Early this year we set a target of 15,000 on the Dow Jones Industrial Average for the end of 2008. At the time we made that forecast the Dow was right around 12,000, so we were essentially calling for an increase of 25%. We stand by that 15,000 forecast despite continued market volatility and renewed economic pessimism following a decline in employment.

Our market forecasts are based on fundamentals. To determine fair value for stocks we take a capitalized profits approach. We use government figures on profits that are based on corporate tax filings – the profits no company likes to falsely boast about – discount those profits with current interest rates and index this to market values based on historical precedent.

Trouble is, because interest rates are now so artificially low, our method generates a fair value of about 20000 on the Dow. So instead of using prevailing interest rates, like we normally do, we are plugging in a 10-year Treasury yield of 6%.

This conservative stance – using a higher interest rate than necessary – generates a fair value for the Dow above 15000. This should not be a huge surprise, profits are still near record highs and the dividend yield on the Dow is 2.6%, which is above the 2-year Treasury yield of 1.8%.

Relative to the price of gold, the stock market is down 75% from its 2000 peak and is back down to levels last seen in 1995. If gold accurately reflects the true extent of inflation in the economic pipeline, business sales will rise with the general price level, potentially lifting profits as well.

More importantly, at this point, the issue of whether or not the US has fallen into recession has become almost irrelevant. Investors have fled risky financial assets and stocks are already priced for a recession.

If, as we still strongly believe, the US economy avoids recession, pessimism about the economy will lift quickly and the stock market will get a nice boost. The Dow was above 14,000 as recently as October 2007. Essentially, we are forecasting that in the absence of a recession the Dow finishes 2008 only about 6% higher than the 2007 peak. Put in those terms, a 15,000 Dow seems downright cautious.

But let’s imagine that we are wrong about the economy. Hypothetically, let’s say a recession started in late 2007 or very early this year. Even under those circumstances, stocks could rally considerably by year end. Take the 1990-91 recession: after stocks bottomed in the first half of the recession, they rallied about 25% in the following six months. Or take the 1981-82 recession: after bottoming in August 1982, the stock market rallied about 40% over the next six months.

This is not unusual. Typically, stocks rally sharply in the latter stages of recessions as easy money lifts the economy. This even happened in the 2001 recession, despite the fact that the stock market was falling from extremely overvalued levels.

As we said back in January, those who maintain their appetite for risk will be richly rewarded sooner than they think.