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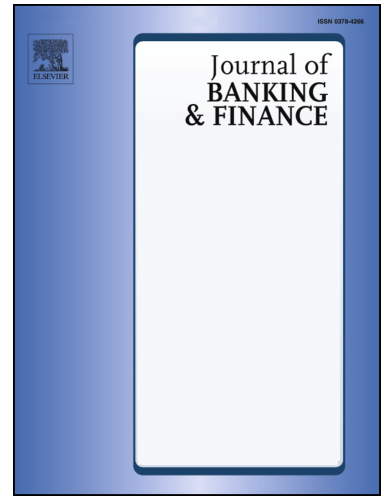

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What Do Asset Prices Have to Say About Risk Appetite and Uncertainty?*

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Abstract

Building on intuition from the dynamic asset pricing literature, we uncover unobserved risk aversion and fundamental uncertainty from the observed time series of the variance premium and the credit spread while controlling for the conditional variance, expectations about the macroeconomic outlook, and interest rates. We apply this methodology to monthly data from both Germany and the US. We find that the variance premium contains a substantial amount of information about risk aversion whereas the credit spread has a lot to say about uncertainty. We link our risk aversion and uncertainty estimates to practitioner and "academic" risk aversion indices, sentiment indices, financial stress indices, business cycle indicators and liquidity measures.

JEL classification: G12; E44

Keywords: Economic uncertainty; Risk aversion; Time variation in risk and return; Credit spread; Volatility dynamics; Financial stress

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