Accepted Manuscript

Financial Contagion Risk and the Stochastic Discount Factor

Louis R. Piccotti

PII: S0378-4266(17)30012-2
DOI: 10.1016/j.jbankfin.2017.01.012
Reference: JBF 5082

To appear in: Journal of Banking and Finance

Received date: 12 April 2016
Revised date: 15 November 2016
Accepted date: 13 January 2017


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I provide evidence that financial contagion risk is an important source of the equity risk premium. Banks’ contributions to aggregate financial contagion are estimated in a state space framework and linked to systemic risk. Greater bank connectedness today leads to increased systemic risk 3-12 months later. More contagious banks earn significantly greater risk-adjusted returns than less contagious ones and the tradable high contagion-minus-low contagion bank portfolio is priced in the cross-section of stock returns. Stocks that co-move more strongly with contagious banks have greater expected returns. These results are robust to factor model specification, test assets, and time period considered.

Keywords: Asset pricing, Equity risk premium, Financial contagion, State-space modeling, Systemic risk.

1. INTRODUCTION

Financial intermediaries serve a special role in the economy through investing on households’ behalf and by issuing credit, both of which can affect the aggregate consumption set. As financial intermediaries experience negative shocks, household wealth decreases (Allen, Bali, and Tang (2012)) and credit may be constrained (Duchin, Ozbas, and Sensoy (2010) and Ivashina and Scharfstein (2010)). In the aggregate, this diminished wealth and credit constraint leads to levels of consumption and consumption responsiveness being diminished (Berger...
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