The Fed Model: The Bad, the Worse, and the Ugly

Javier Estrada *

IESE Business School, Av. Pearson 21, 08034 Barcelona, Spain
Tel: +34 93 253 4200, Fax: +34 93 253 4343, Email: jestrada@iese.edu

Abstract

The negative relationship between stock market P/E ratios and government bond yields seems to have become conventional wisdom among practitioners. Both limited empirical evidence and a misleading suggestion that the model originated in the Fed are used to support the model's plausibility. This article argues that the Fed model is flawed from a theoretical standpoint and reports evidence from 20 countries that seriously questions its empirical merits. Despite its widespread use and acceptance, the Fed model is found to be a failure both as a normative and as a positive model of equity pricing.

January, 2006

* I would like to thank Fernando Alvarez, Mark Kritzman, Ignacio Peña, and participants of the seminar at State Street for their comments. Alfred Prada and Lydia Nikolova provided valuable research assistance. The views expressed below and any errors that may remain are entirely my own.