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Marketing Material

DEFENSIVE STOCKS ARE FIRST TO BENEFIT FROM SECULARLY LOWER TREASURY YIELDS

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IN A NUTSHELL

_ Key global and U.S. benchmark long-term yields have dislocated downward.
_ Theoretical and observed effect of lower Treasury yields on stocks is clear.
_ It is clear if you sort through the many issues intertwined with interest rates.
_ Equity principles: A cyclical drop in yields is bad, but a secular drop is good.
_ Defensive stocks benefit first when investors accept secularly lower yields.
_ We advise to seek municipal and corporate credit, private and listed bond-proxy equities.

KEY GLOBAL AND U.S. BENCHMARK LONG-TERM YIELDS HAVE DISLOCATED DOWNWARD

Long-term interest rates have been declining since late last year and gapped down last week to what are essentially all time U.S. record lows. Treasury yields are about 2% at 30-year, about 1.5% at 10-year, and 10-year Treasury TIPS (Treasury Inflation-Protected Securities) are about 0%. We consider the recent further leg down in yields to be cyclical in nature, albeit less an indicator of recession, but still an indicator of slower global and U.S. economic growth and a very challenging environment for earnings growth, or a profit recession. But with this further drop in global yields, we now consider secular yields or normal yields to be lower than we previously thought. We now consider a roughly 2% 10-year yield to be normal and unlikely to materially exceed 2.25% for the next several years, with inflation at roughly 2%, so a normal 10-year TIPS yield at or barely over 0%. We were using 5.25%-5.5% for S&P 500 real cost of equity (CoE), we now drop that to 5.0%-5.25%. This CoE is 0-100 basis points (bps) 10-30 year real-risk-free rates plus 400-500bps equity risk premium.

THEORETICAL AND OBSERVED EFFECT OF LOWER TREASURY YIELDS ON STOCKS IS CLEAR

The old investor debate about how interest rates should affect equities has returned to the forefront once again as 10 to 30-year Treasury yields are at record lows despite 10+ years of record long U.S. economic growth and 50-year low U.S. unemployment, when so far no incoming economic report suggests the U.S. is in or on the verge of a recession. However, we have long argued that there is actually little mystery to how changes in long-term yields should and actually do affect stocks, including price-to-earnings ratios (P/Es).

IT IS CLEAR IF YOU SORT THROUGH THE MANY ISSUES INTERTWINED WITH INTEREST RATES

The complexities of this debate and in empirically validating the related theoretical concepts, generally come from having to separate the many intertwined issues: 1) separate overnight interest rates and U.S. Federal Reserve (Fed) actions from long-term yields, in this note we focus on long-term Treasury yields, because how Fed actions affect equities usually depends on whether such actions are seen as being "ahead of or behind the curve" (i.e. relative to likely economic conditions); 2) separate nominal from real long-term yields, this spurred many controversies in the late 1970s into the 1980s, which required an accompanying examination of economic health, earnings quality and effective-equity-return taxation to more fully understand the dynamics at play, as high inflation does indeed compress P/E multiples even if real yields are fairly steady; 3) separate cyclical changes in real Treasury yields from secular changes, as cyclical changes presage economic swings and will eventually reverse and offset over time, whereas

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secular changes in real yields relate to longer-term forces like inflation risk premiums, the savings pool or affluence relative to the demand on the savings pool to fund "green field investment spending" (i.e. the creation of new-income-producing assets). But separating cyclical from secular changes in real Treasury yields is only clear in hindsight after the passing of time and cycles; and strict "mean reversion" adherents find the idea of secular changes in long-term real interest rates unsound.

EQUITY PRINCIPLES: A CYCLICAL DROP IN YIELDS IS BAD, BUT A SECULAR DROP IS GOOD

As discounted-cash-flow models demonstrate, a lower real cost of equity raises intrinsic value. But disciplined investors resist large or quick changes to their cost of capital estimates and when made, especially when lowering, are best done incrementally to acknowledge the uncertainty and risk. We believe investors should be sticky with their cost of capital assumptions, especially on the combined very long-term real-risk-free rate and estimated risk premium (consistent inflation within cost of capital and growth estimates will offset any direct effect on intrinsic value).

DEFENSIVE STOCKS BENEFIT FIRST WHEN INVESTORS ACCEPT SECULARLY LOWER YIELDS

When investors accepted secularly lower real interest rates in the past (1986-89, 1996-99, 2012, 2016) the benefit was observed to cascade through markets first in low risk assets like corporate credit, then to defensive stocks, then to growth stocks, and lastly, if any, to cyclical stocks. Financials benefit last, if ever. The period of falling yields in 2006 to 2007, witnessed strong performance from global cyclicals, but this came with a robust global economy and high commodity prices and related capital expenditures (capex).

We make our first and largest cuts (50bp) to our real S&P 500 CoE estimates at defensive sectors, where earnings-per-share (EPS) risk from forces causing cyclically lower yields is the least. We make smaller cuts (25bps) to the stable growth sectors and we leave our real CoE estimates unchanged at the more global, trade-sensitive and highly cyclical sectors. S&P 500 real CoE 5.5 to 5.25%: Utilities, Real Estate Investment Trusts (REITs) 5.0 to 4.5%; Healthcare, Staples 5.25 to 5.00%; Communications, Tech, Consumer Discretionary 5.25% to 5.00%. No changes at Energy, Materials, Industrials, Financials until more clarity on their EPS growth the rest of this cycle. We estimate 2019 end S&P 500 fair intrinsic value at 3000, we expect the S&P 500 to trade at 5% to 10% discount to this value until macro risks subside.

WE ADVISE TO SEEK MUNICIPAL AND CORPORATE CREDIT, PRIVATE AND LISTED BOND-PROXY EQUITIES

We reduce equity allocation again to 52%.

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GLOSSARY

Basis point
One **basis point** equals 1/100 of a percentage point.

Capital expenditures (capex)
Capital expenditure (Capex) are funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment.

Defensive stocks
Defensive stocks are stocks from companies whose sales are expected to fluctuate less than the market average as the demand for their products are less tied to business cycles.

Discounted cash flow (DCF)
Discounted cash flow is a method used to gauge the value of a company by finding the present value of projected future cash flows.

Earnings per share (EPS)
Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Growth stocks
Growth stocks are stocks from companies that are expected to grow significantly above market average for a certain period of time.

Inflation
Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Intrinsic value
The **intrinsic value** is the one that comes closest to the value that an objective fundamental analysis would ascribe to an asset.

Nominal
In economics, a **nominal** value is not adjusted for inflation; a real value is.

Price-to-earnings (P/E) ratio or multiple
The **price-to-earnings (P/E) ratio** compares a company's current share price to its earnings per share.

Real Estate Investment Trust (REIT)
Real Estate Investment Trusts (REITs) are companies, mostly listed, that own and often operate various types of real estate. They are obliged to pay out a minimum of 90% of earnings.

Recession
A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

Risk premium
The **risk premium** is the expected return on an investment minus the return that would be earned on a risk-free investment.

S&P 500
The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Treasuries
Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

Treasury Inflation Protected Securities
Treasury Inflation-Protected Securities (TIPS) are a form of U.S. Treasury bonds designed to protect investors against inflation. These bonds are indexed to inflation and pay investors a fixed interest rate as the bond's par value adjusts with the inflation rate.

U.S. Federal Reserve (Fed)
The **U.S. Federal Reserve**, often referred to as **"the Fed"**, is the central bank of the United States.

Yield
Yield is the income return on an investment referring to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

APPENDIX: PERFORMANCE OVER THE PAST 5 YEARS (12-MONTH PERIODS)

	07/14 - 07/15	07/15 - 07/16	07/16 - 07/17	07/17 - 07/18	07/18 - 07/19
U.S. Treasuries (2-year)	1.0%	1.2%	0.1%	-0.2%	4.0%
U.S. Treasuries (10-year)	5.3%	8.0%	-3.8%	-2.7%	10.4%
U.S. Treasuries (30-year)	9.8%	17.0%	-9.5%	-1.0%	13.1%

Past performance is not indicative of future returns.
Sources: Bloomberg Finance L.P., DWS Investment Management Americas Inc. as of 8/20/19

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