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## Yield curves and international equity returns

James Ross McCown \*

*Florida Atlantic University, John D. MacArthur Campus, 5353 Parkside Drive, Jupiter, FL 33458, USA*

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### Abstract

This paper examines empirical evidence on the international transmission of shocks to financial asset markets. The relationships between yield curves and risk premiums of stocks for eight industrialized countries are examined. Only the stocks of the three largest economies: Germany, Japan, and the USA, show negative risk premiums during periods preceded by the inverted yield curves of their respective government bonds. This is not the case for stocks of the five smaller countries in the sample. However, four of the five smaller countries have negative risk premiums in periods preceded by inverted German or US yield curves. This is consistent with the view that a world risk factor, captured by major country yield curves, affects the pricing of assets in smaller economies. The consumption CAPM is unable to explain the phenomenon of the negative risk premiums. In almost all cases the conditional covariance between consumption growth and the risk premiums is statistically indifferent from zero. © 2001 Elsevier Science B.V. All rights reserved.

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\* Tel.: +1-561-799-8626; fax: +1-561-799-8535.

*E-mail address:* jmccown@fau.edu (J. Ross McCown).

## **1. Introduction**

Many researchers have investigated the relation between yield curves and financial asset returns. Fama and French (1989) show that excess returns on US stocks and corporate bonds are positively related to the slope of the yield curve of US Treasury securities. Fama and French say that the yield curve has predictive ability because it is a proxy for discount rate shocks. Both stocks and long-term Treasury bonds are long-term investments, and are highly susceptible to changes in investors' intertemporal discount rates. Boudoukh et al. (1993) and Ostdiek (1998) show how *ex ante* risk premiums on US stocks and the world stock portfolio are negative in periods preceded by inverted yield curves. For individual foreign countries, the research has been limited, although Asprem (1989) examined the relationship between the US term spread and the returns on stocks of ten European countries.

The purpose of this research is to look at the effects of foreign country yield curves on the risk premiums of their own stocks, and also the effects of the larger economies' yield curves (US, Germany, and Japan) on the smaller countries' stocks. Using returns on country stock indices compiled by MSCI, these relations are tested for eight industrialized countries, including the US, for the period from 1970 to 1994. There is strong evidence for negative risk premiums for only the US, Germany, and Japan, when using each country's own yield curve. However, negative risk premiums occur for many of the smaller economies when the US or German yield curve is inverted. The Japanese yield curve does not show this relation with the other countries' stocks. This is consistent with the view that a world risk factor, captured by the US and German yield curves, affects the pricing of assets in smaller economies.

Boudoukh et al. (1997) find that the relation between the US term spread and the risk premium on US stocks is nonlinear. This research also finds that the relation for the US variables is nonlinear, but does not find the evidence to be so strong for the other seven countries' term spreads and stocks. However, there is a nonlinear relation between the US term spread and the risk premiums of the other seven countries' stocks, in particular for Canada and the UK.

The large differences of the conditional risk premiums signaled by upward-sloping and inverted yield curves may be due at least in part to differences in the volatility of the stock returns. This research finds that in many cases the volatility of the returns is much higher when the yield curves are upward-sloping than when they are inverted, in particular the US or German yield curves. However, the results are not perfectly consistent because the Japanese yield curve gives the opposite results. Moreover, the volatilities cannot explain why the risk premiums become negative when the yield curve inverts. Stocks are always riskier investments than Treasury bills.

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