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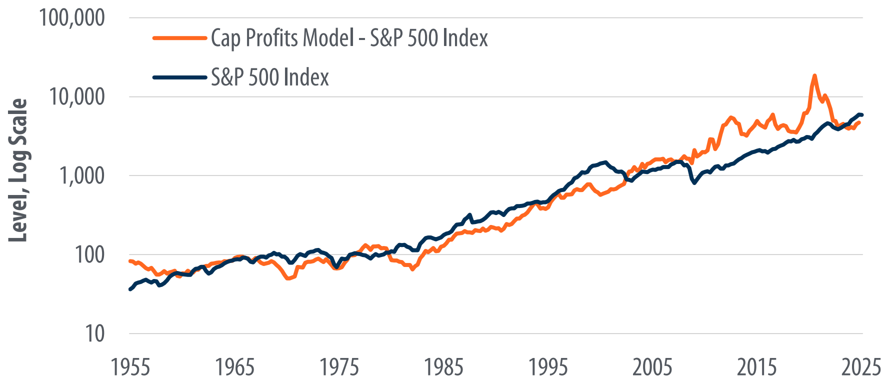
5,200 Target Hit but Still Overvalued? A Look at the Cap Profits Model

The past few weeks have been turbulent, to say the least. A wave of newly implemented U.S. tariffs has served as the catalyst for a broad repricing in equities — and there's a real possibility that stocks could fall further. That said, valuations were stretched even before the tariffs. If it hadn't been tariffs driving the pullback, it likely would have been something else. This is exactly why we expected 2025 to be a more challenging year for markets. Last Friday, the S&P 500 Index touched our year-end target of 5,200. So, where do we go from here? In today's "Three on Thursday," we revisit our Capitalized Profits Model, a framework we use to gauge fair value for the S&P 500 Index. It's important to note that this is a **valuation tool**, not a **market timing indicator**. An overvalued reading doesn't mean stocks will immediately fall, just as undervaluation doesn't guarantee a rally. For a deeper dive, see the chart and two tables below.

First Trust Capitalized Profits Model



Source: First Trust Advisors, Standard & Poor's, Bureau of Economic Analysis, Federal Reserve Board. Quarterly Q1 1955 – Q1 2025.

We use the Capitalized Profits Model to estimate the market's "fair value" based on current interest rates, economy-wide corporate profits, and their historical relationship. However, our year-end market target, released at the start of each year, is not a direct output of the model. Instead, the model helps us assess whether the market is currently overvalued or undervalued. From there, we incorporate broader factors — such as expected profit growth, fiscal and monetary policy, trade developments, and regulatory changes — to estimate how much of the valuation gap might close over the course of the year. In short: the Capitalized Profits Model shows us **how far** the market is from fair value, and our annual forecast reflects **how much** of that gap we think the market could close. In the chart, an orange line above the blue line indicates the market is undervalued; when it's below, the market is overvalued. For the past 18 months, the model has been signaling overvaluation.

S&P 500 Index Fair Value Based on Capitalized Profits Model

2025 Profit Growth	10-Year Treasury Yield: 3.00%	3.25%	3.50%	3.75%	4.00%	4.25%	4.50%	4.75%	5.00%
30%	7,974	7,361	6,835	6,380	5,981	5,631	5,318	5,038	4,786
25%	7,668	7,078	6,572	6,134	5,753	5,414	5,113	4,844	4,602
20%	7,361	6,795	6,309	5,891	5,522	5,198	4,909	4,650	4,418
15%	7,054	6,512	6,047	5,645	5,292	4,981	4,704	4,457	4,234
10%	6,748	6,229	5,785	5,400	5,062	4,764	4,500	4,263	4,050
5%	6,441	5,945	5,522	5,154	4,832	4,548	4,295	4,069	3,866
0%	6,134	5,664	5,259	4,909	4,602	4,331	4,091	3,875	3,682
-5%	5,829	5,381	4,997	4,663	4,372	4,115	3,886	3,682	3,498
-10%	5,522	5,098	4,734	4,418	4,142	3,898	3,682	3,488	3,313
-15%	5,216	4,814	4,471	4,173	3,912	3,682	3,477	3,294	3,129
-20%	4,909	4,531	4,208	3,927	3,682	3,465	3,273	3,100	2,945

Source: First Trust Advisors, Standard & Poor's, Bureau of Economic Analysis, Federal Reserve Board. Quarterly Q1 1955 – Q1 2025.

The adjacent table shows what the Capitalized Profits Model estimates as fair value for the S&P 500 Index, based on a range of profit growth and interest rate assumptions. The most recent economy-wide profit data available is through 2024. Comparing to yesterday's close, anything in green is undervalued, anything in red is overvalued. For example, if you assume 10% profit growth in 2025 and a 10-Year Treasury Yield of 3.75% at year-end, the model suggests a fair value of 5,400 — implying that stocks are currently slightly overvalued. However, given our view that a recession remains a real possibility this year, we're holding to our year-end S&P 500 Index forecast of 5,200, reflecting a more cautious outlook. Under our baseline assumptions — If profits grow 5% this year (half of what the consensus expected) and the 10-year yield stays around 4% — then the fair value of the S&P 500 Index is about 4,800.

Over/Undervaluation Based on Current S&P 500 Index Value

2025 Profit Growth	10-Year Treasury Yield: 3.00%	3.25%	3.50%	3.75%	4.00%	4.25%	4.50%	4.75%	5.00%
30%	46.1%	34.9%	25.3%	16.9%	9.6%	3.2%	-2.5%	-7.7%	-12.3%
25%	40.5%	29.7%	20.4%	12.4%	5.4%	-0.8%	-6.3%	-11.2%	-15.7%
20%	34.9%	24.5%	15.6%	8.0%	1.2%	-4.7%	-10.0%	-14.8%	-19.0%
15%	29.3%	19.3%	10.8%	3.4%	-3.0%	-8.7%	-13.8%	-18.3%	-22.4%
10%	23.7%	14.1%	6.0%	-1.0%	-7.2%	-12.7%	-17.5%	-21.9%	-25.8%
5%	18.0%	8.9%	1.2%	-5.6%	-11.5%	-16.7%	-21.3%	-25.4%	-29.2%
0%	12.4%	3.8%	-3.6%	-10.0%	-15.7%	-20.6%	-25.0%	-29.0%	-32.5%
-5%	6.8%	-1.4%	-8.4%	-14.6%	-19.9%	-24.6%	-28.8%	-32.5%	-35.9%
-10%	1.2%	-6.6%	-13.2%	-19.0%	-24.1%	-28.6%	-32.5%	-36.1%	-39.3%
-15%	-4.4%	-11.8%	-18.1%	-23.5%	-28.3%	-32.5%	-36.3%	-39.6%	-42.7%
-20%	-10.0%	-17.0%	-22.9%	-28.0%	-32.5%	-36.5%	-40.0%	-43.2%	-46.0%

Source: First Trust Advisors, Standard & Poor's, Bureau of Economic Analysis, Federal Reserve Board. Quarterly Q1 1955 – Q1 2025.

The adjacent table shows how far the current S&P 500 Index is from fair value, according to the Capitalized Profits Model, using a range of profit growth and interest rate scenarios. Green cells indicate the market is undervalued, while red cells suggest it's overvalued. For example, if you expect 10% profit growth and a 10-Year Treasury Yield of 3.5% by year-end, the model suggests the S&P 500 Index is undervalued by roughly 6% relative to yesterday's close. If you expect 0% profit growth and a 4% 10-year yield, the market is still overvalued by 15.7% as of yesterday's close. That said, this model is just one piece of the puzzle. It's important to keep in mind the broader factors — including profit outlooks, fiscal and monetary policy, trade dynamics, and regulatory changes — to assess how much of that valuation gap might realistically close over the course of the year.