

Equity Premium Prediction and the State of the Economy*

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Abstract

We detect cyclical variation in the predictive information of economic fundamentals, which can be used to substantially improve out-of-sample equity premium prediction. Economic fundamentals based on stock-specific information (notably the dividend yield) deliver better predictions in expansions. Economic fundamentals based on aggregate information (notably the short rate) deliver better predictions in recessions. A simple forecast combination of the dividend yield and the short rate generates statistically and economically valuable equity premium predictions in both expansions and recessions. This is an effective prediction strategy because it provides strong diversification gains. A strategy timing the business cycle performs even better.

Keywords: Equity Premium; Out-of-Sample Prediction; Economic Fundamentals; Business Cycle; Diversification.

JEL Classification: G11; G14; G17.

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