New Forecasts of the Equity Premium

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Abstract

If investors are myopic mean-variance optimizers, a stock's expected return is linearly related to its beta in the cross section. The slope of the relation is the cross-sectional price of risk, which should equal the expected equity premium. We use this simple observation to forecast the equity-premium time series with the cross-sectional price of risk. We also introduce novel statistical methods for testing stock-return predictability based on endogenous variables whose shocks are potentially correlated with return shocks. Our empirical tests show that the cross-sectional price of risk (1) is strongly correlated with the market's yield measures and (2) predicts equity-premium realizations especially in the first half of our 1927-2002 sample.

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