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## Executive Summary

- Relative valuation techniques suggest that equities could get more expensive before valuation is a real concern.
- The only way to protect against upside risk is to own the market in a prudent way.
- UK's currency independence mitigates risk to EU and softens economic blow to Britain
- Despite the low return, low growth world, markets continue to "climb a wall of worry."

### July Rally Despite Fears of Overvaluation

Index	July 2016	YTD 2016
<b>Equity</b>		
S&P 500	3.7	7.7
S&P MidCap 400	4.3	12.6
S&P SmallCap 600	5.1	11.6
Global REITs	5.1	14.9
EAFE	5.1	12.0
Emerging Markets	4.7	9.9
<b>Fixed Income</b>		
Corporate	1.5	9.3
U.S. Treasury 20+	2.4	18.6
Global Aggregate	0.8	9.8
High Yield	2.7	12.0
Senior Loans	1.3	5.1

Data as of 07/31/2016

Source: FactSet, FTSE NAREIT,  
Voya Investment Management

## Bull Market 2016: The Expensive Gets More Expensive

The corollary to the "cheap gets cheaper" is the "expensive gets more expensive," meaning that selling out in this market due to fear of overvaluation may be a mistake. The current market is confounding because the last time bond yields were this low was in 1792 — just after Alexander Hamilton consolidated the American colonies' debt. Only Byron Wien was around to witness it; the rest of us market mavens are in uncharted territory.

It is not such a far out idea to switch valuation approaches, that is, instead of comparing valuation to its own history, compare it "relative" to other alternatives. For example, the Federal Reserve model, which examines stocks relative to bonds, makes equity look like it could get a lot more expensive before valuation becomes a concern. Similarly, comparing U.S. bond yields to the negative yields of other sovereign bonds also make U.S. Treasuries look extraordinarily cheap with plenty of room to run.

### Relative Equity Valuation

Let's look more closely at stocks versus bonds. To compare their valuation simply convert equity to its yield equivalent for an apples-to-apples view by inverting the P/E (price/earnings) ratio to E/P (earnings yield). The P/E ratio looks expensive at 17 times, but inverting it produces an earnings yield of 5.85% compared to the meager 1.5% 10-year U.S. Treasury yield. In fact, on a P/E basis this "expensive" valuation has room to get even more expensive just as it did in 1999 when it rose to nosebleed levels with a P/E ratio well over 30 times earnings. In today's terms, a 30 P/E would bring the S&P 500 up to 3600 or another 67%! Now hold your horses, we are not saying that is either possible or probable, but it has happened before. It was a totally different time of optimism bordering on euphoria, which is nowhere to be seen today. Instead, what we have now is a feverish hunt for yield in a low growth world. It hardly seems excessive to want a 5.85% earnings yield over a 1.5% bond yield, the motivation behind a seemingly unquenchable thirst for equities that's pushing prices ever higher — and by the way, even in the face of pretty dreadful corporate earnings growth.

Relative valuation is nothing new in financial theory, but it usually applies within an asset class or sector. It can be very uncomfortable indeed for investors when different (not new) methods are applied to traditional asset classes. The alternative is to stick your head in the sand in this unusually low yield environment and completely exit this bull market. It may seem rational, but what will happen to the investor who refuses to adapt and misses an enormous opportunity? The appropriate phrase is "upside risk," and the only way to protect against it is to continue to own the market in a prudent way.

### Relative Bond Valuation

Bonds have a few things going for them, not only U.S. bonds but global bonds as well. First, yields can go lower — even negative yields can go lower — and this generates capital gains. Second, U.S. bonds can realize capital gains from both attractive relative yields and from appreciation of the U.S. dollar. Third, and the main reason we advocate bonds in a portfolio, is for diversification advantages due to low, even negative, correlation to equities and low absolute volatility. But what if interest rates rise? Well, what if interest rates fall? What if equities crash? Are you willing to lose the natural hedge and ballast that bonds provide to your portfolio?

### U.K. Surprises Itself by Voting for Brexit

July had an array of negative surprises but the one that loomed the largest and will continue to dominate geopolitical prognostication is the so-called “Brexit.” The surprise vote of the British to “leave” the European Union sent markets spiraling down and just as quickly (well, within a week) spiraling back up. The market seems to believe the fifth largest economy in the world will be just fine on its own mainly because it already has its own currency, which means no serious disruption to the euro. The British pound sterling summarily plummeted to lows not seen since 2009, but happily, it made U.K. exports immediately more competitive and gave a boost to the tourism industry. The bad news is that the U.K manufacturing and services purchasing managers’ surveys (PMI) both sank to their lowest levels in seven years, increasing fears of a U.K. recession. There is also plenty of uncertainty on how its trade outlook, especially with Europe, will be resolved. There are several possible scenarios.

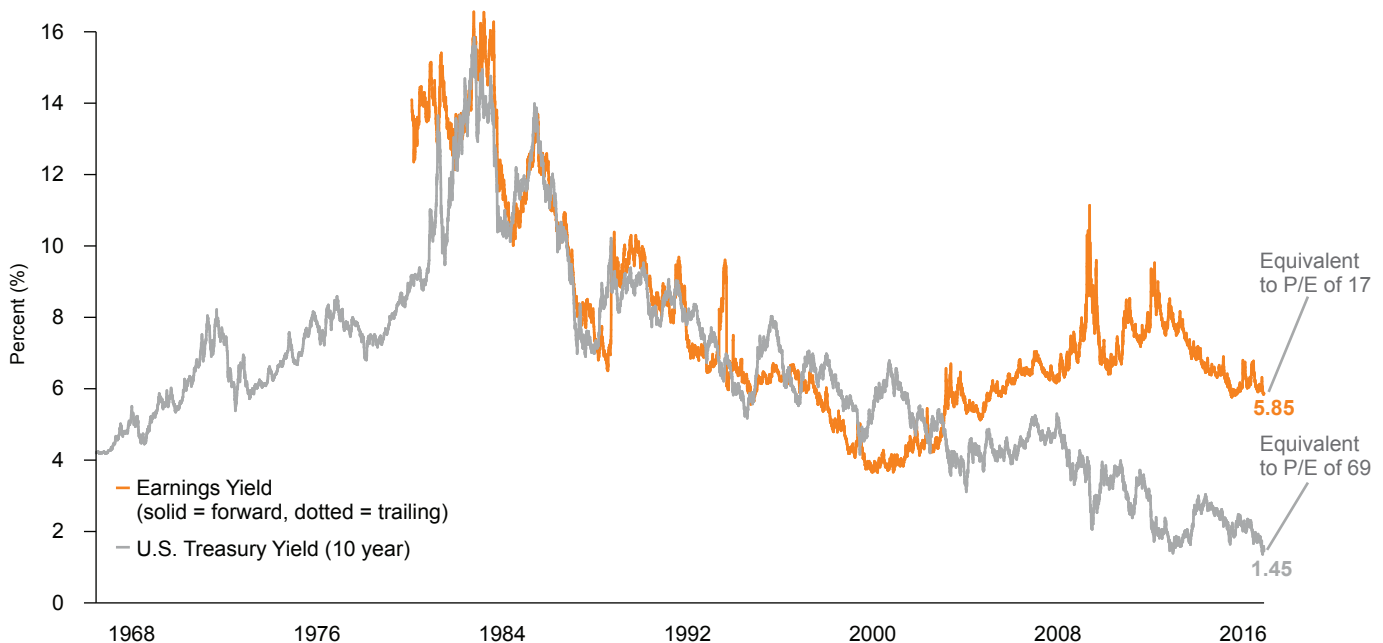
The U.K. may attempt to form a common market agreement similar to that of Norway; this scenario, while improbable, would make the U.K. a member of the European Economic Area, granting them full access to the euro-bloc’s internal single market. On the flip side, this scenario would require the U.K. to follow an open-border EU policy, accept the bulk of EU laws and pay a significant annual contribution to the EEA. The more likely solution would be some version of the Swiss or Turkish approach. The Swiss model includes becoming a

member of the European Free Trade Association, resulting in access to the majority of the EU through bilateral agreements, while making only a small financial contribution each year. Similarly, in the approach adopted by Turkey, the U.K. could form a custom union with the euro zone, thus eliminating all tariffs and quotas when exporting goods to the EU, but accepting EU external tariffs when importing goods from outside the bloc. Whatever the scenario, the process will be drawn-out, complicated and erratic as the ever-stern German Chancellor Angela Merkel likely will clash with newly appointed British Foreign Secretary Boris Johnson. In a side note, look for the newly free Brits, led by Chancellor of the Exchequer Philip Hammond, to establish an ambitious free trade deal with China in the coming years.

Despite the uncertainty surrounding Brexit, there are positive offsets coming from the central banks. The Bank of England blew away expectations on August 4 by cutting rates for the first time in over seven years to 0.25 percent — in addition to resuming a blockbuster bond buying program (“QE”) that has been on hold since 2012. The Bank of Japan left interest rates untouched but expanded its ETF buying program to an annual rate of 6 trillion yen (\$56.7 billion), and doubled its lending program, while the national government announced 4.6 trillion (\$45 billion) in further fiscal stimulus. The Fed, the most cautious and data dependent of all central banks, remained on hold at its July meeting, stating that near-term risks to the economic outlook have diminished since the previous meeting.

### Stock vs. Bond Valuations

Stocks look historically attractive based on their earnings yield (Earnings/Price) compared to the yield-to-maturity of 10-year Treasuries.



Source: Standard & Poor’s, First Call, Reuters, Bloomberg, FactSet.

Note: Earnings Yield is the inverse of the P/E ratio and is calculated as the sum of the reported next twelve months’ earnings estimates divided by market capitalization. The 10-year U.S. Treasury yield is used for bonds. **Past performance is no guarantee of future results.** Please review important disclosures in the back of this book.

The Fed's upbeat assessment was strengthened by yet another blockbuster employment report; the nonfarm payroll figure blew past expectations at 255,000 for July. Central banks across the globe, in reaction to the Brexit vote and ongoing fallout, are firing on all cylinders; expect their record stimulus to support markets in the near term.

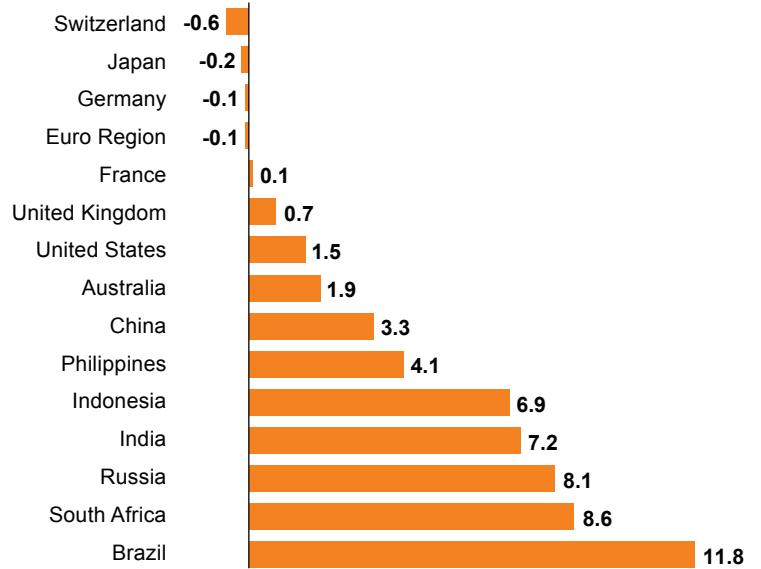
**Conclusion**

As should be obvious, there is no shortage of valid concerns, but against all odds, July witnessed a surge in both equity and fixed income markets around the world. Consumer resilience persists despite negative yields, negative corporate earnings and low global growth. Nonetheless, this already expensive market by traditional measures is likely to get more expensive as it factors in alternative measures of valuation. Because of this unusual environment, the best approach is broad, global diversification.

**Global Yields**

Investors seeking income may benefit from the rich opportunities for higher yield available from global bonds.

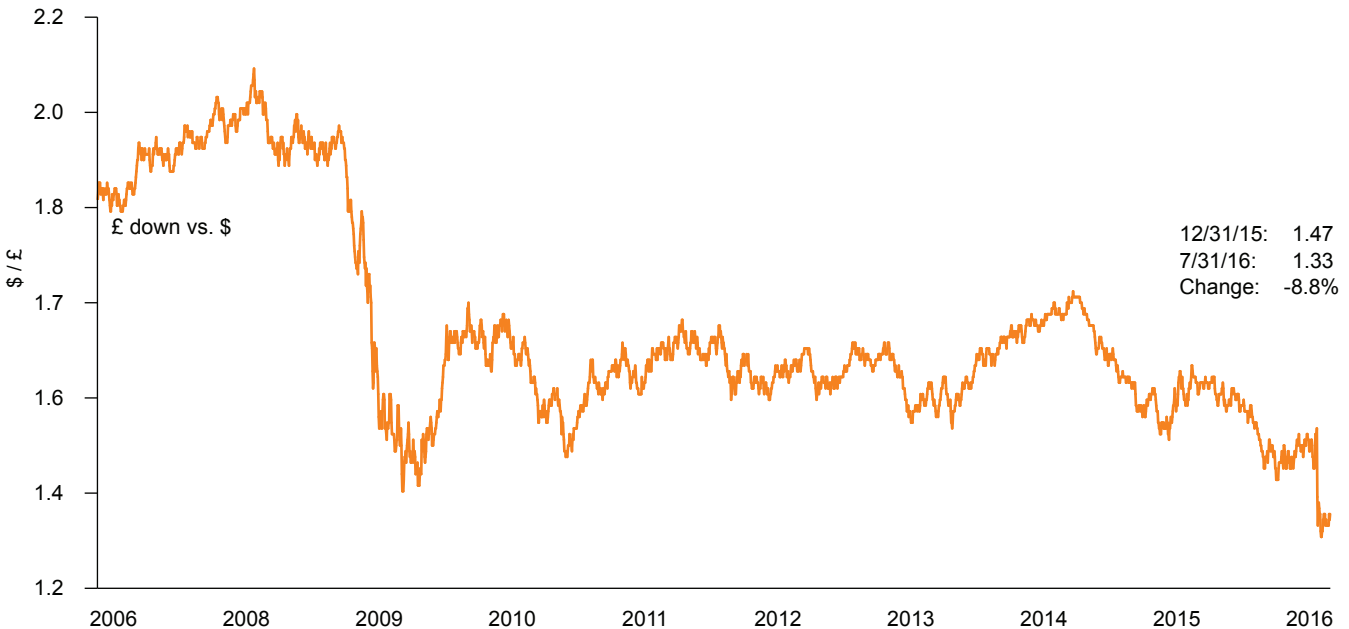
**10-Year Sovereign Bond Yields (%)**



Source: Bloomberg, FactSet

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**After the Surprise Brexit Referendum the British Pound Sterling has Dropped Precipitously**



Source: FactSet

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