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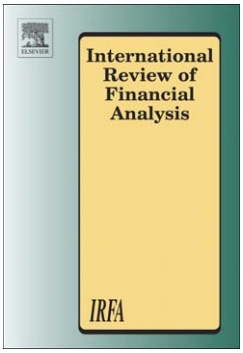

Equity Premium Estimates from Economic Fundamentals under Structural Breaks

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Equity Premium Estimates from Economic Fundamentals under Structural Breaks

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Abstract

This article compares three estimates of the conditional equity premium using dividend and earnings growth rates to measure the expected rate of capital gain. The premia are estimated using a theory-informed Bayesian model that admits structural breaks. The equity premium fell from 8.16% in 1951 to 1.15% in 1985. Approximately half of this decline was reversion of a high conditional premium to the long run mean and the remainder resulted from a decline in the expected stock return. The decline in the expected stock return was largely driven by the Fed Accord (1951) and the Fed's 'monetarist policy experiment' (1979-1982).

Keywords: Equity premium, Structural Break, Bayesian analysis

JEL classifications: G10, C11, C15

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