Role of Macro and Technical Indicators in Equity Risk Premium Prediction: A Principal Component Analysis Approach

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Abstract : Equity risk premium (ERP) is the stock return in excess of risk free return. Even though it is an essential topic of finance but still there is no common consensus upon its forecasting. For forecasting ERP, apart from the macroeconomic variables attention is devoted to technical indicators as well. For this purpose, set of 14 technical and 14 macro-economic variables is selected and all forecasts are generated based on a standard predictive regression framework, where ERP is regressed on a constant and a lag of a macroeconomic variable or technical indicator. The comparative results showed that technical indicators provide better indications about ERP estimates as compared to macro-economic variables. The relative strength of ERP predictability is also investigated by using National Bureau of Economic Research (NBER) data of business cycle expansion and recessions and found that ERP predictability is more than twice for recessions as compared to expansions.