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MACROCOSM

Equity Risk Premium: Regime Change Accomplished

Tuesday, October 25, 2022
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It doesn't mean stocks are expensive: just that there was an historic bear market in bonds.

Last year we called for a "regime change" in the S&P 500 equity risk premium. *We predicted the ERP would revert to its lower and more risk-tolerant mean that prevailed in the years before the Global Financial Crisis* (see "Regime Change for the Equity Risk Premium?" April 19, 2021). *As of yesterday's close, we're just 20 bp from it. At 1.76%, the ERP hasn't been this narrow since October 15, 2007, more than fifteen years ago*. There was still a Bear Stearns then (please see the chart below).

- But we had no idea last year that we'd accomplish it the way we did.
- Normally a sharp narrowing in the ERP is driven by large gains in stocks, and it's a signal to take profits at too-high valuations. But this year there has been a bear market in stocks, with the S&P 500 losing as much as 27.5% from top-tick to bottom.
- After that *it's hard to argue stocks are expensive* – especially considering that, from the prior all-time high in February 2020, before the pandemic, they've grown just 12.7% over more than two and a half years – while forward earnings have grown 33.2%. *Normally that would make the ERP wider, not narrower*.

Update to strategic view

US STOCKS, US BONDS, FEDERAL RESERVE: The US equity risk premium is basis points away from its pre-Global Financial Crisis mean, and at its narrowest in more than 15 years. It's not because stocks are over-valued. Indeed, from pre-pandemic highs, they are up less than half the gain in forward earnings. The narrow ERP is driven by an historic bear market in bonds, more than twice as great as any historical …

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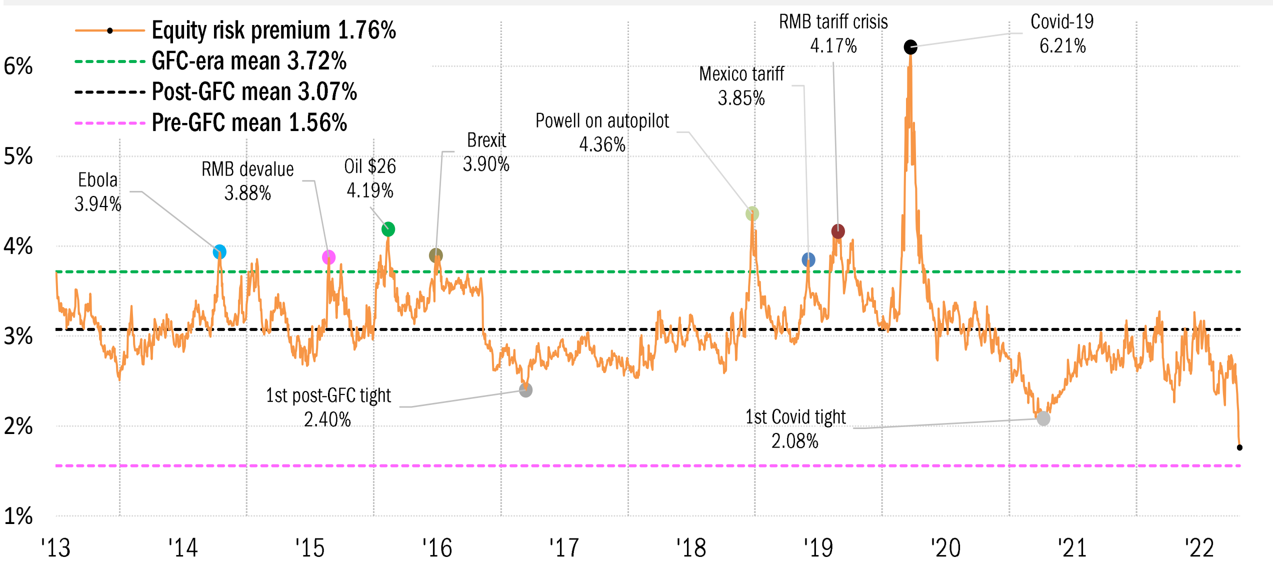
S&P 500 equity risk premium (S&P 500 consensus 1-year forward earnings yield minus 30-year Treasury yield)



Source: Bloomberg, TrendMacro calculations

- This time the driver of the narrowing is bonds. This year the 30-year Treasury yield has risen from 1.90% to 4.38%, driving a bear market in bonds worse than that for stocks – the Bloomberg 10+ year Bond Index has lost 35.0% this calendar year, and 43.3% from the pre-pandemic lows in yields – the worst bear market in history. The prior record-holders were 17.0% lost from February 1967 to May 1970, and 16.9% lost from May 1980 to September 1981.
- Bond volatility has been record-breaking too: 18.1% daily standard deviation of annual returns this year, compared to 8.7% historically. Stocks at 24.1% have been more volatile, and unusually so, but their historical average is 18.8% to begin with. *Bonds this year have been as volatile as stocks are in an average year.*
- *Historically, the annual total return for stocks, at 10.1% on average, has been twice that for bonds, at 5.2%, with about twice the volatility. This year-to-date, while bonds have lost 35.0%, stocks have lost only 19.7% – and stocks have been less than a third more volatile than bonds.*

This extremely narrow ERP is more likely to be a buying opportunity for bonds than a selling opportunity for stocks.

- *Epic opportunities to sell stocks have come from much narrower ERPs*. Compared to today's 1.76%, the ERP was *negative* 2.33% before the crash of October 1987, and *negative* 2.40% before the dotcom crash of March 2000.
- *In the aftermath of the Global Financial Crisis, there were eight extreme peaks in the ERP*, every one above the mean that had obtained *during* the GFC, even though we were then out of it (again, please see the chart on the previous page). Each was associated with a particular critical news event, each was a good buying opportunity for stocks, and each was the subject of a TrendMacro report (see, for example, see "On the Fed's Massive Intervention" March 23, 2020).
- *Over the same post-GFC period there have been two previous narrows* – one on March 13, 2017 and another on April 9, 2021 (again, please see the chart on the previous page). Neither was associated with a particular news event. In both cases, given the absence of defining events or other drivers, we did not choose to

Asset class returns following the two post-GFC ERP narrows

	S&P 500 total return	10+ bonds total return
March 17, 2017 narrow		
1 month	+0.78%	+4.32%
3 months	+0.02%	+6.29%
To mean reversion (1.02 years)	+11.25%	+5.19%
April 9, 2021 narrow		
1 month	+1.59%	+0.93%
3 months	+3.33%	+2.80%
To mean reversion (0.64 years)	+11.59%	+10.25%

Source: Bloomberg, TrendMacro calculations

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… precedent. So the narrow ERP does not imply that stocks should be sold, but rather that bonds should be bought. The 10-year yield is almost flat to the market-implied funds rate for the November FOMC, and inverted to the December FOMC. The two prior hiking cycles ended when the 10-year inverted to the funds rate, and Powell has cited that explicitly as a policy guidepost. He is likely to honor it, as inflation continues to show signs of having peaked. This is consistent with leaked reports that the November FOMC will hint at braking the hiking cycle.

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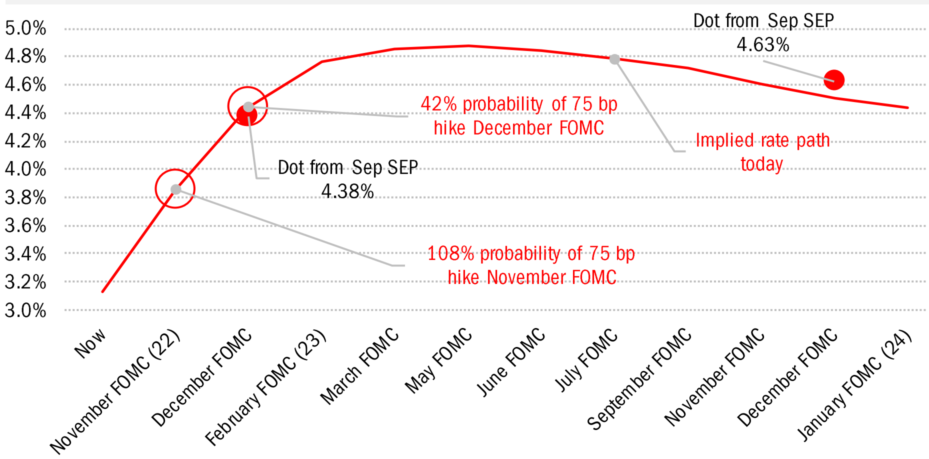
highlight opportunities to sell stocks, and that was the right decision in both cases. In the 2017 case, bonds outperformed stocks sharply over one and three months. In the 2021 case, bonds underperformed stocks, but it was a close call, and better for bonds than the historical norm versus stocks (please see the table on the previous page)

ERP aside, a bull case for bonds would go something like this.

- *First, we posit that inflation has peaked*, and is now going to steadily moderate (see, among many, "Or How I Learned To Love September CPI" October 13, 2022).
- *Second, it follows that the money market curve's current appraisal of the Fed's hiking cycle, peaking below 5% in the first half of 2023, is as bad as it's going to get* (please see the chart below).

Policy rate implied by fed funds futures, by FOMC meeting



Source: Bloomberg, TrendMacro calculations

- *Third, the 10-year yield at 4.07% as of this writing is inverted to the funds rate implied for as soon as December, and only 19 bp above the rate implied for as soon as next week's November FOMC.* The hiking regime under former Fed Chair Ben Bernanke ended in mid-2016 when the 10-year inverted when the funds rate was set at 5-1/4%. The pre-pandemic hiking regime under Jerome Powell ended in mid-2019 when the 10-year inverted to the 2-3/8% policy rate. Indeed, in Senate testimony, Powell has said that he considers long-term Treasury yields to be a stand-in for the neutral rate, and that when they invert to the policy rate, "then maybe your policy's tighter than you think."
- *Fourth, all that is consistent with last week's leaks from the Wall Street Journal's Fed-whisperer Nick Timiraos, suggesting that the November FOMC will be the time to start tapping the brakes on this hiking cycle.*

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- *So if this isn't an interesting time to buy bonds at what may be the bottom of a more-than-historic bear market, we don't know what is.*
- *And all that said – if that's correct – how can that also not be a good time to buy stocks?*

Bottom line

The US equity risk premium is basis points away from its pre-Global Financial Crisis mean, and at its narrowest in more than 15 years. It's not because stocks are over-valued. Indeed, from pre-pandemic highs, they are up less than half the gain in forward earnings. The narrow ERP is driven by an historic bear market in bonds, more than twice as great as any historical precedent. So the narrow ERP does not imply that stocks should be sold, but rather that bonds should be bought. The 10-year yield is almost flat to the market-implied funds rate for the November FOMC, and inverted to the December FOMC. The two prior hiking cycles ended when the 10-year inverted to the funds rate, and Powell has cited that explicitly as a policy guidepost. He is likely to honor it, as inflation continues to show signs of having peaked. This is consistent with leaked reports that the November FOMC will hint at braking the hiking cycle.