

The Equity Premium and Business Cycles: A Defense of Predictability

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ABSTRACT

Our analysis complements the burgeoning equity premium literature. A major contribution of this paper is that we assess the relative forecasting performance of yield-gap, stock-based and interest-related models under different economic climates. In-sample (IS) and Out-of-sample (OOS) tests are employed to assess the statistical merit of seventeen predictor models. This study also quantifies the financial benefits a risk adverse investor would receive from using forecasted returns in a mean variance portfolio allocation trading strategy. Our findings indicate that stock-based and yield-gap models are IS and OOS significant. While many models perform well during economic expansions; investors should exercise a degree of restraint when using most models during recessions.