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Daniel Buncic, Martin Tischhauser

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# Macroeconomic Factors and Equity Premium Predictability<sup>\*</sup>

DANIEL BUNCIC<sup>‡</sup>  
Sveriges Riksbank

MARTIN TISCHHAUSER<sup>↗</sup>  
ETH Zürich

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## Abstract

Neely *et al.* (2014) have recently demonstrated how to *efficiently* combine information from a set of popular technical indicators together with the standard Goyal and Welch (2008) predictor variables widely used in the equity premium forecasting literature to improve out-of-sample forecasts of the equity premium using a small number of principal components. We show that forecasts of the equity premium can be further improved by, first, incorporating broader macroeconomic data into the information set, second, improving the selection of the most *relevant* factors and combining the most relevant factors by means of a forecast combination regression, and third, imposing theoretically motivated positivity constraints on the forecasts of the equity premium. We find that in particular our proposed forecast combination approach, which combines forecasts of the most relevant Neely *et al.* (2014) and macroeconomic factors and further imposes positivity constraints on the equity premium forecasts, generates statistically significant and economically sizeable improvements over the best performing model of Neely *et al.* (2014).

**Keywords:** Equity premium predictability, Factor models, Macroeconomic variables, Adaptive Lasso, Sign restrictions, Forecast combination, Asset allocation.

**JEL Classification:** G12, G17, C53, E44.

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<sup>‡</sup>Corresponding Author: Research and Modelling Division, Financial Stability Department, Sveriges Riksbank, SE-103 37, Stockholm, Sweden. Email: [daniel.buncic@riksbank.se](mailto:daniel.buncic@riksbank.se). Web: <http://www.danielbuncic.com>.

<sup>↗</sup>Email: [mtischhauser@ethz.ch](mailto:mtischhauser@ethz.ch).

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