

The Fed Model: A Questionable Timing Tool

For much of the past 15 years, low bond yields have helped push up stock prices as investors found few alternatives to stocks in attempting to reach their return objectives.

Today, however, high-quality bonds yielding 5% should be formidable alternatives. A commonly cited metric, the “Fed Model,” suggests as much. By measuring the spread between the S&P 500 Index’s earnings yield (the inverse of the index’s P/E ratio) and the 10-year U.S. Treasury bond’s yield, investors attempt to gauge the relative value of stocks over bonds. The larger the spread, the more attractive stocks are to bonds; the narrower the spread, the more attractive bonds are to stocks. After the S&P 500’s 5% gain in May, this spread narrowed to just 0.3%.

Does this narrow spread foretell of difficult times ahead for stock prices? Not necessarily. As the table below shows, narrow spreads between the stock market’s earnings yield and U.S. Treasury bond yields are relatively commonplace. Moreover, when spreads are narrow, forward 12-month stock returns are more frequently positive than not. These numbers are consistent with the long-term history of the S&P 500 which, since 1928, has produced positive annual returns during nearly three-quarters of its 96 years. Only when spreads reached extremes did this measure prove to be a reliable indicator of future returns.

Like many valuation measures that are useful in forecasting longer-term returns, the Fed Model’s usefulness in predicting shorter-term returns is suspect.

CHART OF THE WEEK

S&P 500 Forward 12-Month Returns

Quarterly Spread Between S&P 500 Earnings and 10Y Treasury Yields
From 6/30/90 to 3/31/24

Yield Spread	Observations	Frequency	Hit Rate	Median Return
-4% to -2%	1	1%	0%	-9.1%
-2% to 0%	38	29%	82%	14.4%
0% to 2%	28	21%	86%	11.3%
2% to 4%	47	36%	77%	10.8%
4% to 6%	14	11%	100%	19.5%
6% to 8%	4	3%	100%	23.5%

Source: Bloomberg. Earnings yield calculated using 12M forward earnings expectations.



Equities	Index Returns (%)					
	Level	1 Week	QTD	YTD	1 Year	3-Year Ann.
S&P 500	5291	-0.24	0.95	11.61	25.42	9.40
Russell 1000 Growth	3473	-0.69	2.45	14.14	31.57	11.32
Russell 1000 Value	1722	-0.01	-2.10	6.69	17.46	4.84
FTSE High Dividend Y	413	0.08	-1.89	7.05	17.84	6.52
S&P Small and Mid Ca	16249	-1.06	-3.53	3.81	16.64	2.58
MSCI EAFE	2369	0.20	2.01	8.11	16.68	3.54
MSCI EM	1052	-3.26	1.33	3.81	10.10	-5.93

* Bloomberg U.S. Large Cap Dividend Yield Total Return Index used as substitute for index characteristics.

Fixed Income	Index Returns (%)					
	Yield	1 Week	QTD	YTD	1 Year	3-Year Ann.
U.S. Aggregate	4.96	1.39	0.10	-0.67	2.60	-2.82
U.S. Int. Gov/Credit	4.81	0.88	0.40	0.25	3.48	-1.24
U.S. Corporates	5.40	1.42	0.24	-0.16	5.50	-2.47
High Yield	7.92	0.37	0.56	2.05	10.75	1.82
Municipals (1-10)	3.56	0.12	-1.14	-1.50	2.03	-0.61

Key Rates	Levels (%)					
	Last	1 Wk Ago	Last Qtr	Prev YE	1 Yr Ago	3 Yrs Ago
2-yr Treasury	4.77	4.97	4.62	4.25	4.47	0.15
10-yr Treasury	4.33	4.61	4.20	3.88	3.69	1.56
30-yr Treasury	4.47	4.73	4.34	4.03	3.89	2.23
3-mo. LIBOR	5.66	5.61	5.56	5.59	5.51	0.13
6-mo. CD rate	5.38	5.44	5.35	5.28	5.61	0.09
Prime Rate	8.50	8.50	8.50	8.50	8.25	3.25
30-yr fixed mortgage	7.26	7.40	7.25	6.99	7.03	3.10

Equities	Index Characteristics				
	NTM P/E	NTM P/E (20Y med)	NTM P/S	NTM P/S (20Y med)	Div. Yld
S&P 500	21.9	16.7	2.8	1.7	1.4
Russell 1000 Growth	28.7	19.8	4.5	2.0	0.7
Russell 1000 Value	16.8	14.9	1.8	1.4	2.2
FTSE High Dividend Y	12.6	14.3	1.5	1.6	4.2
S&P Small and Mid Ca	16.7	19.1	1.2	1.2	1.7
MSCI EAFE	15.0	14.6	1.5	1.1	3.0
MSCI EM	12.7	12.6	1.4	1.3	2.7

Currencies	Levels			
	Last	1 Wk Ago	Prev YE	3 Yrs Ago
DXY	104.16	105.12	101.33	90.14
\$ per €	1.09	1.08	1.10	1.22
\$ per £	1.28	1.27	1.27	1.42
¥ per \$	155.87	157.64	141.04	109.52

Commodities	Levels			
	Last	1 Wk Ago	Prev YE	3 Yrs Ago
Oil (WTI)	73.65	79.23	71.97	56.03
Gasoline	3.53	3.57	3.12	3.05
Natural Gas	2.64	2.49	2.51	3.10
Gold	1924	2338	2063	1892
Copper	8350	10326	8464	9940
Wheat	604	693	628	688
BBG Index	238.90	247.64	226.43	202.17

LAST WEEK IN REVIEW

- **1Q GDP – Second Estimate:** Revised downward from 1.6% to 1.3%. Weaker personal consumption—especially autos—led downward revision.
- **Personal Consumption & Expenditures (Apr.):** Moderated growth in incomes and spending suggest consumers becoming more cautious.
- **PCE Inflation (Apr.):** MoM (+0.3% HL, 0.2% Core), YoY (+2.7% HL, 2.8% Core). Deceleration from the first quarter, yet further progress necessary.

THIS WEEK

- **ISM Manufacturing Index (May):** 6/3
- **JOLTS (May):** 6/4
- **ISM Services Index (May):** 6/5
- **Trade Balance (Apr.):** 6/6
- **Payrolls & Unemployment (May):** 6/7

S & P SECTOR RETURNS

