

Dave Fulkerson's December '05 Newsletter

I will never forget the quote: "The markets are experiencing irrational exuberance." – Federal Reserve Chairman, Alan Greenspan, in 1999, near the end of the amazing stock market run of the 1990's. How did Mr. Greenspan know the stock market was way over valued? What data did he evaluate? As most of you know, I use data when making investment decisions.

Mr. Greenspan was referring to the "Fed Model", one tool of many he uses to help determine if interest rates are set at the proper level. He uses the results of the model as a data point to determine if the stock market is fairly valued. I use the model to help me decide if stocks are a low or high risk investment for my clients. The model compares the future "earnings yield" of the S&P 500 companies with the yield on a 10 year U.S. government bond (yield is the annual rate of return paid by a company or bond). In other words, how well are companies doing in comparison to "risk-free" government bonds?*

The main point of the Fed Model is, if the forward stock market earnings yield is greater than the 10 year bond yield (currently 4.5%), the stock market is under priced. If the earnings are less than the 10 year bond, it is overpriced. In March, 2000, according to the Fed Model, the S&P 500 index was 63% overpriced** – the most in history since 1929. This means stock prices were too high for the amount of money the companies were earning in 2000...and we all know what happened to the market in 2000-2002.

Why does the Fed Model work? It is the key measurement institutional money managers (pension funds, mutual funds, insurance company investment managers – who account for approximately 80% of the stock markets direction) look at when deciding how much of their assets to put in stocks and how much to put in bonds. The model provides objective data to evaluate if stocks are a better value than bonds at any particular time.

What does the Fed Model say today? The S&P500 earnings yield is 5.8% and the 10 year bond is 4.5%. The difference is 1.3%. Since 1979, seven times the S&P 500 yield was 1% or more than the 10 year bond at the beginning of the year. All seven years, the S&P 500 index went up. The average increase was 16.5% and the smallest gain was 2%. ***

One final observation: According to the model, the "fair value" of the S&P 500 index should be 1624. The actual S&P 500 index is 1269...28% undervalued. Does this mean the S&P 500 index will go up 28%? Absolutely not; but the end of 2002 was the only time the index was this "under valued" at the end of a year. In 2003, the S&P 500 index went up 28.7%.

Feel free to call for a no obligation look at how this information can be applied to your investment portfolio.

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