State variables, macroeconomic activity, and the cross section of individual stocks

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Abstract

I study whether risk premiums for exposure to state variables in the cross section of individual stocks are consistent with how these variables forecast macroeconomic activity in the time series. I find such time series and cross-sectional consistency. This finding suggests that investors are ultimately concerned about business cycle risk and therefore require a premium for exposure to variables that contain systematic economic news. This finding challenges recent portfolio-level evidence showing that state variable risk premiums are inconsistent with hedging incentives in the Intertemporal CAPM. Moreover, state variable risk premiums are not fully captured by the factors and characteristics of Fama and French (1992, 1993).

JEL classification: G11, G12

Keywords: State variables, Macroeconomic risk, Linear asset pricing models, Individual stock returns, Time series and cross-sectional consistency

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