

The Most Important Charts for 2023

Published February 23, 2023

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Despite recessionary fears and an uncertain path for monetary policy, investors have embraced equity risk to begin 2023. Some measures of the equity risk premium, or the additional return compensation investors require to hold risky assets (like equities), are now hovering around lows last observed during the middle of the global financial crisis in 2008.

Steno Research recently framed the equity risk premium by analyzing the spread between the earnings yield for the U.S. equity market and those available on U.S. Treasury securities. The Federal Reserve's rate hike campaign over the past year has trimmed this spread to below 2%.

Equity investors now face a unique question. Are bonds a direct threat to equity allocations just because there is meaningful [income back in fixed income](#), where investors can earn less volatile yields?

If so, how long will these yields last? The short end of the yield curve tends to track Fed policy more closely, and the current inversion of the overall curve suggests that today's higher rates are not expected to last over the medium- to longer-term once the Fed pivots to rate *cuts*.

The "risk premium" is at decade lows in US equities

The compensation (earnings yield - risk free yield) for taking equity risk is mediocre

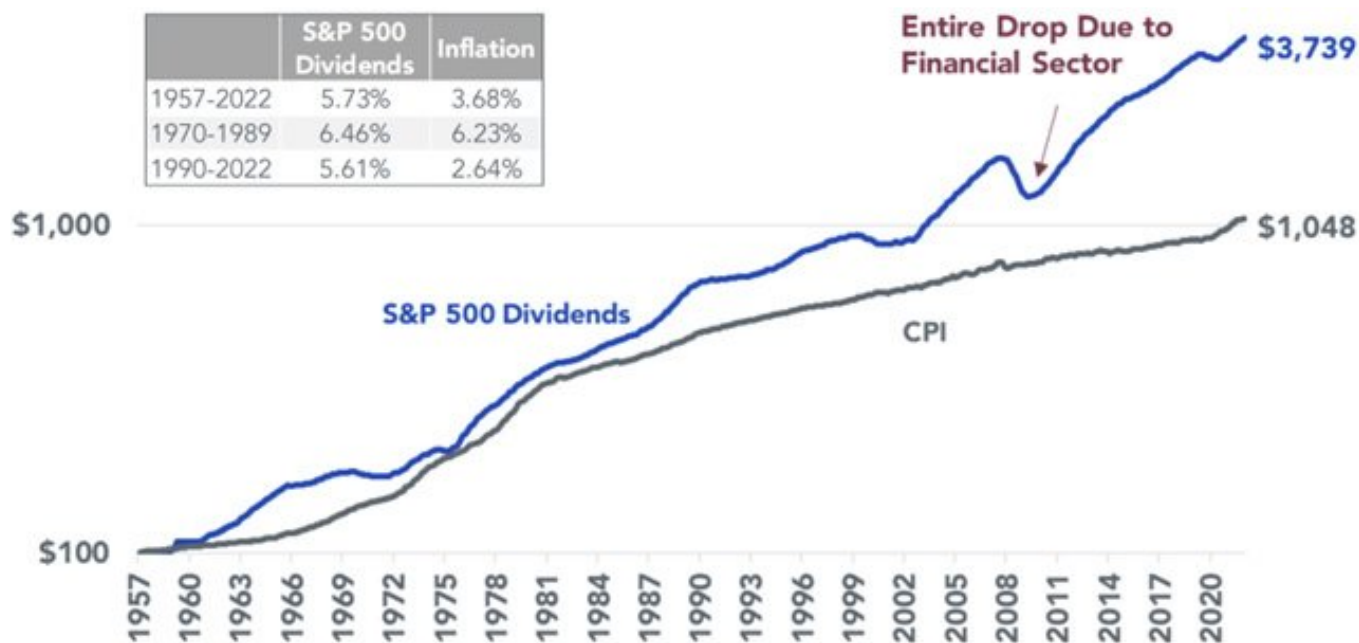


Source: Steno Research, as of 12/31/22. Earnings yields for the U.S. equity market are represented by the S&P 500 Index. You cannot invest directly in an index.

Real Yields Are Key

The Fed has been hiking rates because of inflation. We believe stocks are the best long-term hedge for inflation due to the historical risk premium they have exhibited *above* inflation, but also because companies are able to pass along rising input costs over time to their customers.

This pricing power is evidenced by the long-term earnings and dividend growth of the market, outpacing inflation. Even during the 1970s and 1980s, when inflation averaged over 6% for two decades, dividend growth kept pace with inflation.



Source: Bob Shiller, <http://www.econ.yale.edu/~shiller/data.htm>. Data from 12/31/57 to 12/31/22. CPI: Consumer Price Index. Past performance is not indicative of future results.

Over shorter periods, when the Fed enacts tight monetary policy to combat inflation, stock prices ultimately suffer from higher interest rates, as they did in 2022. But over the long term, equities have innate inflation-hedging characteristics that help compensate for inflationary pressures. For this reason, we view them as real assets.

That compels us to analyze *real* rates and *real* bond yields, as opposed to nominal ones, when we observe different measures of equity risk premiums.

We prefer to compare equity earnings yields (or the reward for investors) over those on risk-free, inflation-indexed bonds, like TIPS in the U.S.

This model of equity risk premium is not a perfect guide for markets, but as Professor Siegel explains in the sixth edition of *Stocks for the Long Run*:

Nevertheless, when earnings yields and real bond yields are at extremes, that often signals a turning point. At the peak of the dot-com bubble in 2000, the earnings yield on stock was just over 3 percent, while the 10-year TIPS bond yielded over 4 percent. This led to an extraordinarily rate negative risk premium (earnings yield minus TIPS yield) and reliably signaled the subsequent decline in equity prices.

By these standards, equity risk compensation is not as dire as implied by the original chart from Steno Research.

Using both trailing and forward S&P 500 earnings yields, less the 10-Year TIPS yield, risk premiums are right at their longer-term averages from the past 25 years.

Contrast this with the tech bubble in 2000, when the earnings yield spread over TIPS turned negative, and it's apparent that today's markets have approximately 500 basis points in additional compensation for U.S. equities relative to TIPS.

S&P 500 Equity Risk Premium (Estimated Earnings Yield – 10-Year TIPS Yield)



S&P 500 Equity Risk Premium (Trailing Earnings Yield – 10-Year TIPS Yield)



Sources: WisdomTree, FactSet, as of 1/31/23. You cannot invest directly in an index.

For much of the last decade, equities comfortably outpaced bonds with rates near 0% and little additional yield to be found in riskier fixed income sectors. This period became known as the “TINA” era, suggesting “**T**here **I**s **N**o **A**lternative” to owning stocks when rates are low and yield is scarce.

While there are now some real alternatives—with income back in short-duration fixed income—by historical standards, today’s equity risk premium remains quite reasonable relative to inflation-indexed bonds.