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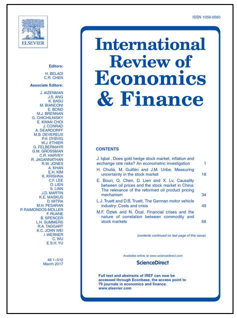

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Regime Shifts and Stock Return Predictability ☆

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Abstract

Identifying economic regimes is useful in a world of time-varying risk premia. We apply regime switching models to common factors proxying for the macroeconomic regime and show that the ensuing regime factor is relevant in forecasting the equity risk premium. Moreover, the relevance of this regime factor is preserved in the presence of fundamental variables and technical indicators which are known to predict equity risk premia. Based on multiple predictive regressions and pooled forecasts, the macroeconomic regime factor is deemed complementary relative to the fundamental and technical information sets. Finally, these forecasts exhibit significant out-of-sample predictability that ultimately translates into considerable utility gains in a mean-variance portfolio strategy.

Keywords: Return Predictability, Regime Switching, Predictive Regressions
PACS: G11, G12, G17

Considering the ongoing turmoil spurred by the global financial crisis in 2008, one may have the impression of a paradigm shift in investors' assessment of risky assets. Instead of prudently evaluating the investment opportunity set, investors tend to either buy or sell risky assets across the board according to the prevailing general risk appetite. Of course, this behaviour is typical in times of crises which often induce asset correlations close to one. However, the pace of market participants' switching between these two states—risk-on or risk-off—has dramatically increased [Lee (2012)].

In a risk-on/risk-off world, regime switching methods appeal as a natural remedy for identifying the current state of the market and adjusting one's portfolio strategy accordingly. As Ang and Timmermann (2012) state: "[R]egime switching models can match narrative stories of changing fundamentals that sometimes can only be interpreted ex post, but in a way that can

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