

Where's the Equity Risk Premium?

- Much of the attention in equity markets today is focussed on whether we are in an AI bubble
- We don't know whether investors are right to pay 33x earnings for Microsoft. It is certainly a rich price, but it is also fantastic business with an incredible track record of growing earnings
- We are much more confident that stocks outside of AI are in a bubble and that the equity risk premium is close to zero. To illustrate this, we picked two stalwart quality stocks from the US market
- Walmart trades on over 40x earnings even though its cash-flow growth has lagged inflation over the last decade, it pays a free cashflow yield of 1.7%
- Proctor & Gamble trades on a more "modest" 21x earnings, like Walmart its cash-flow growth has lagged inflation. Given the lower multiple of earnings, the cash-flow yield is rather higher at 3.8%.
- A 20Y inflation linked bond in the US pays a yield of 2.3%
- Even the higher yielding P&G offers a paltry 150bp pick-up over the risk-free government bond, by any measure that is an inadequate equity risk premium
- These valuations for so-called "bond proxies" might have made sense in a world of zero interest rates. In today's world they cannot be justified, particularly if bond yields continue to rise in order to absorb the ever-greater supply of new government debt
- At best future real equity returns will be much lower than in the past, at worst they will undergo a substantial correction. Either way investors should not extrapolate their recent wonderful experience in US equities into the future
- We maintain a very low exposure to equities in general and US equities in particular.