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The "Fed Model" and the Predictability of Stock Returns

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Paulo Maio

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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.

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

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