

# The “Fed Model” and the Predictability of Stock Returns

[Get access >](#)

Paulo Maio

*Review of Finance*, Volume 17, Issue 4, July 2013, Pages 1489–1533,

<https://doi.org/10.1093/rof/rfs025>

**Published:** 25 July 2012

## Abstract

The focus of this article is on the predictive role of the stock-bond *yield gap*—the difference between the stock market earnings (dividend) yield and the 10-year Treasury bond yield—also known as the “Fed model”. The results show that the *yield gap* forecasts positive excess market returns, both at short and long forecasting horizons, and for both value- and equal-weighted stock indexes, and it also outperforms competing predictors commonly used in the literature. These findings go in line with the predictions from a present-value decomposition. The absence of predictive power for dividend growth, dividend payout ratios, earnings growth, and future one-period interest rates, actually strengthens the return predictability associated with the *yield gap* at very long horizons. By performing an out-of-sample analysis, the results show that the *yield gap* has reasonable out-of-sample predictability for the equity premium when the comparison is made against a simple historical average, especially when one imposes a restriction of positive equity premia. Furthermore, the *yield gap* proxies generally show greater out-of-sample forecasting power than the alternative state variables. An investment strategy based on the forecasting ability of the *yield gap* produces significant gains in Sharpe ratios.

© The Author 2012. Published by Oxford University Press on behalf of the European Finance Association. All rights reserved. For Permissions, please email: [journals.permissions@oup.com](mailto:journals.permissions@oup.com)

**JEL:** [E44 - Financial Markets and the Macroeconomy](#), [G11 - Portfolio Choice; Investment Decisions](#), [G12 - Asset Pricing; Trading volume; Bond Interest Rates](#), [G14 - Information and Market Efficiency; Event Studies; Insider Trading](#)

**Subject:** [Investment Strategies and Anomalies](#), [Investment and Innovation](#)

You do not currently have access to this article.

## Sign in

 [Get help with access](#)

### Personal account

- Sign in with email/username & password
- Get email alerts
- Save searches
- Purchase content
- Activate your purchase/trial code
- Add your ORCID iD

Sign in >

[Register](#)

### Institutional access



Sign in through your institution

[Sign in through your institution](#)

[Sign in with a library card](#)

[Sign in with username/password](#)

[Recommend to your librarian](#)

### Institutional account management

[Sign in as administrator](#)

## Purchase

[Subscription prices and ordering for this journal](#)

[Purchasing options for books and journals across Oxford Academic](#)

## Rental



This article is also available for rental through DeepDyve.