Equities

Fight the Fed Model

September 1, 2003

Strategists, portfolio managers and market pundits often claim that the high market multiples of the early 2000s were justified by low interest rates and/or inflation.

The most widespread version of this comparison of stocks to bonds is often deemed the Fed model. This model, allegedly found in the annals of a Fed report (not named because of any official Fed endorsement), comes in various forms, but generally asserts that the stock market's earnings yield should be compared to current nominal interest rates (the earnings yield, or E/P, is the inverse of the well-known price-to-earnings ratio or P/E).

This has the appearance but not the reality of common sense. The empirical evidence tells us the Fed model has no power to forecast long-term real stock returns. On the contrary: Traditional methods, like examining the market's unadjusted P/E alone, have been very effective.

In the end, we believe the Fed model is a misleading sales tool for stocks. Its popularity is presumably driven by its simplicity; its flexibility (if you don't like the E/P, just call some expenses non-recurring); its superficial rigor (it looks like math); its false initial resemblance to common sense (pundit after pundit enjoys explaining to a presumably impressed audience how bonds really have a P/E too); and most assuredly the fact that it is now, and for some time has been, more bullish than the traditional model.

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