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Qi Lin

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Technical Analysis and Stock Return Predictability: An Aligned Approach

Qi Lin *

School of Finance, Zhejiang University of Finance & Economics,
Hangzhou 310018, China

Telephone: 86-571-87557108
Email: qlin_sf@zufe.edu.cn

Abstract

This paper provides an empirical evaluation of the U.S. aggregate stock market predictability based on a new technical analysis index that eliminates the idiosyncratic noise component in technical indicators. I find that the new index exhibits statistically and economically significant in-sample and out-of-sample predictive power and outperforms the well-known technical indicators and macroeconomic variables. In addition, it can predict cross-sectional stock portfolio returns sorted by size, value, momentum, and industry and generate substantial utility gains for a mean-variance investor. A vector autoregression-based stock return decomposition shows that the economic source of the predictive power predominantly comes from time variations in future cash flows (i.e., the cash flow channel).

***Keywords*: Technical analysis; Equity risk premium; Partial least squares method; Predictive regression; Cash flow channel
***JEL Classification*: C53, G11, G12

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* Corresponding author: School of Finance, Zhejiang University of Finance & Economics, 18 Xueyuan Street, Hangzhou 310018, China. Tel: +86 571 8755 7108. E-mail: qlin_sf@zufe.edu.cn.