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The Predictive Ability of the Bond-Stock Earnings Yield Differential Model

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Abstract

In this article, the authors survey the bond-stock prediction model for five worldwide equity markets. This model is useful for predicting the time-varying equity risk premium (ERP) and for strategic asset allocation of bond-stock equity mixes. The focus is on the model's economic and financial implications and its application to the study of stock market strategies and corrections. The model has two versions. The first model, formulated more than 35 years ago by Ziemba and Schwartz, is the difference between the most liquid long bond, usually the 10 or 30-year bond, and the trailing equity yield. The idea is that asset allocation between stocks and bonds is related to their relative yields. When the bond yield is too high, a shift out of stocks into bonds can cause an equity market correction. This model predicted the 1987, 2000, and 2002 corrections in the United States and the 1990 correction in Japan. The second model and equivalent version, the Fed model, uses the ratio, or equivalently the logs, of the two yields, and has its origins in reports and statements from the Federal Reserve System under Alan Greenspan dating from about 1996. The ERP can thus be negative or

positive and is, therefore, partially predictable. Despite its predictive ability, the bond-stock model has been criticized as being theoretically unsound because it compares a nominal quantity (the long-bond yield) with a real quantity (the earnings yield on stocks). Theoretical models of fairly priced equity indices can be derived and compared to actual index values to ascertain danger levels.

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