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Unobservable Systematic Risk, Economic Activity and Stock Market

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Abstract

I extract a latent systematic risk factor, which is orthogonal to idiosyncratic risk and observable systematic risk, from credit spreads for 1,764 Eurobonds across euro area non-financial firms over the 1999-2015 period. The extracted common latent factor negatively predicts stock market excess returns, the growth rate in real economic activity and economic sentiment. It predicts the financial crisis and the two economic recessions.

Keywords: Corporate credit spreads, excess bond premium, forecasts, euro area.

JEL classification: C32, F36, G12, G15

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