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Stock Returns and Expected Business Conditions: Half a Century of Direct Evidence

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Abstract

Using survey data, we characterize directly the impact of expected business conditions on expected excess stock returns. Expected business conditions consistently affect expected excess returns in a counter-cyclical fashion. Moreover, inclusion of expected business conditions in otherwise-standard predictive return regressions substantially reduce the explanatory power of the conventional financial predictors, including the dividend yield, default premium, and term premium, while simultaneously increasing R^2. Expected business conditions retain predictive power even when including the key nonfinancial predictor, the generalized consumption/wealth ratio. We argue that time-varying expected business conditions likely capture time-varying risk, whereas time-varying consumption/wealth may capture time-varying risk aversion.

KEY WORDS::

Business cycle | Equity premium | Expected equity returns | Livingston survey | Prediction | Risk aversion | Risk premium

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