WELLS FARGO
Investment Institute

Market Commentary

Weekly perspective on current market sentiment **March 6, 2024**

Scott Wren
Senior Global Market Strategist

Last week's S&P 500 Index: +1.0%

Are investors getting paid to take equity risk?

Key takeaways

- Are investors getting adequately compensated for taking on the higher potential volatility of equities?
- It is tough to conclude anything other than investors are not being adequately compensated.

Notwithstanding the large, recent moves in fixed-income yields, a longer-term history of the interest-rate markets does show that stocks tend to be much more volatile than bonds. The Capital Market Assumptions (CMAs) we use in our asset-allocation process help determine portfolio asset-class weightings and reflect this historical relationship. For this reason, portfolios in the conservative category typically have more exposure to bonds than stocks.

U.S. Treasury securities, being backed by the full faith and credit of the American government, are often perceived as a close approximation to a risk-free security in terms of the likelihood that principal and interest will be paid in full. Of course, Treasury securities that are not held to maturity are subject to price volatility as interest rates move up and down, just like any other bond.

So, given the current yield available from Treasuries and the record highs being posted by the S&P 500 Index (SPX) on a seemingly regular basis so far this year, this is the question: Are investors getting adequately compensated for taking on the higher potential volatility of equities? Let's take a look at the concept of Equity Risk Premium (ERP) to see if that helps us put that question into the proper perspective.

The ERP, under its most basic interpretation, says that given the higher likely price volatility of stocks, the earnings yield on the SPX should be higher than the yield on a U.S. Treasury security. First, the earnings yield of the SPX is calculated by dividing the estimated earnings per share of this large-cap index by the index's current price level. To illustrate, at the time of this writing, we would divide our 2024 earnings-per-share estimate on the index, $230, by the current level of the SPX, 5,145. That gives us an earnings yield of 4.5% (the ERP is the inverse of the P/E, or price-to-earnings ratio). Now we compare that to the yield of the two-year Treasury note of 4.61%. Based on this take, it would appear as though investors are not being adequately compensated for taking on the higher volatility of equities as the earnings yield on the SPX is less than the yield on the two-year Treasury note. That makes the ERP negative.

And putting that ERP current statistic up against history won't make anyone feel any better. Bloomberg data shows that since January 1, 1998, the average ERP has been 2.98% using the two-year Treasury note yield. That means the current negative ERP is more than 3% below the long-term average.

Market participants can argue over what an adequate ERP might be in any given economic and valuation environment, but it is tough to conclude anything other than, at least based on the ERP methodology, investors are not being adequately compensated for owning the SPX at current levels.

Investment and Insurance Products: ➤ NOT FDIC Insured ➤ NO Bank Guarantee ➤ MAY Lose Value

Risk considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. Although **Treasuries** are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate.

Definitions

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

An index is unmanaged and not available for direct investment.

General Disclosures

Global Investment Strategy (GIS) is a division of Wells Fargo Investment Institute, Inc. (WFII). WFII is a registered investment adviser and wholly owned subsidiary of Wells Fargo Bank, N.A., a bank affiliate of Wells Fargo & Company.

The information in this report was prepared by Global Investment Strategy. Opinions represent GIS' opinion as of the date of this report and are for general information purposes only and are not intended to predict or guarantee the future performance of any individual security, market sector or the markets generally. GIS does not undertake to advise you of any change in its opinions or the information contained in this report. Wells Fargo & Company affiliates may issue reports or have opinions that are inconsistent with, and reach different conclusions from, this report.

The information contained herein constitutes general information and is not directed to, designed for, or individually tailored to, any particular investor or potential investor. This report is not intended to be a client-specific suitability or best interest analysis or recommendation, an offer to participate in any investment, or a recommendation to buy, hold or sell securities. Do not use this report as the sole basis for investment decisions. Do not select an asset class or investment product based on performance alone. Consider all relevant information, including your existing portfolio, investment objectives, risk tolerance, liquidity needs and investment time horizon. The material contained herein has been prepared from sources and data we believe to be reliable but we make no guarantee to its accuracy or completeness.

Wells Fargo Advisors is registered with the U.S. Securities and Exchange Commission and the Financial Industry Regulatory Authority, but is not licensed or registered with any financial services regulatory authority outside of the U.S. Non-U.S. residents who maintain U.S.-based financial services account(s) with Wells Fargo Advisors may not be afforded certain protections conferred by legislation and regulations in their country of residence in respect of any investments, investment transactions or communications made with Wells Fargo Advisors.

Wells Fargo Advisors is a trade name used by Wells Fargo Clearing Services, LLC and Wells Fargo Advisors Financial Network, LLC, Members SIPC, separate registered broker-dealers and non-bank affiliates of Wells Fargo & Company. PM-09052025-6455330.1.1