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Business Cycle and the Beta Estimation: The Cross-Section of Expected Stock Returns Re-visited

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Abstract

This study investigates the role of beta in explaining stock returns conditioning on the four different phases of the business cycle - Early Expansion, Expansion, Early Recession, and Recession and highlights the importance of the strong association between economic activity and stock returns. Earlier research has concentrated on capturing the time variation in beta by conditioning on various variables that have a close association with economic activity. Yet the findings of these studies reported a weak connection between stock returns and macroeconomic variables. Our methodology identifies the similar economic activity periods in our sample period of 1963-2017 and categorizes them into four business cycle phases using the NBER business cycle date announcements. Findings show that the explanatory power of size and book-to-market equity vanish, and beta sticks out as the sole determinant of the variation in the cross-section of expected stock returns when we controlled for the level of the business cycle.

Conference Track

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