LSF Lunchtime Seminar:

The Time Variation in Risk Appetite and Uncertainty

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Abstract

We develop new measures of time-varying risk aversion and economic uncertainty that can be calculated from observable financial information at high frequencies. Our approach has four important elements. First, we formulate a dynamic no-arbitrage asset pricing model that consistently prices all assets under assumptions regarding the joint dynamics among asset-specific cash ow dynamics, macroeconomic fundamentals and risk aversion. Second, both the fundamentals and cash ow dynamics feature time-varying heteroskedasticity and non-Gaussianity to accommodate dynamics observed in the data, which we document. This allows us to distinguish time variation in economic uncertainty (the amount of risk) from time variation in risk aversion (the price of risk). Third, despite featuring non-Gaussian dynamics, the model retains closed-form solutions for asset prices. Fourth, our approach exploits information on realized volatility and option prices for the two main risky asset classes, equities and corporate bonds, to help identify and differentiate economic uncertainty from risk aversion. We find that equity variance risk premiums are very informative about risk aversion, whereas credit spreads and corporate bond volatility are highly correlated with economic uncertainty. Model-implied risk premiums beat standard instrument sets predicting excess returns on equity and corporate bonds. A financial proxy to our economic uncertainty predicts output growth negatively and significantly, even in the presence of the VIX.

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12:30 – 13:45pm

Location
Faculty of Law, Economics and Finance
JFK Building
29, avenue Kennedy
L-1855 Luxembourg
Ground Floor, Nancy-Metz Room

Langue
English

Registration
- Free seminar
- Registration by e-mail to lsf-events@uni.lu (please specify full name and institution)

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