ECONOMIC RESEARCH

Global Equity Weekly

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October 5, 2018

Yield to the Bond Selloff?

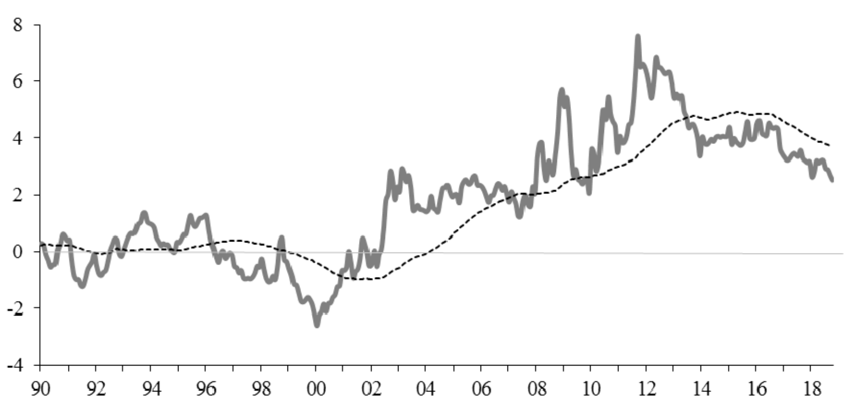
Equity markets were mostly lower this week, with the S&P 500 down 1.0% and Europe slipping more than 2%. The TSX, despite it coming up all roses this week with the USMCA deal, LNG Canada announcement and strong data run, dipped 0.8%. Perhaps most notable is the breakout in bond yields that now looks very real, with the 10-year Treasury yield rising to 3.25% for the first time since the Spring of 2011. This is bound to raise some questions about equity valuations. Indeed, the spread between the forward earnings yield on the S&P 500 and the 10-year Treasury yield has now compressed to the lowest level since we were emerging from the financial crisis, and more than a full percentage point below the 5-year average. On the surface, that argues for some caution as stocks become more expensive relative to their risk-free alternative. However, a few factors could ease the concern. First, while bond yields have risen, so have earnings expectations—a lot. This has helped limit the deterioration in relative valuations that we would otherwise see with yields jumping 100 bps in a year. Also, keep in mind that we are coming off a very favourable post-recession valuation base. Indeed, despite the recent contraction, the spread is still wider than the range the market settled into during the 2003-to-2007 bull market. Finally, although most stand-alone equity valuation metrics are stretched, this could as much reflect what's happening on the yield side of the equation—that is, Treasuries becoming less overvalued as monetary policy normalizes.

Market Performance as of October 5, 2018

	Current Price	Performance (percent) 1 Week	1 Month	3 Months	1 Year	YTD	2017
China CSI 300	3,439	0.0	4.3	2.9	-10.4	-14.7	21.8
Dow Jones	26,447	0.0	1.8	8.6	16.1	7.0	25.1
S&P/TSX	15,946	-0.8	-1.2	-2.0	1.1	-1.6	6.0
S&P 500	2,886	-1.0	-0.1	5.4	13.1	7.9	19.4
DAX	12,112	-1.1	0.6	-2.8	-6.6	-6.2	12.5
NIKKEI 225	23,784	-1.4	5.3	10.4	15.3	4.5	19.1
CAC 40	5,359	-2.4	1.9	-0.1	-0.4	0.9	9.3
FTSE 100	7,319	-2.6	-0.9	-3.7	-2.5	-4.8	7.6
NASDAQ	7,788	-3.2	-2.6	2.7	18.3	12.8	28.2

Source: Bloomberg

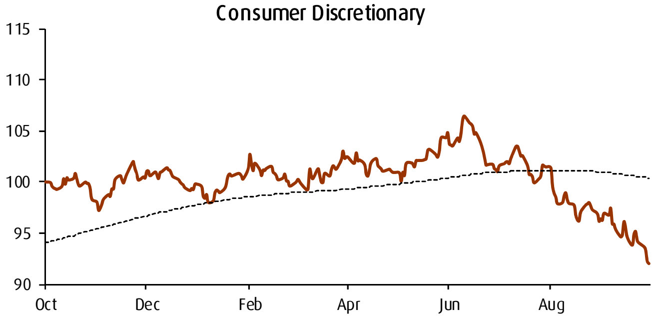
S&P 500 Earnings Yield minus 10-Yr Treasury Yield
(%, dashed line is 5-year average)



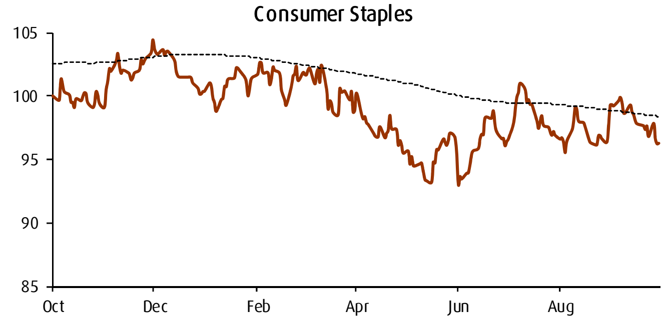
From a Canadian perspective, the forward earnings yield gap versus the S&P 500 has widened to the highest level of the cycle so far, leaving the TSX relatively cheap versus its U.S. counterpart. Recall that the earnings yield gap between the TSX and S&P 500 reached similar levels, but in the opposite direction (i.e., Canada was expensive) around late-2010, and the subsequent underperformance of Canadian stocks really hasn't let up since. Could this be a value trap? Sure. The TSX simply doesn't have the exposure to what is working right now at this stage of the cycle—technology and consumer discretionary—while it has plenty of exposure to banks, which tend to lag when credit growth slows and the yield curve flattens. Meantime, while energy is working elsewhere, Canada's sector is being held back by the record discount for Canadian crude. But, could we be setting up for a solid run in Canada? Sure. Sentiment toward Canada could very well turn with a major trade risk now removed, and any relief on the oil price front would provide some fuel. Relative valuations certainly won't prevent a positive run for Canada.

TSX Sector Performance (Relative to the index, year-ago = 100, dashed line = 200-day m.a.)

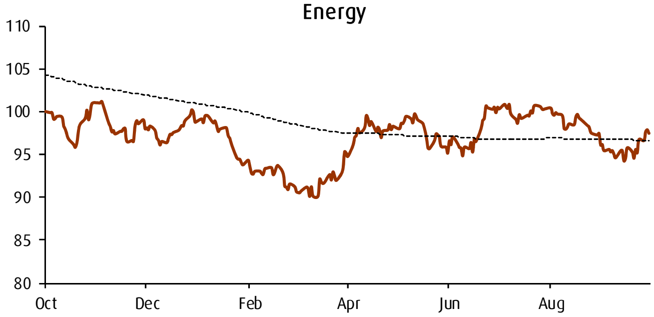
Consumer Discretionary



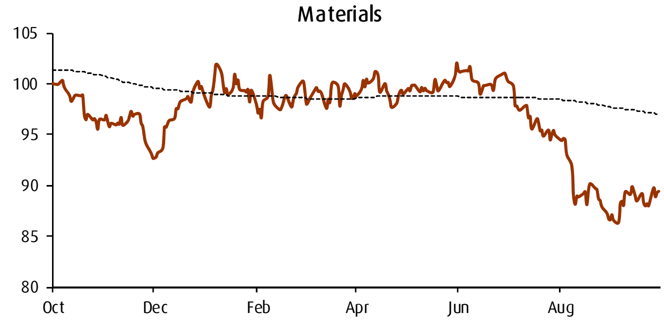
Consumer Staples



Energy

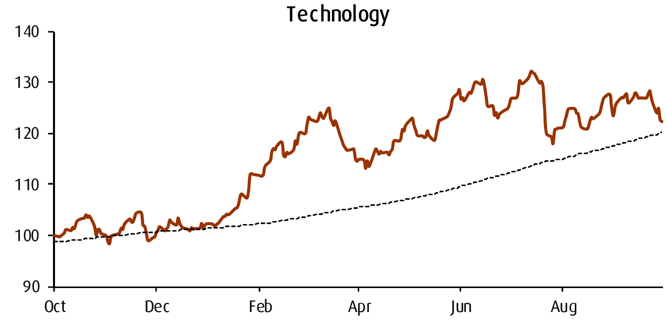


Materials



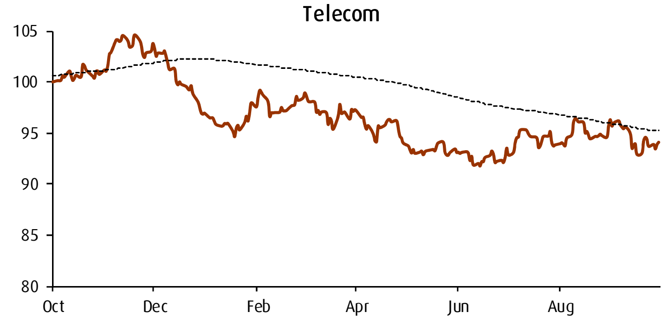
Industrials

Technology

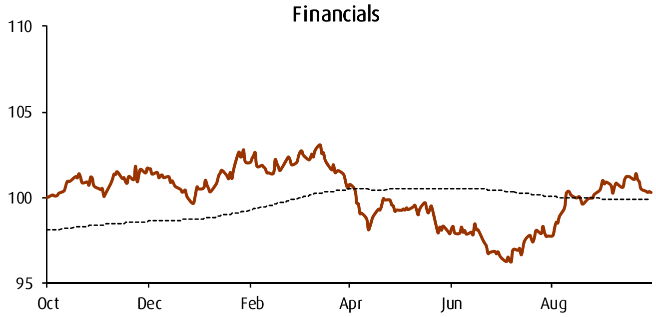


Health Care

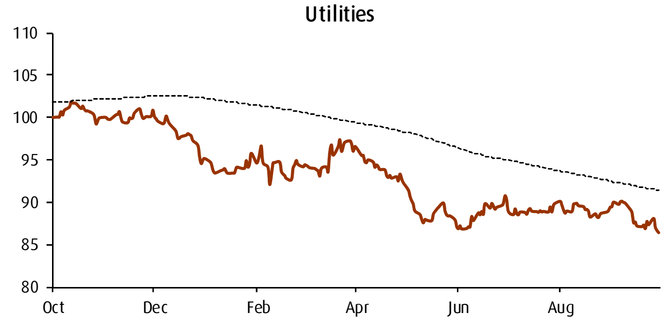
Telecom



Financials

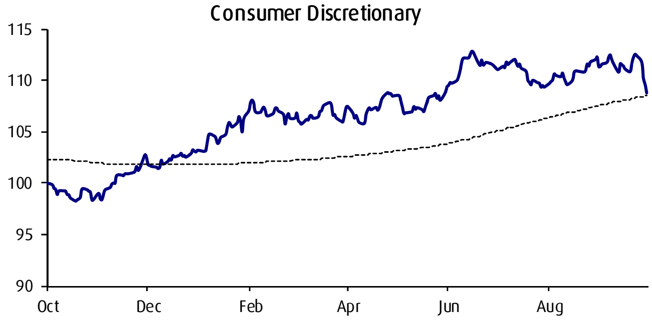


Utilities

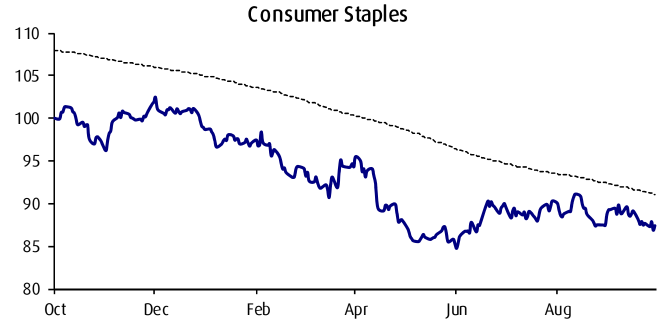


S&P 500 Sector Performance (Relative to the index, year-ago = 100, dashed line = 200-day m.a.)

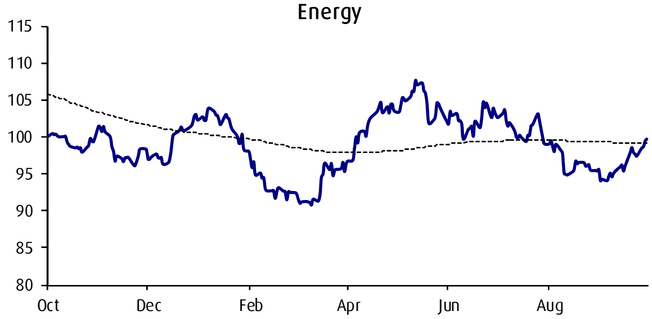
Consumer Discretionary



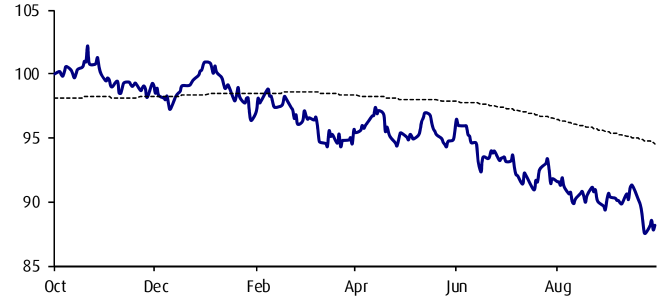
Consumer Staples



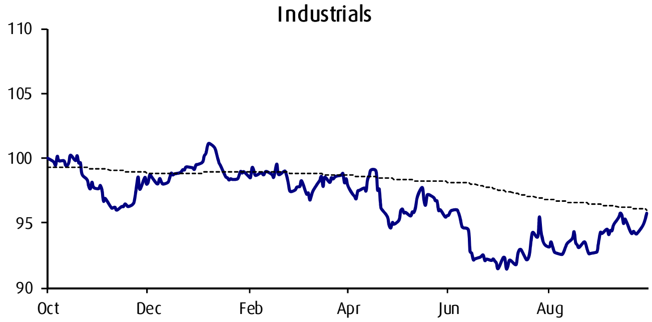
Energy



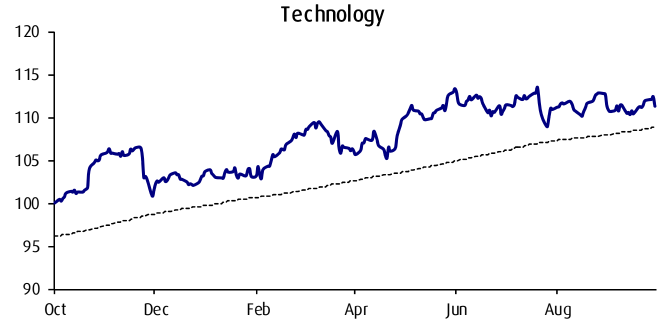
Materials



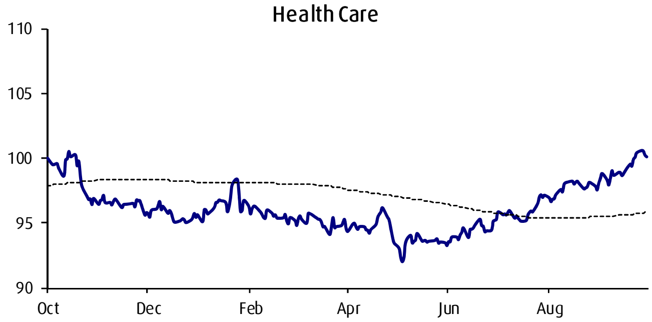
Industrials



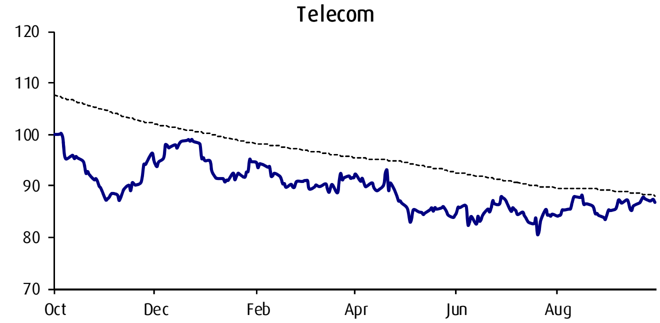
Technology



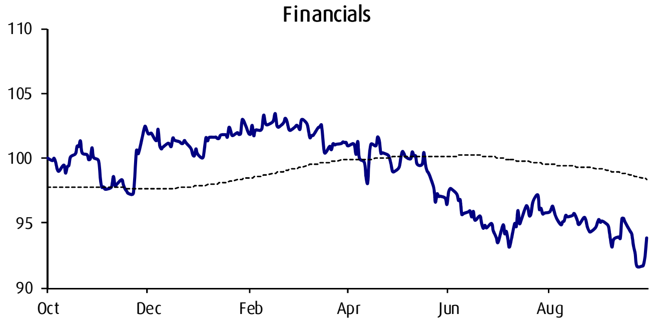
Health Care



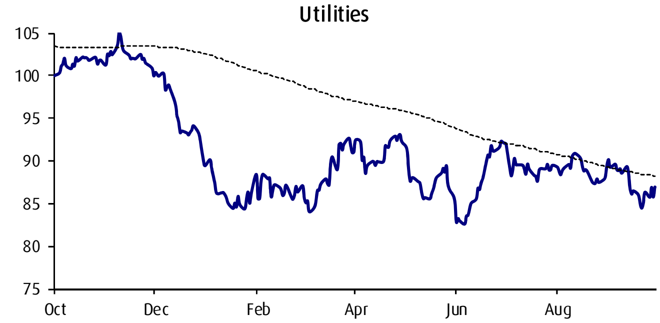
Telecom



Financials



Utilities



North American Sector Performances as of October 5, 2018

S&P 500 Sectors	1 Week	1 Month	3 Months	1 Year	YTD	2017
Energy	**1.9**	4.7	2.8	12.5	7.1	-3.8
Utilities	**1.9**	-0.9	1.7	0.4	1.8	8.3
Banks	**1.6**	-3.3	5.2	7.3	-0.3	20.0
Financials	**1.5**	-1.5	5.6	6.4	0.2	20.0
Industrials	**0.8**	2.2	9.9	8.4	4.1	18.5
Materials	**-0.5**	-2.6	-0.8	-0.7	-4.7	21.4
Health Care	**-0.8**	2.4	11.3	13.8	14.2	20.0
Cons Staples	**-0.9**	-1.2	2.8	-1.6	-6.4	10.5
Information Technology	**-2.2**	-0.8	4.9	25.4	16.8	36.9
Telecom Services	**-2.2**	2.2	4.1	-4.2	-5.5	-6.0
Cons Discretionary	**-4.4**	-2.6	3.0	23.0	14.2	21.2
S&P 100 Large Cap	**-0.8**	0.3	6.7	13.9	8.5	19.3
S&P 400 Mid Cap	**-2.6**	-3.5	-0.3	8.1	3.5	14.5
S&P 600 Small Cap	**-2.8**	-5.5	-0.9	12.5	10.2	11.7
S&P 500	**-1.0**	**-0.1**	**5.4**	**13.1**	**7.9**	**19.4**

TSX Sectors	1 Week	1 Month	3 Months	1 Year	YTD	2017
Gold	**2.1**	4.0	-21.5	-23.3	-20.3	-2.6
Energy	**1.5**	-1.3	-4.4	-2.5	-2.6	-10.0
Materials	**0.5**	1.8	-13.3	-9.3	-10.5	6.3
Industrials	**0.1**	0.9	6.2	16.9	11.5	17.9
Health Care	**-0.1**	8.5	30.3	82.3	28.9	32.7
Telecom Services	**-1.1**	-2.8	-0.3	-4.5	-7.1	9.9
Banks	**-1.3**	-1.6	2.4	4.3	0.1	10.4
Financials	**-1.5**	-1.6	1.5	1.6	-1.8	9.4
Utilities	**-1.5**	-3.4	-5.9	-11.7	-12.4	6.2
Cons Staples	**-2.5**	-2.9	-2.1	-2.9	-6.9	6.4
Cons Discretionary	**-2.8**	-5.1	-10.5	-6.3	-8.9	20.4
Information Technology	**-5.5**	-3.5	-4.2	23.2	18.7	16.2
Income Trusts	**-2.2**	-2.0	-1.6	1.8	-0.9	4.5
REITs	**-2.6**	-3.2	-1.7	5.3	2.9	3.8
S&P/TSX 60 Large Cap	**-0.5**	-1.4	-1.6	1.8	-1.3	6.6
S&P/TSX Small Cap	**-1.1**	-0.8	-4.4	-4.6	-7.1	0.3
S&P/TSX Mid Cap	**-1.6**	-0.5	-3.2	-1.2	-2.6	4.2
TSX	**-0.8**	**-1.2**	**-2.0**	**1.1**	**-1.6**	**6.0**

Source: Bloomberg