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## Further thoughts on the equity risk premium

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By No Author    Thu, Apr 16, 2020

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Dear editor,

In response to your April 6 article, "[The Shape-Shifting Equity Premium](#)," I'd like to point out the following:

1. **The inflation illusion.** Stocks were a tremendous buy in the 1970s when interest rates rose with inflation. You should always make clear that you are talking about the real interest rate.
2. **Risk premium versus risk.** If (real) interest rates fall and the equity risk premium stays the same, it is still likely that the risk has risen. Put another way, if the equity risk premium is 5%, and interest rates fall to 0% from 2%, then expected equity returns fall to 5%. Assuming that is below the long-term mean of 7%, the risk of holding stocks at high valuation levels is much greater since there is a likely reversion back to more normal (mean) valuations. Note the implications here for DB pension plans and pensioners.
3. **The current wealth bubble.** In my article on the Third Postwar Wealth Bubble (*Journal of Business Economics*) last year, I showed how we were at an all-time high in terms of net-worth-to-income. (My ratio was more like a price/earnings ratio for all assets than for the stock market by itself.) Yes, we're below the all-time high now, but we're still way up relative to historical precedent. This bubble and its sustainability are related to your article's mention of the Fed "indulging the fallacy" that risks are minimal. The Fed and the related huge international investment in U.S. Treasuries and other assets can only indulge that type of fallacy for so long. Put another way, the Fed's power (like Congress's fiscal power) to turn the economy around is in the second derivative (e.g., the change in the change in the money supply)—which cannot forever be kept positive.

Sincerely, Eugene Steuerle

Urban Institute

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