Credit Has Outshined Equities Amid Unfavorable Risk Premium

Over the course of 2023 and the first half of 2024, equity markets rose steadily, driven by positive economic and earnings news, a technology boom driven by AI-related firms, and the recently confirmed expectation that the U.S. Federal Reserve (Fed) would begin to cut rates at some point in the near future. One consequence of such a strong rally is that the equity risk premium, the expected excess return that compensates an investor for the risk of investing in equities, hasn't been this unfavorable since 2001 (**Figure 1**).

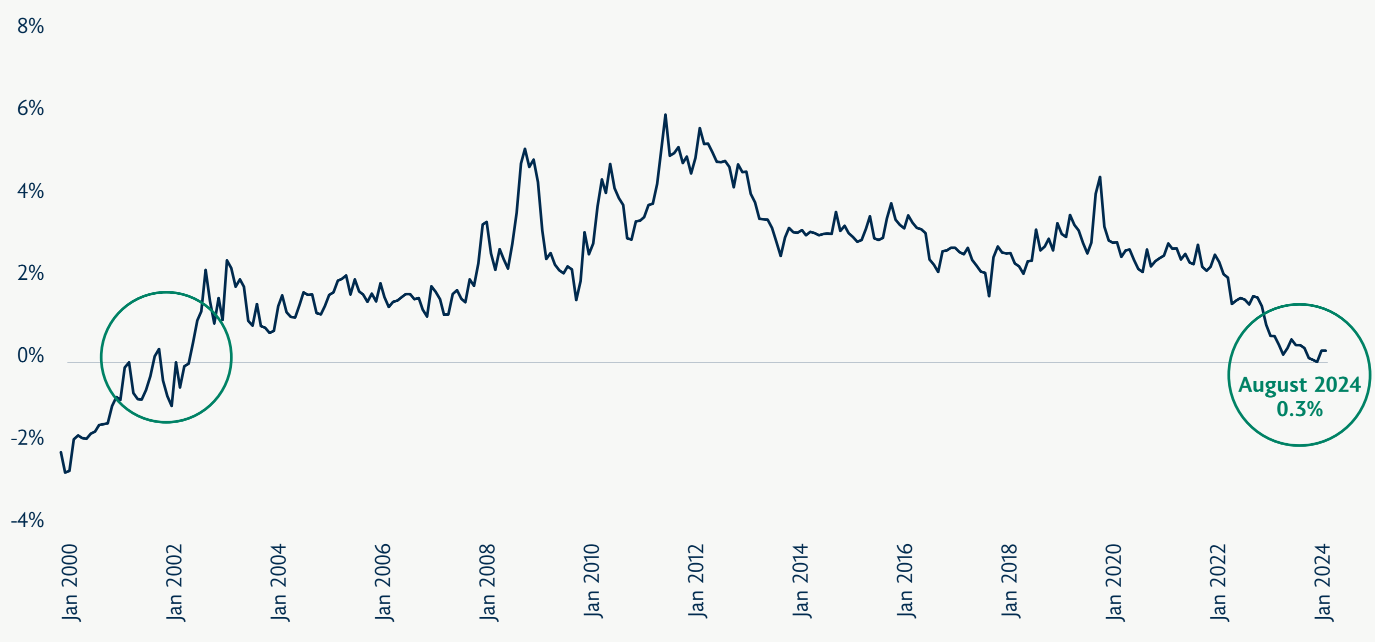
The narrowing of the equity risk premium occurs at a time when investing in credit is quite appealing, a result of a "new normal"–with elevated yields not seen in decades–after the Fed began hiking interest rates in 2022.

In this new environment, credit assets have produced strong results: for example, the yields of the high yield bond and senior loan markets have increased meaningfully in the last few years, without sacrificing quality. Meanwhile, defaults have remained below recessionary averages, partly as a result of refinancing activity that has extended the maturity wall. Until recently, the Fed remained hands-off regarding rates, refraining from cutting them while inflation remained sticky and growth was strong.

In short, credit may offer competitive relative value in the current environment. As Howard Marks noted in his *Sea Change* memo (December 14, 2022), "Investors can now potentially get solid returns from credit instruments, meaning they no longer have to rely as heavily on riskier investments to achieve their overall return targets."

Figure 1: Credit May Offer Superior Relative Value in This New Era

The Equity Risk Premium Hasn't Been This Unfavorable Since 2001[1]



Source: Bloomberg, as of August 31, 2024.

Equity Risk Premium is the expected excess return that compensates an investor for the risk of investing in equities; it is defined as the S&P Earnings Yield (reciprocal of the P/E ratio) minus the yield on the current 10-year U.S. Treasury. The indexes are unmanaged and cannot be purchased directly by investors.

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