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STOCK EARNINGS AND BOND YIELDS IN THE US 1871 - 2017: THE STORY OF A CHANGING RELATIONSHIP

Abstract:

Using historical data that spans almost 150 years, we examine whether there is a long-run equilibrium relationship between the stock's earnings and bond yields. The novelty of our econometric methodology consists in using a vector error correction model where we allow multiple structural breaks in the equilibrium relationship. The results of our analysis suggest the existence of equilibrium relationship over 1871-1929 and 1958-2017. On the two historical segments, our analysis finds that the stock's earnings yield followed the bond yield in both the short- and long-run, but not the other way around. Perhaps the most important and surprising finding of our empirical study is that, after the break in 1929, a completely new equilibrium relationship re-emerged in 1958 that was later termed as the "Fed model." Our main argument for the emergence of a new equilibrium relationship is that a major "paradigm shift" in the stock valuation theory occurred in the late 1950s. To support our argument, we highlight the main historical events that potentially could have caused the transition from the old to the new paradigm. Finally, we identify the primary impetus for the paradigm shift.

Keywords:

equity valuation model, equilibrium relationship, Granger causality, vector error correction, structural break analysis, historical development, monetary policy

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