JOURNAL ARTICLE

# Time-Varying Risk Premiums and the Output Gap

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*The Review of Financial Studies*, Volume 22, Issue 7, July 2009, Pages 2801–2833, https://doi.org/10.1093/rfs/hhn087

**Published:** 02 October 2008

## Abstract

The output gap, a production-based macroeconomic variable, is a strong predictor of U.S. stock returns. It is a prime business cycle indicator that does not include the level of market prices, thus removing any suspicion that returns are forecastable due to a "fad" in prices being washed away. The output gap forecasts returns both in-sample and out-of-sample, and it is robust to a host of checks. We show that the output gap also has predictive power for excess stock returns in other G7 countries and U.S. excess bond returns.