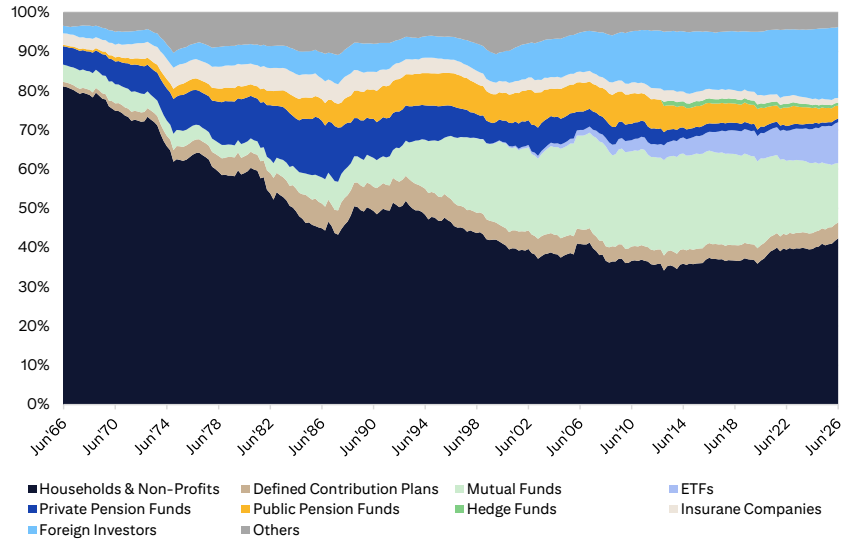
Equity Ownership Trends

Here, it is prudent to take a step back and understand the ownership profile of US equities and the relative size of the cohorts that may be important for finding this new cross asset balance.

Notably, private and public pension funds in the US have become less relevant to equity ownership. Foreign investors provide an interesting offset. While ETF growth has been significant, it still mostly relates to direct or indirect retail investor

participation as it has run counter to mutual fund ownership. Hedge funds don't matter much as to overall equity ownership although they may matter a lot to shorter term trading dynamics.

Figure 16. US Equity Ownership by End Investor Type



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Source: Citi Research, Federal Reserve Bank

Now the chart above is interesting as we can see two main regime changes in the ownership profile of US equities over time. Important to note is that these categories essentially roll up to three distinct end investor portfolio decision makers.

First, individual US households via their direct equity holdings, their direct equity holdings within Defined contribution plans, and their indirect equity holdings via household mutual fund and ETF holdings. Here we have either an individual US investor or a financial advisor controlling the asset allocation mix for the end investor. As we discuss later, a regime change over time for this cohort is that an increasing portion of these assets are price insensitive when it comes to cross asset valuations.

Second, US Public (Gov) and Private (Corp) pension funds where the fund manager is the decision maker shifting the asset allocation based on the funding status and required return hurdle for each individual plan. Here, the ownership imprint of this group has dwindled as the US retirement market has gone through a regime change, structurally shifting the risk from defined benefit to defined contribution plans. While the equity ownership imprint of this group has shrunk, this cohort is still capable of making large asset allocation shifts in response to cross asset valuation imbalance.

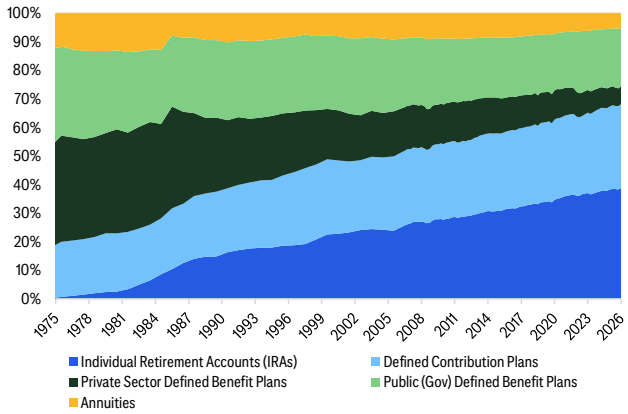
Third, Foreign investors which have grown over time to be an important ownership group in aggregate. Here there is largely a defined benefit structure where Sovereign Wealth and Pension fund managers are the decision makers, with asset allocation mix influenced by a multitude of factors, some unique and others overlapping with the US DB plans. Here this group may be responsive to cross asset valuations at some level but the overarching trend in recent years has been this

cohort increasing US equity allocations relative to US fixed income and this trend does not appear to be slowing down.

Our aim here is to explain why the regime changes in the ownership groups highlighted above may contribute to the weaker cross asset valuation connection observed in Figure 1 since the turn of the century.

We start with the structural US retirement market shift from US DB to DC plans. This has been ongoing and is mainly a function of corporate DB plans being phased out in favor of 401ks, moving the retirement shortfall risk off of company balance sheets to individual retirees. Figures 17 and 18.

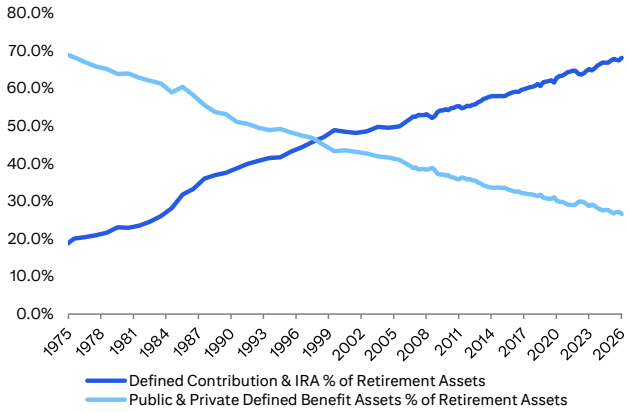
Figure 17. US Retirement Market Composition Shift



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Source: Citi Research, ICI

Figure 18. Defined Benefit to Defined Contribution Shift



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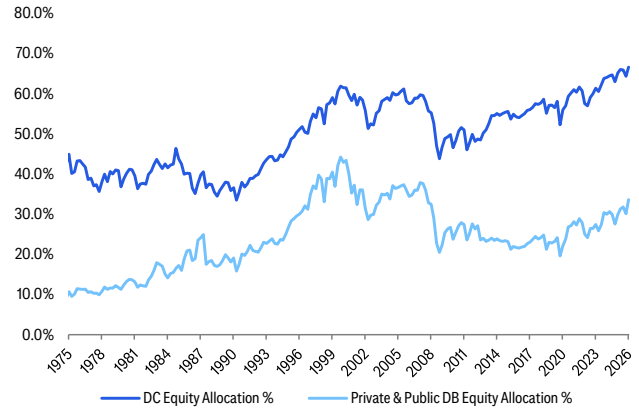
Source: Citi Research, ICI

This has effectively pushed equity allocations higher over time for the end investor. The DB plans had lower equity weights relative to fixed income than the average individual investor. In turn, as dollars have linearly transitioned from DB to DC over time, the cross-asset demand has shifted, in aggregate, from fixed income to equities.

Importantly, connecting Figure 18 above to Fig 1, it jumps out to us that the interest rate to equity multiple connection broke down in Fig 1 at the turn of the century, coinciding with the point in Fig 18 when DC & IRA assets overtook DB assets in the US.

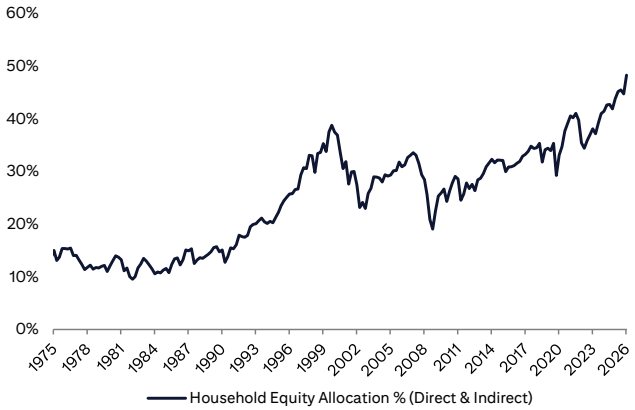
The evolving story related to this is as to the current state of equity allocations. Figure 19 points to higher equity allocations for each of DC and DB, with DC reaching new highs. DB has been steadily increasing during the post-Covid timeframe. In both cases, equity outperformance has likely contributed to this. Still, per Figure 20, it is quite apparent that overall Household Equity allocations have reached multidecade highs. Our take is that this reflects an ongoing "equity culture" bias which is increasingly ingrained in investor psyche.

Figure 19. DB & DC Equity Allocations



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Source: Citi Research, Federal Reserve Bank

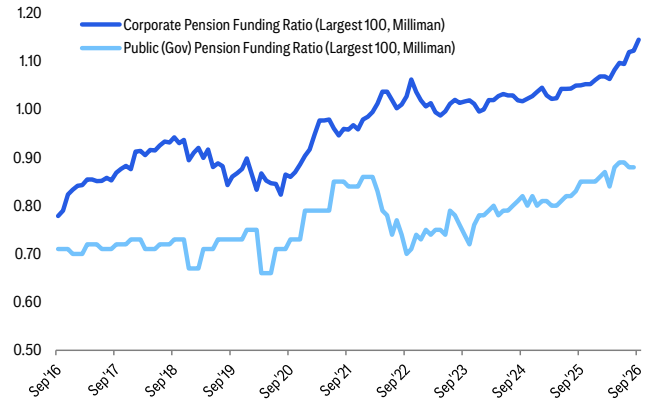
Figure 20. Household Equity Allocations



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Source: Citi Research, Federal Reserve Bank

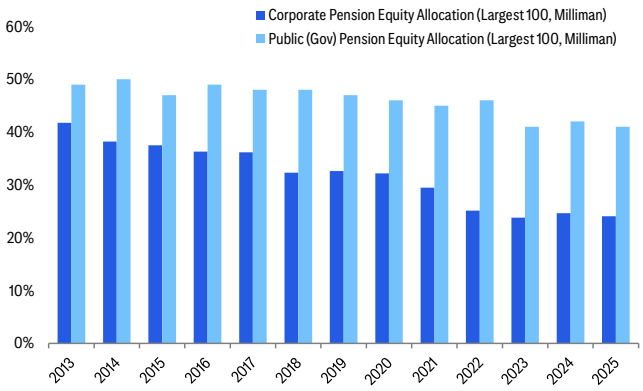
We hypothesize that the shift from DB to DC plans should have resulted in higher equity valuations for a given level of interest rates. But now, after the degree of equity market outperformance relative to fixed income in recent years, DB pension funds, both corporate and gov, have seen their funded ratios improve markedly (Figures 21 and 22). With modest equity allocations and the equity outperformance relative to the backup in rates, their asset values have increased relative to the discounted liability projections, pushing funded ratios to decade-plus highs. Typically, equity allocations decline in this space after an improvement in funded status, particularly if rates are high enough to begin immunizing liabilities. Some level of equity exposure will remain to hedge inflation risk imbedded in liabilities, yet it is rational to expect this cohort in aggregate to dial back equity risk, nudging up the fixed income allocation in the portfolio. Still, the point is that this is a declining portion of aggregate equity ownership, thus making its cross-asset decisions less impactful as time passes.

Figure 21. Corporate & Public (Gov) Pension Funding Ratio



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Figure 22. Corp & Public (Gov) Pension Equity Allocations



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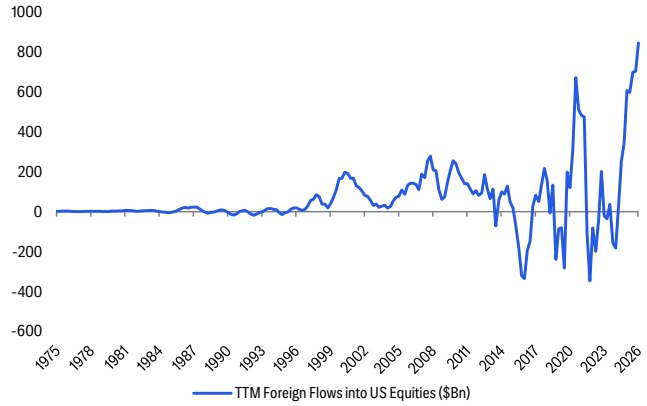
Sovereign wealth funds are another potential source of funds for an equity to fixed income allocation shift, yet this would run counter to the trends in allocations for this group over the last few years where they have been consistent buyers of US

equities. Here we look at all foreign holdings of US securities from the Z1 data and their relative weights through time against recent flows. Figure 23 reflects a fascinating ROW flow picture over the past couple of years. Per Figure 24, a related story is one of increased equity allocation but at the expense of Fixed Income.

This supports the ongoing "equity culture" narrative which seems to be at work more broadly. Our view is that the upticks in interest rates experienced of late are probably not sufficient to cause a change in that sentiment. Rather, it may take a more prolonged period of equity underperformance.

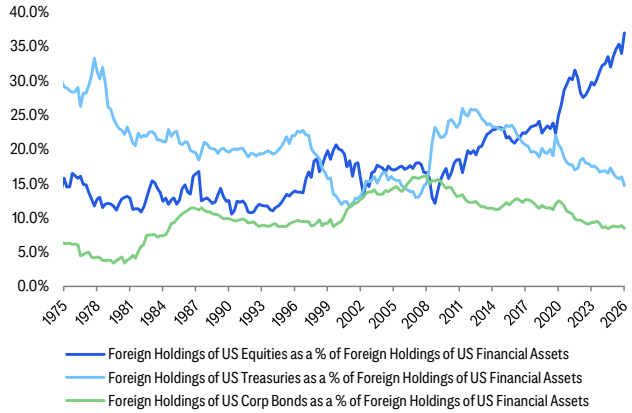
At the same time, this does beg the question as to who is the incremental buyer of US equities? There is no easy answer to this from a traditional stock vs bond perspective.

Figure 23. Rest of World Flows into US Equities



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Source: Citi Research, Federal Reserve Bank

Figure 24. Rest of World US Asset Mix

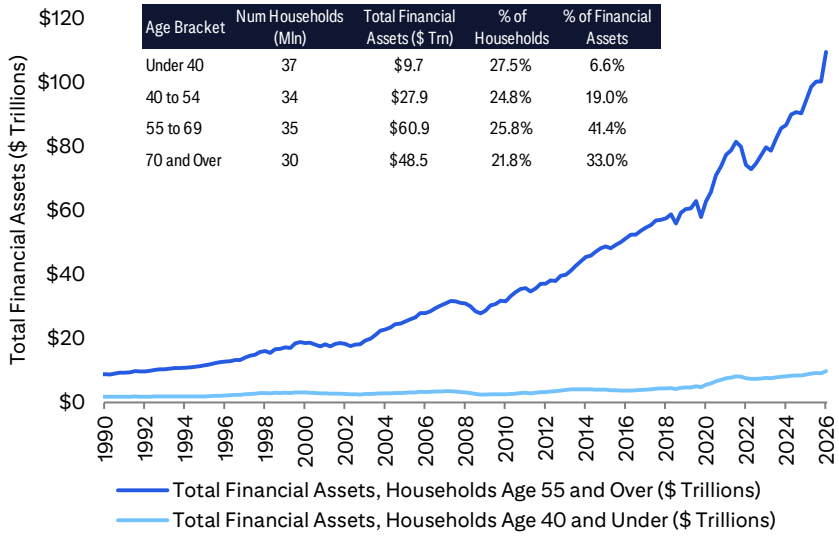


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Source: Citi Research, Federal Reserve Bank

A closer look at the US household investor cohorts by age provides another level of insight. Investors over the age of 55 hold about 75% of the financial assets of US households. So, this demographic is very important in terms of assessing the stock vs bond allocation discussion. Hereto, our general takeaway is that the equity culture angle may be somewhat self-reinforcing but predicated on equity outperformance.

Figure 25. Household Financial Assets: Age Under 40 vs. 55+

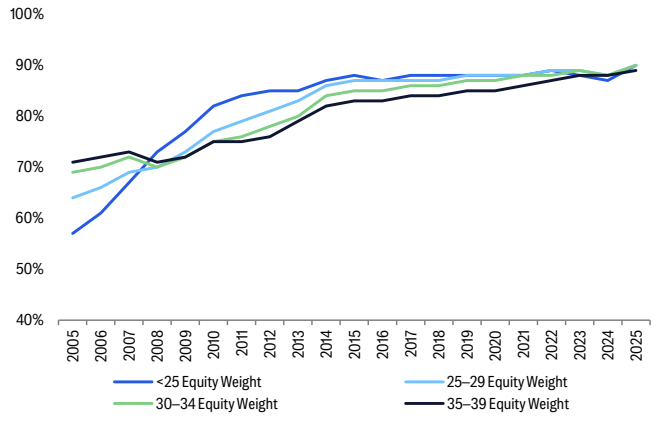
Age Bracket	Num Households (Mln)	Total Financial Assets ($ Trn)	% of Households	% of Financial Assets
Under 40	37	$9.7	27.5%	6.6%
40 to 54	34	$27.9	24.8%	19.0%
55 to 69	35	$60.9	25.8%	41.4%
70 and Over	30	$48.5	21.8%	33.0%



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Source: Citi Research, Federal Reserve Bank

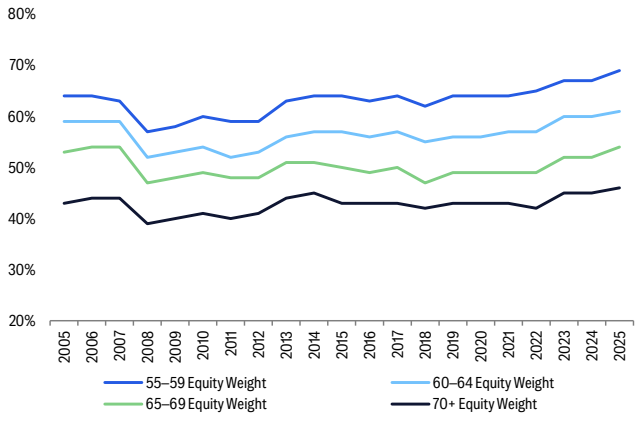
The under 40 aged cohort is increasingly tied to Defined Contribution. Figure 26. As we'll describe below, a very high equity allocation seems well ingrained, and part of this is due to the increasing usage of target date funds in DC plans. For the 55+ cohort, equity allocations are stratified. But this is not a surprise as the focus on income generation increases with age. Yet, even here, equity allocations have been moving higher in the post-Covid timeframe albeit clearly influenced by equity returns.

Figure 26. Historical DC Equity Allocations Age Under 40



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Source: Citi Research, Vanguard "How America Saves 2026"

Figure 27. Historical DC Equity Allocations Age 55+

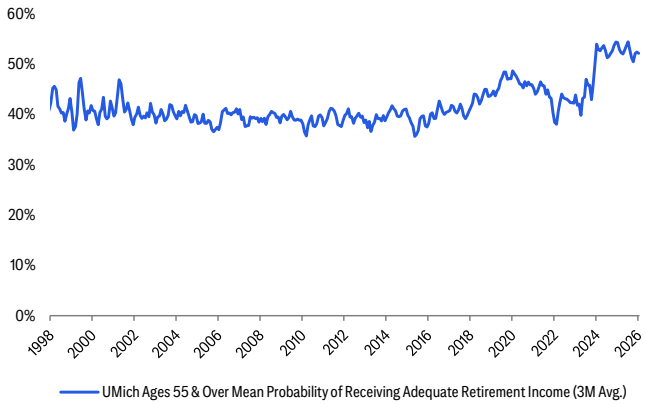


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Source: Citi Research, Vanguard "How America Saves 2026"

UMich survey data generally supports the equity culture mindset as stronger equity markets have provided some comfort for the 55+ component in reaching retirement security. Similar to the dynamic of US DB plans reaching a healthier funded status, it is possible that as the 55+ cohort gets more comfortable in their retirement security, they could become an influential source of equity to fixed income allocation migration. Yet, UMich data also shows that the 55+ age group

increasingly expects interest rates to be higher a year from now, alongside persistent confidence in equity returns. Here we conclude that an expectation for higher interest rates would likely be a disincentive to aggressively shift allocations from stocks to bonds, as investors await higher yields.

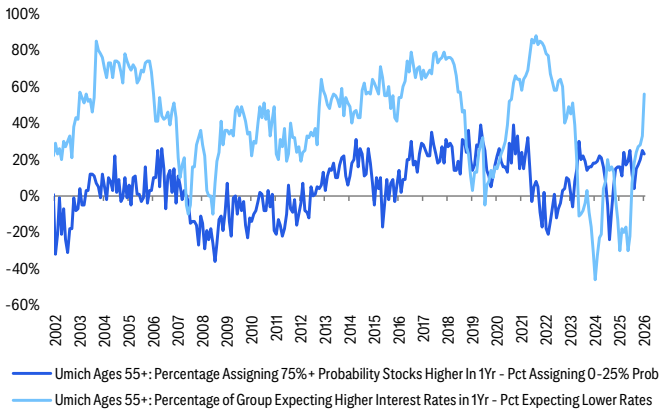
Figure 28. UMich Adequate Retirement Probability: Age 55+



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Source: Citi Research, Bloomberg

Figure 29. UMich Stocks & Interest Rates Outlook: Age 55+



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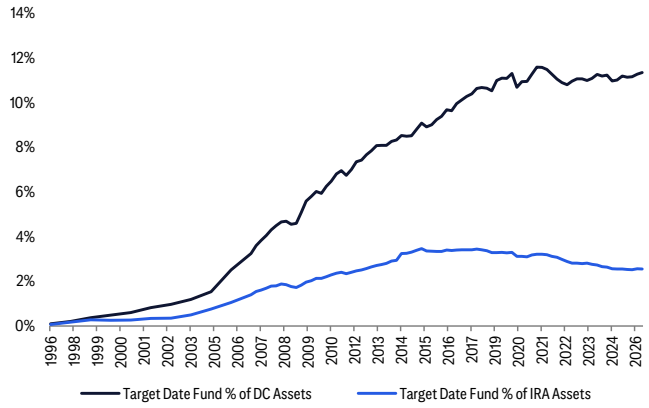
Source: Citi Research, Bloomberg

A subtle implication of the shift from DB to DC is as to how DC funds are deployed. The data shown in Figures 30-31 points to a fascinating situation where Target Date funds become an important aspect of this asset class discussion.

The observation here is that more of the younger cohort defaults to Target Date funds for deploying DC monies. Yet, the nature of Target Date asset allocation is that it skews in favor of equities for these investors. The critical point of this refers back to the shift away from DB and toward DC. Implicit in this is an equity bias relative to the conventional approach to stock vs bond allocations in the traditional pension fund/DB models, which on the margin has made the aggregate investor less price sensitive to cross asset valuation imbalance.

This supports our contention that the underlying evolution of retirement investing has lessened, if not negated, the conventional discussion on equity vs fixed income allocation shifts tied to interest rate considerations.

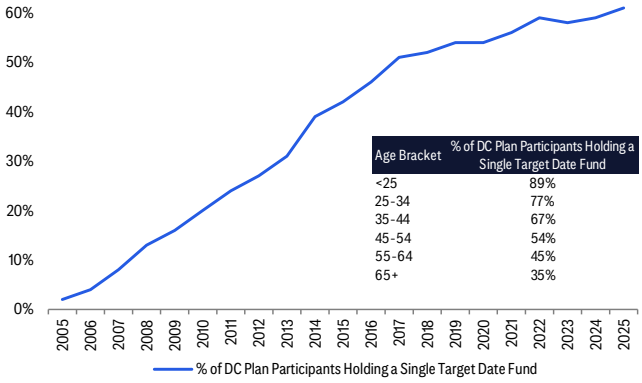
Figure 30. Target Date Fund Assets % of DC & IRA Assets



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Source: Citi Research, ICI

Figure 31. Percentage of DC Plan Participants Invested in a Single Target Date Fund



Age Bracket	% of DC Plan Participants Holding a Single Target Date Fund
<25	89%
25-34	77%
35-44	67%
45-54	54%
55-64	45%
65+	35%

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Source: Citi Research, Vanguard "How America Saves 2026"

In conclusion, this analysis has influenced our thinking that the interest rate connection to both valuations and asset allocation shifts may be less than conventionally expected. For example, there may not be an interest rate level that will alter a target date allocation for younger cohorts. Thus, we do not see a magic interest rate level which will necessarily trigger a rotation out of stocks and into bonds. This also lessens the concern of higher interest rates implicitly tied to lower multiples. So, the default interest rate concern is ultimately tied to the impact on economic conditions and, thus, fundamental trajectories. Thus, the good news is that the equity culture which has unfolded in the post-GFC timeframe is well ingrained. The not-so-good news is that it opens the discussion as to where the marginal buyer of equities comes from, while putting ongoing pressure on equity returns and earnings growth to support sentiment.

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