

# Fed Model

The Fed Model is a model of stock price valuation. It was based on comments by the Federal Reserve in a Humphrey-Hawkins report and popularized by Edward Yardeni. The Fed model says that the earnings yield on the stock market will be proportional to the yield on long-term government bonds. The 10-year T-Bond yield is normally used. The model looks something like this:

$$\frac{\text{Earnings}}{\text{Stock Market Price}} = \text{TBond Yield}$$

There are variations on the Fed model that are slightly more sophisticated. One looks like this:

$$\frac{\text{Earnings}}{\text{Stock Market Price}} = \text{TBond Yield} * \frac{1}{\text{TBond Yield}}$$

This model says that as the T-Bond Yield increases, the earnings yield should too (i.e. stock prices should go down), but at a decreasing rate.

In reality, the Fed model is a basic model and there are many variations on it that work better than the standard fed model. There are models that replace the earnings yield with the dividend yield. And there are models that replace the T-Bond Yield with a corporate bond yield.

The greatest contribution from the Fed model was probably popularizing the practice of comparing the stock market to some measure of value (i.e. using a ratio like earnings yield or dividend yield on the left side of the equation) before comparing that ratio to some measure of interest rates.