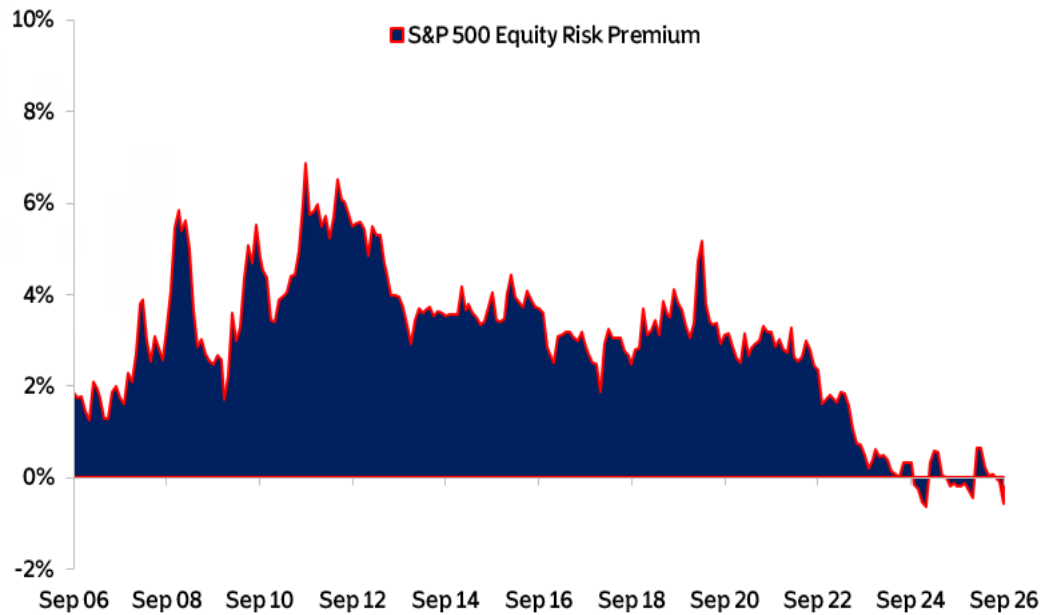


Equities vs. Bonds: Bond is back... with a licence to yield

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Source: Bloomberg Finance L.P., data as at 30 September 2026. The Equity Risk Premium takes the difference between the earnings yield (1 over P/E ratios using average sell-side 1y forward EPS estimates) for the S&P 500 and the US 10-year treasury.

What does the chart show?

This week's 'chart of the week', illustrates the declining 'risk premium' for investing in equities over bonds. The further earnings yields fall below government bond yields, the stronger the incentive to allocate capital towards bonds. In a world where asset classes compete for the same pool of capital, every bond purchased often requires an equity position to be reduced. Through this mechanism, the bond and equity markets are intrinsically linked.

The earnings yield provides an estimate of the annual return available from equities based on their valuation and expected earnings. The underlying principle is straightforward; investors should be compensated for taking equity risk. Equities should offer an expected return premium above that of risk-free government bonds. When that premium falls towards zero or below, investors should question whether they are being adequately rewarded.

Why this is important

Asset classes are only attractive on a relative basis. Every decision to hold one asset is, by definition, a decision not to hold another. A portfolio can generally only add up to 100%, so every purchase requires an equivalent sale.

The last few years have caused investors to question the role of traditional safe haven assets within portfolios. For decades, the mantra of many multi-asset managers was that investors should always hold some medium to long duration government bonds. In a risk off environment, the long end of the yield curve would typically benefit from a "flight to safety", generating strong gains and offsetting losses elsewhere in the portfolio. This principle has been a cornerstone of portfolio construction for generations.

Since 2021, however, investors have endured extraordinary pain from this recessionary hedge. UK gilt yields reaching 6%, and long dated bond benchmarks falling by more than 50% from levels 5 years ago, would have seemed inconceivable. As long duration bonds became increasingly painful, investors reassessed their allocations, trimming exposure repeatedly until this structural allocation all but slipped into history books. The question now remains: what brings investors back to bonds?

Fundamentally, economic growth remains sufficiently strong that the need for a recessionary hedge appears limited. However, shocks can often appear from nowhere and growth forecasts are often misled. Now that yields are approaching 6%, even if a recession is among the least expected outcomes, has the risk reward trade off become so attractive that bonds are worth buying anyway? Some investors may conclude yes, and the higher yields go, the greater the incentive.

After decades in which equities were clearly the most attractive destination for capital, is that still the case today? Perhaps this buy signal does need to become more extreme before investors are willing to return to an asset class that has inflicted so much pain over the last five years. In the short term, overcoming the powerful recency bias from one of the worst bond bear markets in history may prove to be the biggest challenge of all.



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