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Investor Sentiment and Economic Forces*

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Abstract

Economic theory suggests that pervasive factors should be priced in the cross-section of stock returns. However, our evidence shows that portfolios with higher risk exposure do not earn higher returns. More important, our evidence shows a striking two-regime pattern for all 10 macro-related factors: high-risk portfolios earn significantly higher returns than low-risk portfolios following low-sentiment periods, whereas the exact opposite occurs following high-sentiment periods. These findings are consistent with a setting in which market-wide sentiment is combined with short-sale impediments and sentiment-driven investors undermine the traditional risk-return tradeoff, especially during high-sentiment periods.

JEL Classification: G02, G12, G14

Keywords: investor sentiment, macro risk, factor, beta, market efficiency

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