



ASSET ALLOCATION

Honey, the Fed Shrank the Equity Premium

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The future path of interest rates is highly uncertain, but we can at least be fairly confident that the level of rates will be substantially higher in the medium term than it has been in recent decades — in the U.S. and many other major economies. What, if any, are the implications for asset allocation? Does a higher cash rate tide lift all asset return boats? This article presents a simple empirical analysis covering stocks, bonds and alternative investments, and compares those historical patterns to yield-based expected returns as of mid-2023.

One result is clear: equity markets have earned slimmer excess returns when the cash baseline is higher. We discuss the role of so-called “cash-plus” liquid alternative strategies — overlooked beneficiaries of higher cash rates — and conclude with a simple allocation case study. In a higher-rate world that investors haven’t seen for many years, diversification away from equities may prove to be especially valuable.

About the Portfolio Solutions Group

The Portfolio Solutions Group provides thought leadership to the broader investment community and custom analyses to help AQR clients achieve better portfolio outcomes.

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