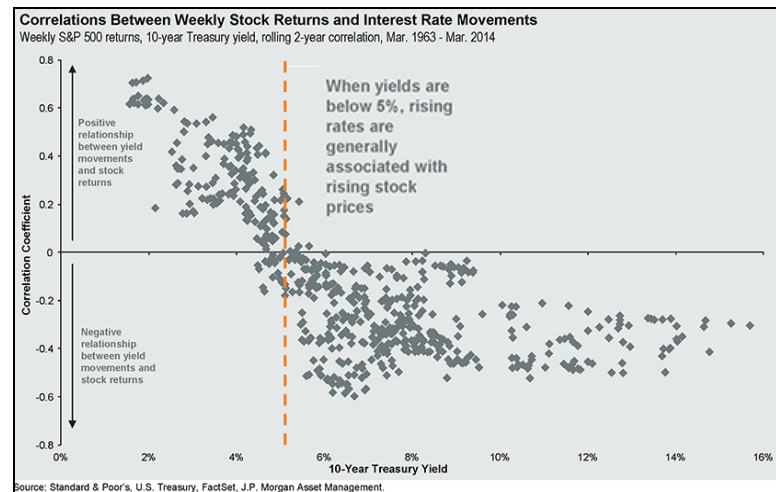
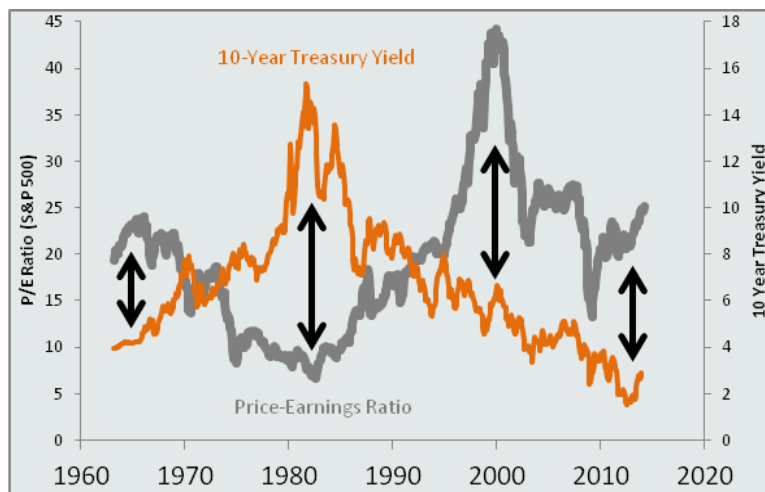


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Stock Valuations and Interest Rates

April 2014

Over the past 30 years, long-term treasury yields have experienced a dramatic secular decline. This trend corresponds with a decline in core domestic inflation. How have interest rates correlated to equity valuations? The first chart below reveals a negative correlation between interest rates and price to earnings ratios. At first glance this would lead to the following conclusion: when rates rise, equity prices fall – reducing P/E multiples and when rates fall, equity prices rise – increasing P/E multiples.



However, a closer look reveals that at levels of low yield, stock prices (P/E ratios) become positively correlated to interest rates, where this relationship appears to be today. The second chart shows that as rates begin moving back up from such low levels, there is a delay to falling stock prices (P/E ratios). When the 10-year yield reaches 5%, history shows that P/E ratios begin to fall.

Equity values are generally based on what investors are willing to pay for a company's future profits. A discount rate is used to evaluate how much those future profits are worth in today's terms. This means valuations are sensitive to discount rates, inflation, and the overall state of the economy. With low to moderate levels of inflation, it is highly unlikely the Fed will raise policy rates – which it uses as a tool to combat levels of high inflation. This in theory should allow for discount rates to remain low. As a result, lower discounting will allow the present value of future profits to remain high, boosting higher equity valuations, thus supporting higher P/E ratios.

These charts support the following conclusion: for the current level of interest rates, the argument can still be made that equities are fairly priced, with room for multiples to expand.

With interest rates near historically low levels, BCA believes that investors are willing to push stock prices to higher levels. History would indicate the impact of a rise in interest rates as insignificant to stock prices until the 10-year treasury yield surpasses the 5% level.

