SECOR | ASSET MANAGEMENT

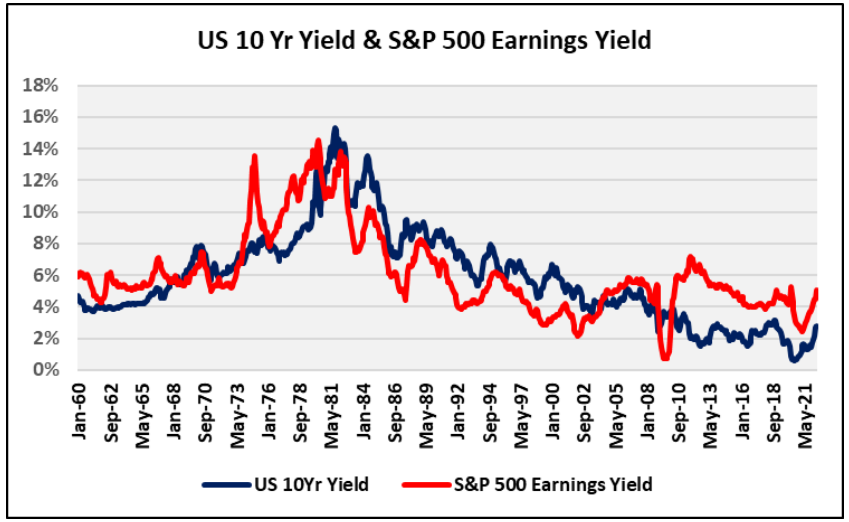
SECOR Asset Management

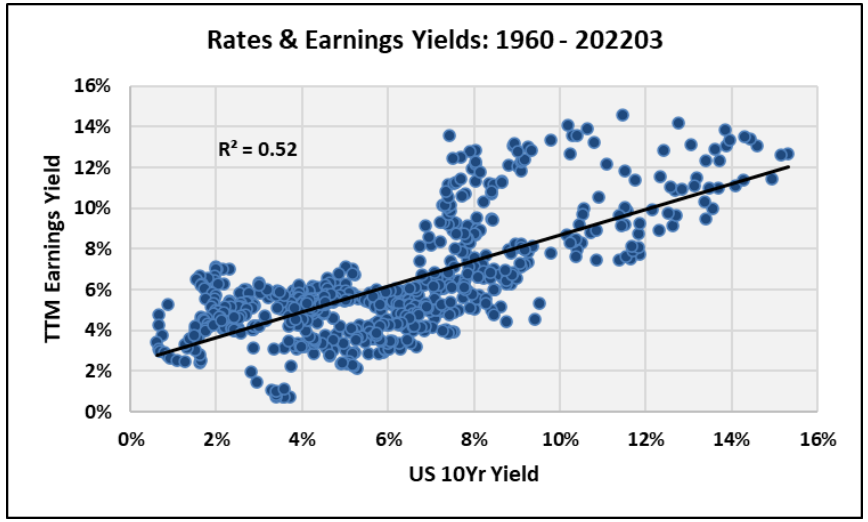
Equity Update

June 14, 2022

Earnings Yields and Rates

- There has been a very strong relationship between the long bond yield and the S&P 500 earnings yield since 1960.



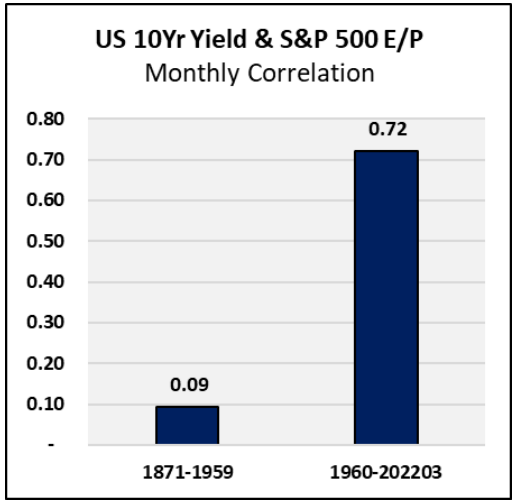


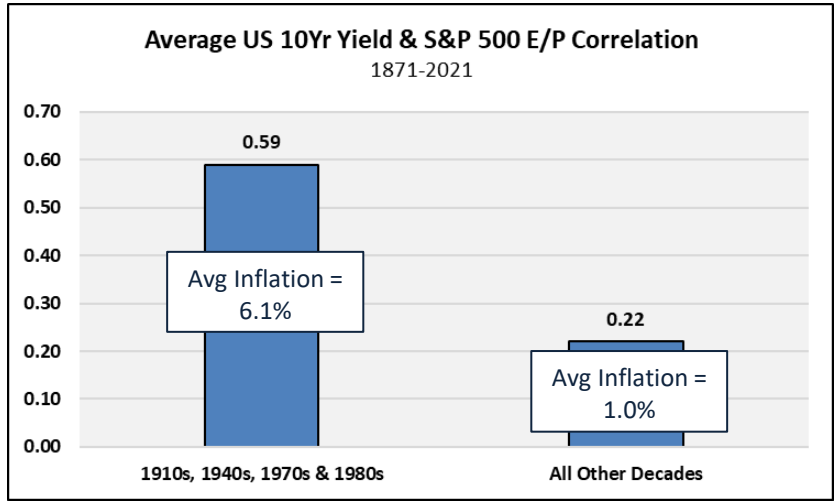
  - The current earnings yield of 5.13% compares to a long bond yield of 3.04%.
  - The spread of 209 bps compares to an average of 21 bps from 1960.
    - The 10Yr yield would have to rise by 188 bps assuming no change in the earnings yield for the spread to revert to average.
    - Or, assuming no change in the US 10Yr yield and in earnings, equity prices would need to rise by 63% for the current spread to revert to average over this period.

Sources: Robert Shiller's Website, www.econ.yale.edu/~shiller/, SECOR.

Earnings Yields and Rates

- Criticisms of the Fed Model:
  - The relationship between interest rates and earnings yields was much weaker in the years before 1960.
  - The Fed Model has exhibited no efficacy in predicting equity returns.
    - 0.01 correlation between the Yield Gap and next 5 years S&P 500 return since 1871.
  - The Fed Model compares nominal bond yields with equity yields that are inflation-adjusted (inflation is passed through to equity earnings and prices).
    - But the highest inflation decades (the 1910s, 1940s, 1970s & 1980s) exhibited the tightest relationship between the nominal US 10Yr Yield and the S&P 500 Earnings Yield.

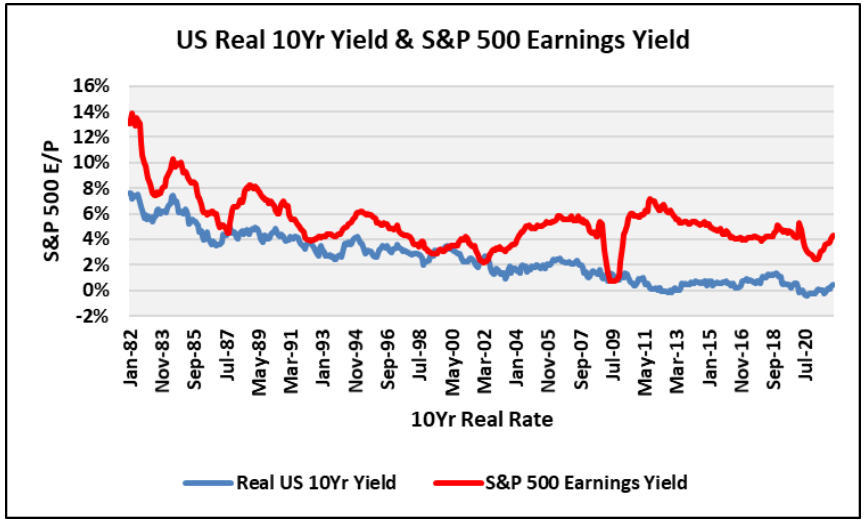


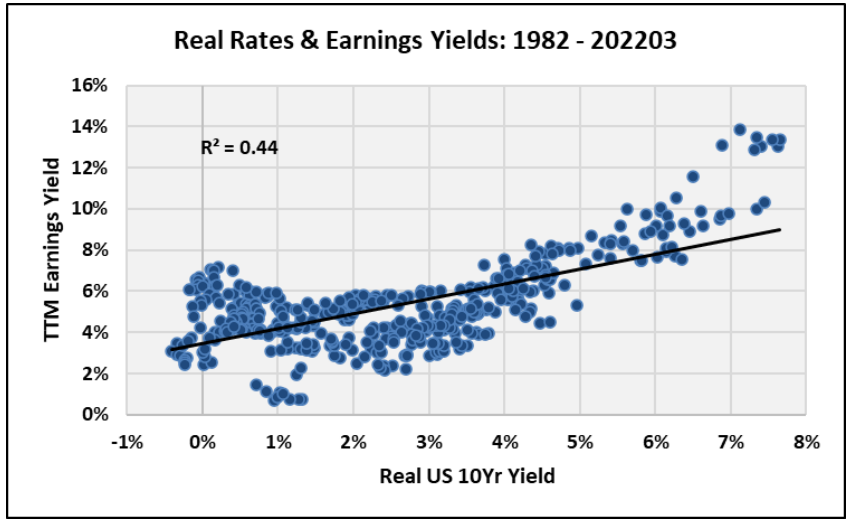


Sources: Robert Shiller's Website, www.econ.yale.edu/~shiller/, SECOR.

Earnings Yields and Real Rates

- The relationship between the real bond yield and the S&P 500 earnings yield has been very similar to that between the nominal 10Yr yield and the earnings yield.



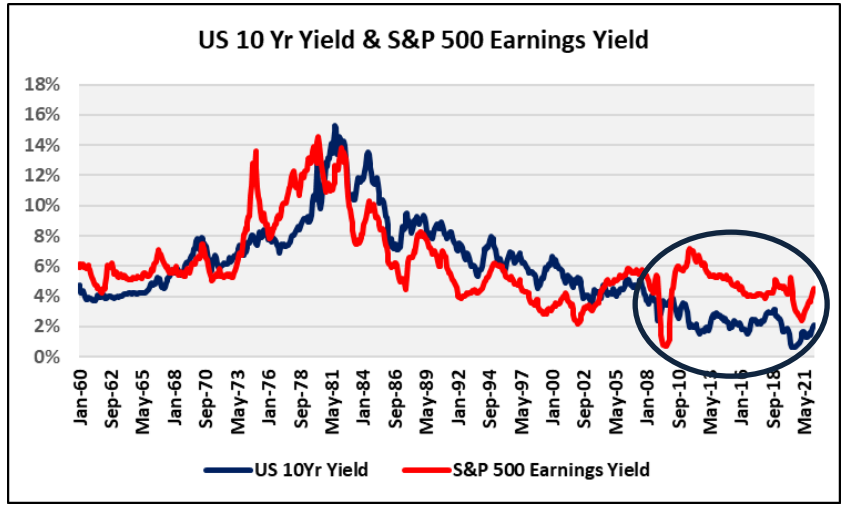


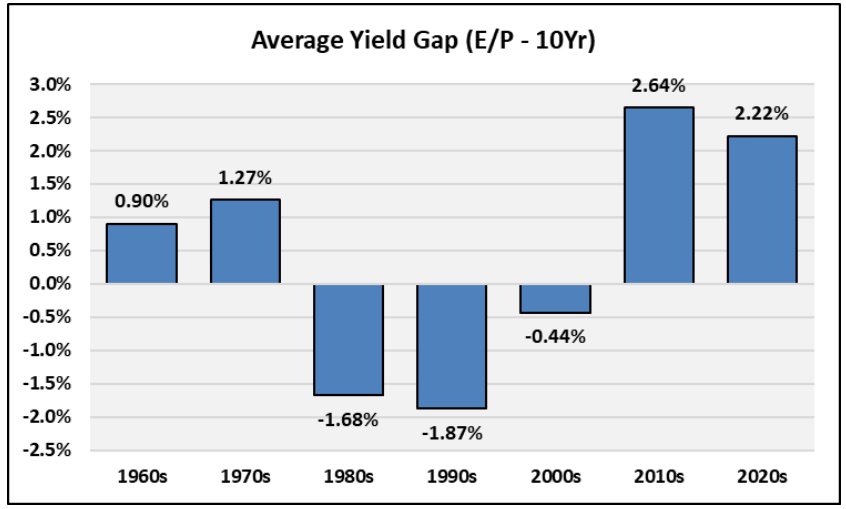
  - The current earnings yield of 5.13% compares to a real long bond yield of 0.28%.
  - The current spread of 485 bps compares to an average of 276 bps from 1982.
    - Real rates would need to rise by 209 bps (with no change in the earnings yield) to 237 bps (compared to an average 10Yr real yield of 249 bps since 1982); or equity prices go up by 59% (with no change in the real 10Yr yield or earnings) for this spread to revert to average since 1982.

Sources: Robert Shiller's Website, www.econ.yale.edu/~shiller/, Federal Reserve Economic Data, Bloomberg, SECOR.

Earnings Yields and Rates

- The last 10+ years have been exceptional relative to the last sixty years with the earnings yield exceeding the nominal long bond yield by more than 200 bps.
  - In the fifty years from the 1960s through the end of the first decade of the 2000s, the average spread was -36 bps.
  - Bond yields handily exceeded earnings yields in the 1980s & 1990s (Stocks for the Long Run by Prof. Jeremy Siegel published in 1994); the yield gap did not turn positive until the era of rate repression following the GFC.
  - The yield gap has resisted converging over the last decade+, but with the apparent end of a multi-decade decline in rates and a Fed intent on fighting inflation, should we now expect convergence?
    - If so, how does that occur? Can today's low absolute level of earnings yield (5.13% vs median 5.4% since 1960) persist while rates "catch up" or will rates rise at faster pace than the earnings yield as stock prices fall? (Or will earnings collapse thereby dragging down the earnings yield?)
    - Shouldn't equity yields be higher than bond yields?
    - What is the "right" level of spread in earnings yield versus bond yield?



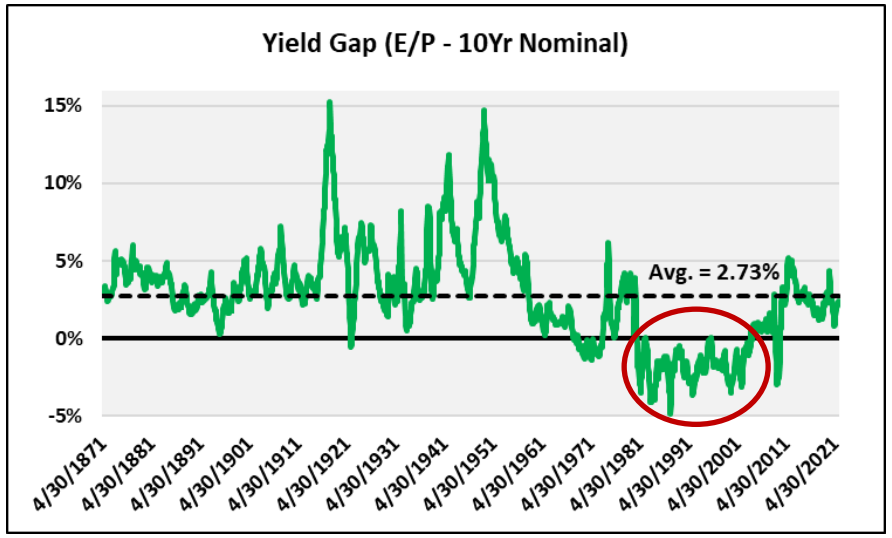


Data as of 10 June 2022.

Sources: Robert Shiller's Website, www.econ.yale.edu/~shiller/, SECOR.

Earnings Yields and Rates

- But over the very long-term, the post-GFC experience of a 2%+ yield gap has been much closer to that of history; the decades of the 1980s and 1990s with negative yield gaps have been the outliers.
  - Instead of convergence, long-term history would suggest further widening in the yield gap from today's 209 bps.
  - Asness[1] asserted that the size of the Yield Gap is a function of the perceived relative volatilities of stocks and bonds.



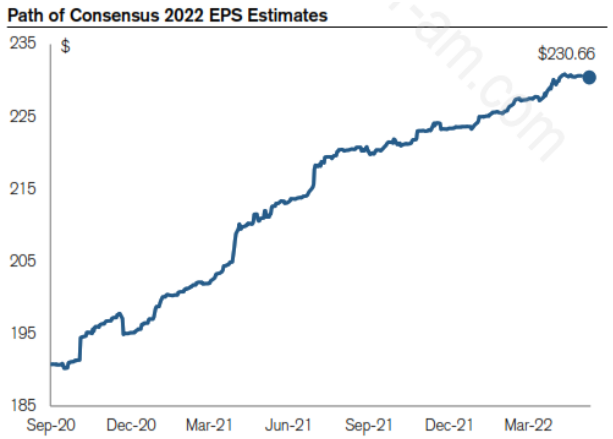
  - A negative yield gap has been extremely rare, occurring most notably during periods of high optimism like the 1980s/1990s and the late 1960s/early 1970s.
  - The Yield Gap spiked to ~15% in the wake of WWI & WWII and averaged ~350 bps in the 1930s following the 1929 crash. Averaged 5.8% from the beginning of WWI in 1914 through the end of the Korean War in 1953.
  - Were the current yield gap to widen to the long-term average of 273 bps, the nominal 10Yr yield would need to fall by 36 bps (to 2.37%) or the earnings yield would need to increase from 5.13% to 5.77%, which implies a further 11% drop in the US stock market from today's (June 10) level.

1) Asness, Clifford S., "Stocks Versus Bonds: Explaining the Equity Risk Premium", *Financial Analysts Journal*, March/April 2000.

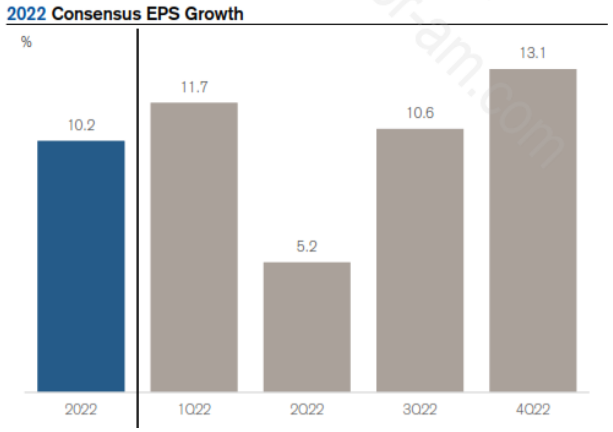
Sources: Robert Shiller's Website, www.econ.yale.edu/~shiller/, SECOR.

2022 S&P 500 Consensus Earnings Estimates

- After a steady drift upwards, consensus 2022 S&P 500 estimates have levelled off.
  - Consensus expectation is for 10.2% earnings growth in 2022.



- As is frequently the case, expectations are more optimistic for the second half despite revisions recently turning negative.



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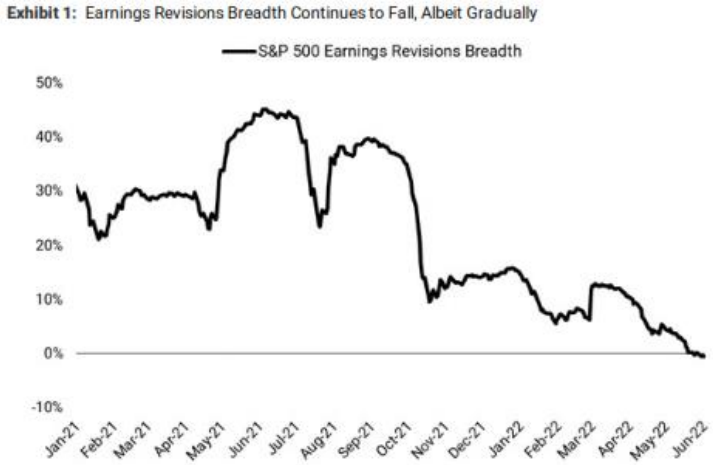
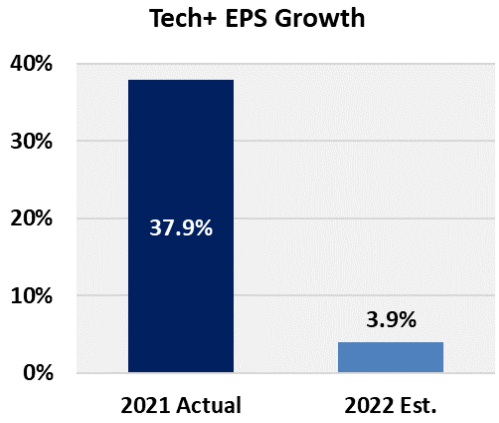


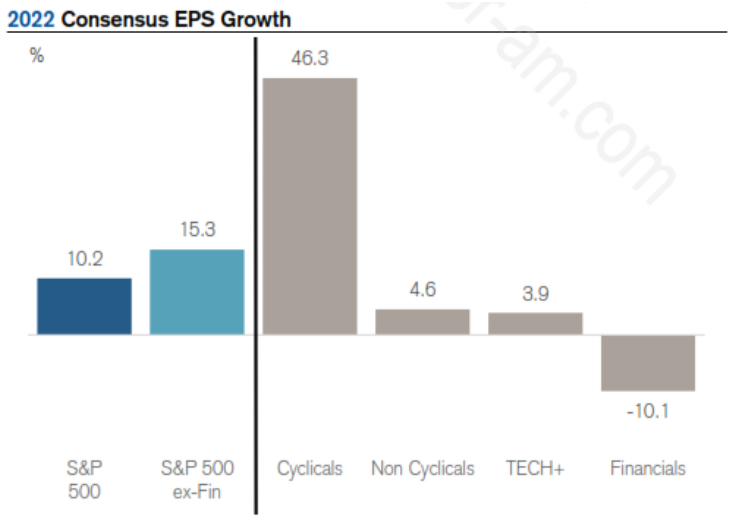
Sources: Credit Suisse, Standard & Poor's, Refinitiv, FactSet, Morgan Stanley Research.

2022 S&P 500 Consensus Earnings Estimates

- After strong earnings growth in 2021, earnings expectations for Tech-related companies are much more subdued in 2022.
  - Note: 2021 S&P 500 Earnings Growth 47.1%, Cyclicals 141.9%.



- 2022 earnings growth expectations are expected to be sourced almost exclusively from the economically-sensitive Cyclicals.



Data as of 10 June 2022.

Sources: Credit Suisse, Standard & Poor's, Refinitiv, FactSet.

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