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## Investor Sentiment and Economic Forces<sup>\*</sup>

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## Abstract

Economic theory suggests that pervasive factors should be priced in the cross-7 section of stock returns. However, our evidence shows that portfolios with higher 8 risk exposure do not earn higher returns. More important, our evidence shows a 9 striking two-regime pattern for all 10 macro-related factors: high-risk portfolios earn 10 significantly higher returns than low-risk portfolios following low-sentiment periods, 11 whereas the exact opposite occurs following high-sentiment periods. These findings 12 are consistent with a setting in which market-wide sentiment is combined with short-13 sale impediments and sentiment-driven investors undermine the traditional risk-return 14 tradeoff, especially during high-sentiment periods. 15

<sup>16</sup> JEL Classification: G02, G12, G14

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<sup>17</sup> Keywords: investor sentiment, macro risk, factor, beta, market efficiency

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