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Wall Street's dislocation gauge

Authors
Luke Templeman
+44(20)754-17373
luke.templeman@db.com

Jim Reid
+44(20)754-72943
jim.reid@db.com

Sahil Mahtani
+44(020)754-51552
sahil.mahtani@db.com

www.dbresearch.com

'Reattachment' stocks have begun to outperform The dislocation of stock prices from underlying profitability since the financial crisis is well known. However, their reattachment is finally in full swing.

Stocks that were unfairly punished by the market have begun to outperform. After years in the wilderness, these hidden gems have returned 55 per cent, double the broader market, since bond yields bottomed in 2016. And with a significant fundamentals gap to close, these stocks appear set to continue their run.

What do we mean by dislocation? First, we look at the dispersion of returns on equity for S&P 500 stocks, that is, the extent of RoE variation between companies. We then compare this dispersion with that of stock market returns. If company RoEs show considerable variation, so too should market returns.

Yet, our dislocation gauge tells us that RoE dispersion is much higher than stock price dispersion. In other words, investors are paying similar prices for very different stocks. But as bond yields rise, this dislocation is contracting.

Our report identifies 74 stocks that could benefit from further normalisation and a further 76 stocks that could be hurt. In effect, this is a 'value'-type justification fora momentum-based strategy and highlights the benefits of a blend.

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