Ed Yardeni Can Live With Higher Yields for the Sake of Earnings

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by Lu Wang

As harrowing as it has been to watch bond yields jump, watching them sit still would've been worse for stock investors banking on a major revival in earnings this year.

So says Ed Yardeni, who watched with everyone else as rising rates on 10-year Treasuries sowed angst through global equity markets last week. Not only is the veteran strategist comfortable with yields running up to 2%, he sees it as an inescapable backdrop for the sort of economic turnaround already priced into stocks.

"It's an indication that the economy is doing well and that will be very good for earnings," Yardeni, the president and founder of Yardeni Research Inc., said by phone. "The years prior to the pandemic, bond yields were 3% to 4%. So I don't really have a problem with 2% to 3%, which is probably where they're likely to settle in the second half of the year."

Underpinning Yardeni's confidence is an economy roaring back from the Covid-19 pandemic, buttressed by vaccines and President Joe Biden's $1.9 trillion stimulus package. It's those things that have pulled yields up from below 1% and set the stage for S&P 500 companies to rattle off the streak of earnings growth analysts currently estimate -- at least six quarters of double-digit expansions, including a 49% surge in the June-April period.

The view has some basis in history, when periods of sustained earnings growth are compared with bond yields at the time. Since 1962, S&P 500 companies had achieved eight episodes of prolonged profit expansions such as the one contemplated now in analyst estimates. In six of them, yields rose over the stretch, adding 81 basis points on average.

The other two -- one during the 2010 European debt crisis and the other on the heels of the 1987 market crash -- were accompanied by lower yields that partly resulted from demand for haven assets.

While the sample is too small to draw any meaningful conclusion, the experience is a rebuttal to those why say higher yields are trouble for equities. In Bank of America's latest survey of money managers, respondents cited 2% as the level that may trigger a correction in the stock market.

"There is a virtuous reason for rates to rise, when they're rising because the economic outlook and the outlook for growth is improving," said Craig Fehr, an investment strategist at Edward Jones. "In that environment, investors should expect interest rates to move higher."

To be sure, the yield spike partly reflected concern that an overheating economy could force the Federal Reserve to roll back monetary support earlier than expected. Yet in the eyes of bulls, the increase marks an end to an era where a deflation scare persisted amid anemic growth and corporate America was reluctant to spend money on anything but their own stock.

For now, inflation means benefits for earnings as many executives become increasingly confident they can charge more for their products without losing business. S&P 500 firms will likely be able to expand profit margins for at least the next three years, analyst estimates show.

One oft-cited cause of concern is the valuation threat from fixed income. As yields increase, bonds become more attractive, and price-earnings ratios have to come down for stocks to stay competitive. The logic appears to explain the bleeding in richly-valued stocks such as technology this year.

A potential counter exists in the other input that affects market pricing: earnings. That is, if earnings grow fast enough, it's buffer to the market even when multiples shrink.

Just consider: should 10-year yields climb to 2%, that would require the S&P 500's P/E ratio to contract 24% to keep the equilibrium. Yet the blow would be absorbed should profits manage to hit analyst targets for average growth of 17% each year through 2023.

“A yield of 1.7% on the 10-year is not a show stopper for the economy or the stock market,” said David Donabedian, chief investment officer of CIBC Private Wealth Management. “The move we’ve seen is logical, including the overall somewhat higher direction for equities -- because we’re going to have an earnings boom.”