

Accepted Manuscript

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PII: S1059-0560(17)30520-8

DOI: [10.1016/j.iref.2017.07.013](https://doi.org/10.1016/j.iref.2017.07.013)

Reference: REVECO 1458

To appear in: *International Review of Economics and Finance*

Received Date: 1059-0560 1059-0560

Revised Date: 1059-0560 1059-0560

Accepted Date: 1059-0560 1059-0560

Please cite this article as: Lin F.-L., Yang S.-Y., Marsh T. & Chen Y.-F., Stock and bond return relations and stock market uncertainty: Evidence from wavelet analysis, *International Review of Economics and Finance* (2017), doi: 10.1016/j.iref.2017.07.013.

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Stock and Bond Return Relations and Stock Market Uncertainty: Evidence from Wavelet Analysis

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Abstract

This paper adopts continuous wavelet analysis to investigate the time variation features of stock-bond return relations across different frequencies from 1988 to 2014. We also examine whether the time variation features of stock-bond return relations can be linked to two dimensions: fundamental economic factors and stock market uncertainty. The empirical results show that the short-term and long-term dependencies between stocks and bonds did vary over time. In addition, the relations between stock and bond returns have positive sign sensitivity to the short rate and the slope of term structure, while their sensitivity to stock market volatility is negative. Moreover, the impact of crises on the long-term stock-bond relation is significantly negative and the impact on short-term relation is significantly positive. Hence, the fundamental economic factors which drive the stock-bond relations do not vary across time frequencies; however, the impacts of crises do vary across the time frequencies. The findings have economic implications to help investors determine their portfolio allocations. Furthermore, policy makers monitor the financial markets and adjust the macroeconomic policies by observing changes in these state variables.

Keywords: Stock-bond return relations, Stock market uncertainty, Wavelet analysis

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