Market Commentary

Scott Wren
Senior Global Market Strategist

Last week’s S&P 500 Index: -2.5%

Stocks vs. bonds

Key takeaways

- Should investors lock in a bond yield close to 5% or take on the historically higher risk of equities?
- But stocks offer the potential opportunity to benefit from increased earnings and dividends over time.

The competition has been getting serious since the middle of summer. What competition, you might ask? Investors are trying to assess and analyze the game between the equity market and bond yields, which have shot up to the highest levels in 15 years. On one side of the field are equities. On the whole, they generally offer the strategy of growth over time and the possibility of a decent dividend. On the other side of the field (or pitch if you are a soccer fan) are bonds. The bond team, historically, is not as exciting as the equity team and usually gets its wins by grinding it out and not taking too many chances. At least that has been the game over most of the last 40 years.

That isn’t the case today. The yield on the 10-year Treasury note moved from less than 1.5% in December 2021 to just a touch over the 5% level in October of this year. And while the magnitude of that upward surge in interest rates over such a relatively short period of time happens only on rare occasions, it has made the yield on longer-term fixed income much more attractive. In comparison, based on Bloomberg data as of October 30, 2023, the dividend yield on the S&P 500 Index (SPX) sits at just 1.7%. We continue to recommend that investors overweight long-term bonds to take advantage of current Treasury yields.

In the simplest terms, investors are now asking themselves if they would rather lock in a rate close to 5% on a 10-year Treasury note or take on what has been historically the higher risk of equities, which, at least at the current index level, offer a far smaller dividend yield. Of course, investors demand a higher return for taking on higher risk over time. Over long stretches of time, the return on stocks has been considerably higher than the return on bonds.

Another angle on the question of stocks versus bonds is in terms of what is called the equity risk premium (ERP). This can help answer the question as to whether investors are being compensated for taking on the added risk of equities relative to the historical risk of bonds. The ERP is calculated by subtracting the yield on the 10-year Treasury note from the earnings yield of the SPX. Based on our $205 per share earnings estimate for the SPX this year and using Monday’s close, the ERP calculates to zero (4.9% SPX earnings yield minus 4.9% 10-year Treasury yield). Given that the 10-year Treasury yield is considered the “risk free rate” by most market participants, one could argue that, based this particular analysis, stocks are overvalued, bond yields are too high, or a combination of the two is occurring.

But stocks offer more than just a dividend yield. Stocks offer the opportunity to benefit from owning companies that can potentially increase their earnings and dividends as the domestic and global economies grow over time. We are recommending an overweight to large-cap equities to take advantage of this growth combination. The potential to grow earnings and dividends over time is a key reason why equities have posted higher long-term total returns than bonds.

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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.

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