



Kroll Lowers Its Recommended U.S. Equity Risk Premium to 5.5%

Executive Summary

Kroll regularly reviews fluctuations in global economic and financial market conditions that may warrant changes to our equity risk premium (ERP) and accompanying risk-free rate recommendations. The risk-free rate and ERP are key inputs used to calculate the cost of equity capital in the context of the Capital Asset Pricing Model (CAPM) and other models used to develop discount rates. We also update country risk data on a quarterly basis for 175+ countries using various models.

The Kroll Recommended U.S. ERP is decreasing from 6.0% to 5.5% when developing USD-denominated discount rates as of June 8, 2023 and thereafter, until further notice. The Kroll Recommended Eurozone ERP is being reaffirmed in the range of 5.5% to 6.0% until further notice.

Background

According to our last update “Impact of High Inflation and Market Volatility on Cost of Capital Assumptions” (dated October 18, 2022), the Kroll Recommended U.S. ERP was increased to 6.0% (from 5.5%) when developing USD-denominated discount rates as of October 18, 2022 and thereafter, until further guidance was issued.

In March 2023, we reaffirmed our 6.0% U.S. ERP guidance, largely due to the emerging banking crisis that led to a number of banks declaring bankruptcy or being bailed out (through acquisitions).

More recently, we observed that the factors we monitor suggested (on the whole) that equity risks had diminished relative to our previous March 2023 analysis, but the stalemate in the U.S. debt ceiling negotiations was the factor preventing us from lowering the recommendation to 5.5%. In early May, U.S. Treasury Secretary Janet Yellen warned that the country could breach the debt ceiling as early as June 1 (later changed to June 5), which could have led to the first-ever debt default by the United States.

The stalemate over the debt ceiling has been resolved with the passage of the “Fiscal Responsibility Act of 2023” (signed into law by the U.S. President on June 3). In addition, the factors we normally monitor continue to suggest that equity risks have diminished relative to when we issued our October 2022 guidance, as well as relative to the turmoil observed during the March 2023 banking crisis:

- The Federal Reserve (Fed) hinted at a pause of its recent interest-rate hiking cycle, taking a wait-and-see approach. Although some Fed officials still think that additional rate hikes could be in the cards, this pause has removed some of the uncertainty from financial markets.

- At the end of May 2023, the S&P 500 index was up about 17% from its October 12, 2022 local low (in price terms). The NASDAQ index, a barometer of the tech sector, was up by 27% since its December 28, 2022 local low. The S&P 500 and NASDAQ improvements since the beginning of this year do not compensate for their overall 2022 losses of 19% and 33%, respectively. However, it does reflect the fact that markets have generally been more optimistic in 2023.
- The VIX (the volatility index on the S&P 500), known informally as the “fear index”, has generally been around or below its long-term average of approximately 20 since the beginning of the year (except during the March banking crisis, when it reached a local high of 26.5 on March 13).
- U.S. corporate credit spreads (i.e., the difference between yields of speculative-grade bonds and investment-grade bonds) are still low on a historical basis, even though the underlying corporate yields have increased significantly since early 2022. Similar to the VIX, corporate credit spreads are generally considered a barometer of investors’ “fear”.
- Forward-looking ERP models have been lower relative to their September/October 2022 highs when we last increased our U.S. ERP recommendation to 6.0%.
- While there is a chance the U.S. economy will tip into recession later in 2023 or in early 2024, many economists do not expect it to be a deep or prolonged one.
- While the U.S. unemployment rate increased to from 3.4% in April to 3.7% in May, this is still very low by historical standards. The labor market is still tight and unemployment rate projections are relatively tame when compared to past recessionary periods.
- Inflation, as measured by the Consumer Price Index (CPI), is still far above the Fed’s 2.0% target, but it seems to be on a steady downward path. In the 12 months ending in April 2023, CPI inflation (before seasonal adjustments) increased 4.9%, down from its 41-year high of 9.1% for the 12 month-period ending June 2022. Nevertheless, risks do remain. The Fed’s preferred gauge for inflation, the Personal Consumer Expenditures (PCE) Price Index has actually accelerated in April to 4.4%. Likewise, the core PCE index (i.e., excluding food and energy) accelerated to 4.7% in April, demonstrating the challenge the Fed is facing in bringing down inflation.
- For now, the world economy appears to have avoided the worst-case scenarios from the Russia-Ukraine war.

Meanwhile, a period of “stagflation”—where the economy experiences sluggish or no growth—accompanied by high inflation is still a realistic scenario for some economies within the eurozone. For example, according to recent data, Germany—Europe’s largest economy—entered a technical recession in Q1 2023, after two consecutive quarters of negative real economic growth. There was some optimism in early 2023 that a contraction could be avoided, as an unseasonably warm winter in Europe contributed to lower energy prices. However, high prices continued to erode German consumer purchasing power.

Inflation in Germany remained at an elevated level of 6.3% (estimated) in May and is expected to remain a key challenge for the rest of the year.

In the broader eurozone, inflation has been slowly coming down from 25-year highs, standing at an estimated 6.1% at the end of May. However, core inflation (excluding volatile energy and food prices) remained stubbornly high at an estimated 5.3%, and far from the European Central Bank's (ECB) 2.0% inflation target. The ECB slowed down the pace of interest rate hikes at its May 2023 meeting, but signaled more tightening is still coming. The revision in Germany's real GDP growth for Q1 2023 helped tip the eurozone economy into a technical recession, after also having contracted in Q4 2022. This will make ECB's job in 2023 even more challenging.

Cost of Capital Recommendations

- **United States:** With the aforementioned factors suggesting that equity risks in the U.S. have diminished, and the immediate risks associated with the debt ceiling debate resolved with the passage of the "Fiscal Responsibility Act of 2023", **Kroll is lowering its Recommended U.S. ERP from 6.0% to 5.5% when developing USD-denominated discount rates as of June 8, 2023 and thereafter, until further notice.** This is matched with the *higher* of a normalized risk-free rate of 3.5% or the spot 20-year U.S. Treasury yield as of the valuation date.
- **Eurozone (from a German investor perspective):** The current Kroll Recommended Eurozone ERP remains in the range of 5.5% to 6.0%. Based on current economic and financial market conditions, we continue to believe that an ERP towards the higher end of the range (i.e., 6.0%), used in conjunction with a German normalized risk-free rate of 3.0%, is more appropriate when developing EUR-denominated discount rates as of June 8, 2023 and thereafter, until further guidance is issued.

Incremental country risk adjustments for other eurozone countries with a sovereign debt rating below AAA may be appropriate. Please note that this information does not supersede Germany's IDW (Institut der Wirtschaftsprüfer) guidance for projects that will be reviewed by German auditors or regulators.

However, we are monitoring markets and the geo-political and economic environment closely to determine whether indications point to an ERP closer to the lower end of our recommended range.

We will continue to closely monitor the situation and publish new guidance when appropriate.

Please contact our support team with any questions: costofcapital.support@kroll.com