Special Report

US Equity Risk Premium: Rebound Ahead

aranca

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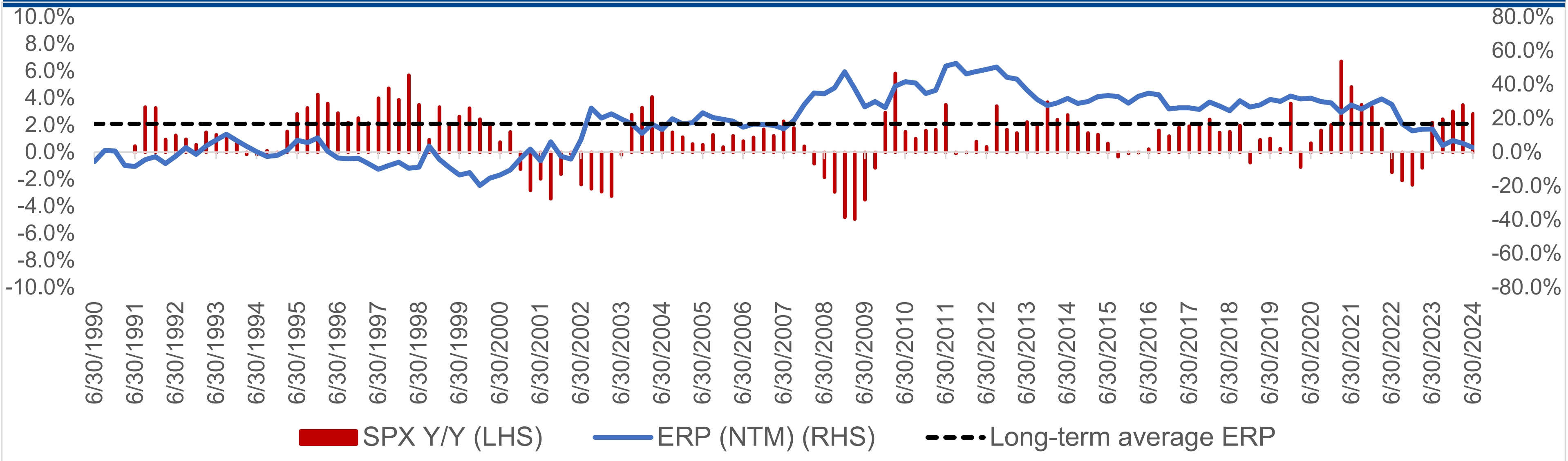
US Equity Risk Premium is at a 23-year low

- **Equity Risk Premium (ERP)** is a measure of the differential between the earnings yield of stocks and the expected returns on bonds. It represents the additional returns that an investor receives for investing in relatively riskier asset class (equities) over government bonds.
- Over the past 10 quarters, the US Federal Reserve's (the Fed) most aggressive interest-rate hikes in four decades have pushed Treasury yields to their highest levels in over 15 years. On the other hand, robust macro-economic activity has pushed the equity markets to new highs with the S&P 500 gaining >50% in the ongoing bull run.
- Consequently, ERP has fallen to a 23-year low of 0.33%, significantly below its historical average of ~2.09% (since 1990).
- Such low levels of ERP are not sustainable as equity investors need to be rewarded for taking the risk of investing in a riskier asset class.

S&P 500 vs. Equity Risk Premium



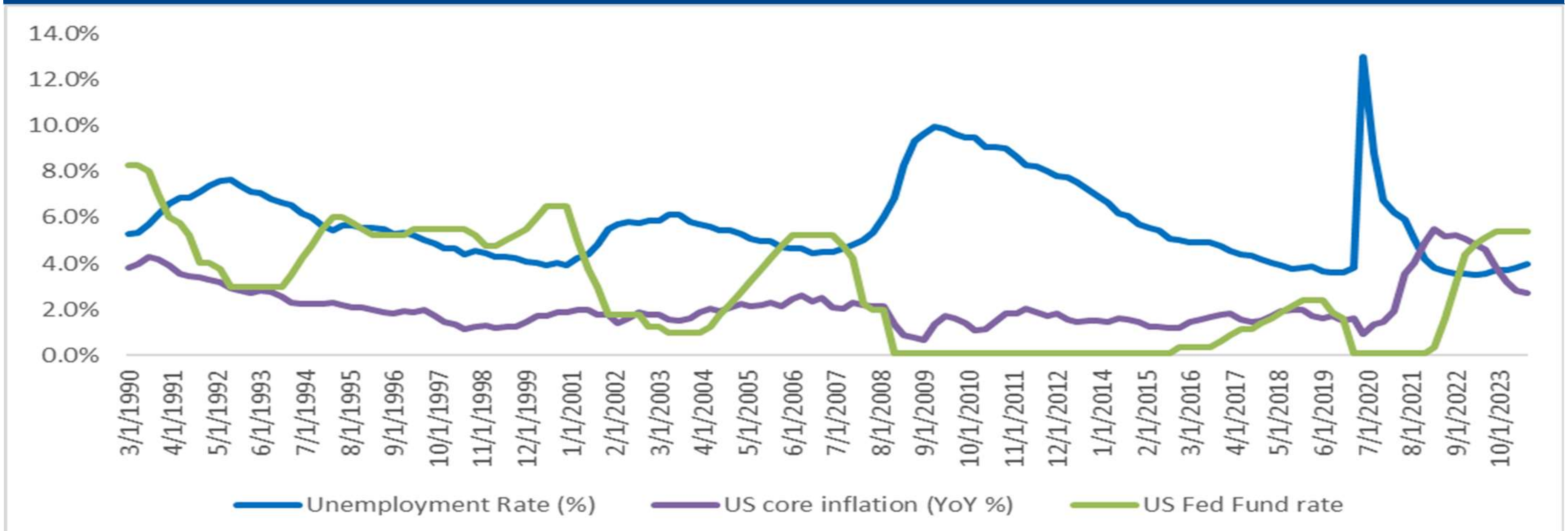
- Hence, we examine the current trend of macro-economic indicators and how these may affect the two variables in the ERP equation, i.e., the US 10Y bond yield and the S&P 500 earnings yield.

Source: *Aranca Research*

Current macro-economic indicators and the ERP equation

- An analysis of the current macro-economic environment in the US reveals that inflation is moderating and moving towards the Fed's target range while unemployment at ~4% is meaningfully below its 35-year average of ~5.7%.
- The unemployment rate and Inflation are the key determinants for the Fed to take a stance on the interest rates, which in turn impact the bond yields. With both showing signs of stabilization in recent times, the Fed is well positioned to ease interest rates. Further, The FOMC forecast at least one rate cut this year and expects the Fed fund rates to reach 4.10% by December 2025.
- On the second component of the ERP equation, i.e., earnings yield, an interest rate cut will help companies secure funds at lower borrowing costs, which will boost corporate earnings and thereby earnings yield.
- With bond yield falling and earnings of S&P 500 constituents rising, ERP is bound to improve from the current levels.

Macro Indicators



Source: *Aranca Research*

ERP mean reversion

The ERP in the US is trending at historically low levels. We expect this to increase and trend towards its long-term average of 2.09%. We run three possible scenarios with different changes in bond yields and projected EPS growth rates to arrive at a probable S&P 500 level at the next year-end.
The following table summarizes the findings of our scenario analysis.

Scenerios	Change in Bond Yield	Annual growth in EPS	USGG10YR Index	ERP	S&P 500 Earnings yield (NTM)	S&P 500 Index value	Potential change in S&P 500
Current value			4.39%	0.33%	4.72%	5460	
Bear case	-100bps	5.00%	3.39%	2.09%	5.48%	5066	-7.2%
Base case	-150bps	10.00%	2.89%	2.09%	4.98%	5982	9.6%
Bull case	-200bps	15.00%	2.39%	2.09%	4.48%	7117	30.3%

Our base case scenario analyses reveal that even if ERP trends back to the long-term average of 2.09%, the S&P 500 can further grow by ~9.6% from the current levels without multiple expansion, highlighting the potential for strong market performance as ERP reverts to its historical average.

Source: *Aranca Research*

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