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Regime Specific Predictability in Predictive Regressions*

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Abstract

Predictive regressions are linear specifications linking a noisy variable such as stock returns to past values of a more persistent regressor such as valuation ratios, interest rates etc with the aim of assessing the presence or absence of predictability. Key complications that arise when conducting such inferences are the potential presence of endogeneity, the poor adequacy of the asymptotic approximations amongst numerous others. In this paper we develop an inference theory for uncovering the presence of predictability in such models when the strength or direction of predictability, if present, may alternate across different economically meaningful episodes. This allows us to uncover economically interesting scenarios whereby the predictive power of some variable may kick in solely during particular regimes or alternate in strength and direction (e.g. recessions versus expansions, periods of high versus low stock market valuation, periods of high versus low term spreads etc). The limiting distributions of our test statistics are free of nuisance parameters and some are readily tabulated in the literature. Finally our empirical application reconsiders the literature on Dividend Yield based stock return predictability and contrary to the existing literature documents a strong presence of predictability that is countercyclical, occurring solely during bad economic times.

Keywords: Endogeneity, Persistence, Return Predictability, Threshold Models.

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1 Introduction

Predictive regressions with a persistent regressor (e.g. dividend yields, interest rates, realised volatility) aim to uncover the ability of a slowly moving variable to predict future values of another typically noisier variable (e.g. stock returns, GDP growth) within a bivariate regression framework. Their pervasive nature in many areas of Economics and Finance and their importance in the empirical assessment of theoretical predictions of economic models made this particular modelling environment an important and active area of theoretical and applied research (see for instance Jansson and Moreira (2006) and references therein).

A common assumption underlying old and new developments in this area involves working within a model in which the persistent regressor enters the predictive regression linearly, thus not allowing for the possibility that the strength and direction of predictability may themselves be a function of some economic factor or time itself. Given this restriction, existing work has focused on improving the quality of estimators and inferences in this environment characterised by persistence and endogeneity amongst other econometric complications. These complications manifest themselves in the form of nonstandard asymptotics, distributions that are not free of nuisance parameters, poor finite sample approximations etc. Important recent methodological breakthroughs have been obtained in Jansson and Moreira (2006), Campbell and Yogo (2006), Valkanov (2003), Lewellen (2004) while recent applications in the area of financial economics and asset pricing can be found in Cochrane (2007), Lettau and Nieuwerburgh (2008), Bandi and Perron (2008) amongst others.

The purpose of this paper is to instead develop an econometric toolkit for uncovering the presence of predictability within regression models with highly persistent regressors when the strength or direction of predictability, if present, may alternate across different economically meaningful episodes (e.g. periods of rapid versus slow growth, period of high versus low stock market valuation, periods of high versus low consumer confidence etc). For this purpose, we propose to expand the traditional linear predictive regression framework to a more general environment which allows for the possibility that the strength of predictability may itself be affected by observable economic factors. We have in mind scenarios whereby the predictability induced by some economic variable kicks in under particular instances such as when the magnitude of the variable in question (or some other variable) crosses a threshold but is useless in terms of predictive power otherwise. Alternatively, the predictive impact of a variable may alternate in sign/strength across different regimes. Ignoring such phenomena by proceeding within a linear framework as it has been done in the literature may mask the forecasting ability of a particular variable and more generally mask the presence of interesting and economically meaningful dynamics. We subsequently apply our methodology to the prediction of stock returns using valuation ratios such as the Dividend Yield.

Contrary to what has been documented in the linear predictability literature our findings strongly point towards the presence of regimes in which DY based predictability kicks in solely during bad economic times. More importantly, our analysis also illustrates the fact that the presence of regimes may make predictability appear as nonexistent when assessed within a linear model.

The plan of the paper is as follows. Section 2 introduces our model and hypotheses of interest. Section 3 develops the limiting distribution theory of our test statistics. Section 4 explores the finite sample properties of the inferences developed in Section 3, Section 5 proposes an application and Section 6 concludes. All proofs are relegated to the appendix.

2 The Model and Hypotheses

We will initially be interested in developing the limiting distributional theory for a Wald type test statistic designed to test the null hypothesis of a linear relationship between y_{t+1} and x_t against the following threshold alternative

$$y_{t+1} = \begin{cases} \alpha_1 + \beta_1 x_t + u_{t+1} & q_t \leq \gamma \\ \alpha_2 + \beta_2 x_t + u_{t+1} & q_t > \gamma \end{cases} \tag{1}$$

where x_t is parameterized as the nearly nonstationary process

$$x_t = \rho_T x_{t-1} + v_t, \qquad \rho_T = 1 - \frac{c}{T} \tag{2}$$

with $c > 0$, $q_t = \mu_q + u_{qt}$ and u_t, u_{qt} and v_t are stationary random disturbances. The above parameterisation allows x_t to display local to unit root behaviour and has become the norm for modelling highly persistent series for which a pure unit root assumption may not always be sensible. The threshold variable q_t is taken to be a stationary process and γ refers to the unknown threshold parameter. Under $\alpha_1 = \alpha_2$ and $\beta_1 = \beta_2$ our model in (1)-(2) coincides with that in Jansson and Moreira (2006) or Campbell and Yogo (2006) and is commonly referred to as a predictive regression model while under $\alpha_1 = \alpha_2, \beta_1 = \beta_2 = 0$ we have a constant mean specification.

The motivation underlying our specification in (1)-(2) is its ability to capture phenomena such as regime specific predictability within a simple and intuitive framework. We have in mind scenarios whereby the slope corresponding to the predictor variable becomes significant solely in one regime. Alternatively, the strength of predictability may differ depending on the regime determined by the magnitude of q_t. The predictive instability in stock returns that has been extensively documented in the recent literature and the vanishing impact of dividend yields from the 90s onwards in particular (see Ang and Bekaert (2007) and also Table 5 below) may well be the consequence of the presence of regimes for instance. Among the important advantages of a threshold based parameterisation are the rich set of dynamics it allows

to capture despite its mathematical simplicity, its estimability via a simple least squares based approach and the observability of the variable triggering regime switches which may help attach a "cause" to the underlying predictability. Following Petruccelli (1992) it is also useful to recall that the piecewise linear structure can be viewed as an approximation to a much wider family of nonlinear functional forms. In this sense, although we do not argue that our chosen threshold specification mimics reality we believe it offers a realistic approximation to a wide range of more complicated functional forms and regime specific behaviour in particular. It is also interesting to highlight the consequences that a behaviour such as (1)-(2) may have if ignored and predictability is assessed within a linear specifications instead, say $y_t = \beta x_{t-1} + u_t$. Imposing zero intercepts for simplicity and assuming (1)-(2) holds with some γ_0 it is easy to establish for instance that $\hat{\beta} \xrightarrow{p} \beta_1 + (\beta_2 - \beta_1)P(q_t > \gamma_0)$. This raises the possibility that $\hat{\beta}$ may converge to a quantity that is very close to zero (e.g. when $P(q_t > \gamma_0) \approx \beta_1/(\beta_1 - \beta_2)$) and thus tests conducted within a linear specification may frequently and wrongly suggest absence of any predictability.

Our choice of modelling x_t as a nearly integrated process follows the same motivation as in the linear predictive regression literature where such a choice for x_t has been advocated as an alternative to proceeding with conventional Gaussian critical values which typically provide poor finite sample approximations to the distributions of t statistics. In the context of a stationary AR(1) for instance, Chan (1988) demonstrates that for values of $T(1-\rho) \geq 50$ the normal distribution offers a good approximation while for $T(1-\rho) \leq 50$ the limit obtained assuming near integratedness works better when the objective involves conducting inferences about the slope parameter of the AR(1) (see also Cavanagh, Elliott and Stock (1995) for similar points in the context of a predictive regression model). Models that combine persistent variables with nonlinear dynamics as (1)-(2) offer an interesting framework for capturing stylised facts observed in economic data. Within a univariate setting (e.g. threshold unit root models) recent contributions towards their theoretical properties have been obtained in Caner and Hansen (2001) and Pitarakis (2008).

In what follows the threshold parameter γ is assumed unknown with $\gamma \in \Gamma = [\gamma_1, \gamma_2]$ and γ_1 and γ_2 are selected such that $P(q_t \leq \gamma_1) = \pi_1 > 0$ and $P(q_t \leq \gamma_2) = \pi_2 < 1$ as in Caner and Hansen (2001). We also define $I_{1t} \equiv I(q_t \leq \gamma)$ and $I_{2t} \equiv I(q_t > \gamma)$ but replace the threshold variable with a uniformly distributed random variable making use of the equality $I(q_t \leq \gamma) = I(F(q_t) \leq F(\gamma)) \equiv I(U_t \leq \lambda)$. Here $F(.)$ is the marginal distribution of q_t and U_t denotes a uniformly distributed random variable on $[0, 1]$. Before proceeding further it is also useful to reformulate (1) in matrix format. Letting y denote the vector stacking y_{t+1} and X_i the matrix stacking the elements of $(I_{it} \;\; x_t I_{it})$ for $i = 1, 2$ we can write (1) as $y = X_1\theta_1 + X_2\theta_2 + u$ or $y = Z\theta + u$ with $Z = (X_1 \;\; X_2)$, $\theta = (\theta_1, \theta_2)$ and $\theta_i = (\alpha_i, \beta_i)'$ $i = 1, 2$. For later use we also define $X = X_1 + X_2$ as the regressor matrix which stacks the constant and x_t. It is now easy to see that for given γ or λ the homoskedastic Wald statistic for testing a general restriction on θ,

say $R\theta = 0$ is given by $W_T(\lambda) = \hat{\theta}' R'(R(Z'Z)^{-1}R')^{-1}R\hat{\theta}/\hat{\sigma}_u^2$ with $\hat{\theta} = (Z'Z)^{-1}Z'y$ and $\hat{\sigma}_u^2$ is the residual variance obtained from (1). In practice since the threshold parameter is unidentified under the null hypothesis inferences are conducted using the "Sup-Wald" formulation expressed as $\sup_{\lambda\in[\pi_1,\pi_2]} W_T(\lambda)$ with $\pi_1 = F(\gamma_1)$ and $\pi_2 = F(\gamma_2)$.

In the context of our specification in (1)-(2) we will initially be interested in the null hypothesis of linearity given by $H_0^{(A)} : \alpha_1 = \alpha_2, \beta_1 = \beta_2$ and we write the corresponding restriction matrix as $R_A = [I \ -I]$ with I denoting a 2×2 identity matrix. The corresponding SupWald statistic is given by $\sup_\lambda W_T^A(\lambda) = \sup_\lambda \hat{\theta}' R_A'(R_A(Z'Z)^{-1}R_A')^{-1}R_A\hat{\theta}/\hat{\sigma}_u^2$. At this stage it is important to note that the null hypothesis given by H_0^A corresponds to the linear specification $y_{t+1} = \alpha + \beta x_t + u_{t+1}$ and thus does not test predictability per se since x_t may appear as a predictor under both the null and the alternative hypotheses. Thus we also consider the null given by $H_0^B : \alpha_1 = \alpha_2, \beta_1 = \beta_2 = 0$ with the corresponding SupWald statistic written as $\sup_\lambda W_T^B(\lambda)$ where $W_T^B(\lambda) = \hat{\theta}' R_B[R_B(Z'Z)^{-1}R_B']^{-1}R_B\hat{\theta}/\hat{\sigma}_u^2$ and $R_B = [1\ 0\ -1\ 0, 0\ 1\ 0\ 0, 0\ 0\ 0\ 1]$. Under this null hypothesis the model is given by $y_{t+1} = \alpha + u_{t+1}$ and the test is expected to have power against departures from both linearity and predictability.

3 Large Sample Inference

Our objective here is to investigate the asymptotic properties of Wald type tests for detecting the presence of threshold effects in our predictive regression setup. We initially obtain the limiting distribution of $W_T^A(\lambda)$ under the null hypothesis $H_0^A : \alpha_1 = \alpha_2, \beta_1 = \beta_2$. We subsequently turn to the joint null hypothesis of linearity and no predictability given by $H_0^B : \alpha_1 = \alpha_2, \beta_1 = \beta_2 = 0$ and explore the limiting behaviour of $W_T^B(\lambda)$.

Our operating assumptions about the core probabilistic structure of (1)-(2) will closely mimic the assumptions imposed in the linear predictive regression literature but will occasionally also allow for a greater degree of generality (e.g. Campbell and Yogo (2006), Jansson and Moreira (2006), Cavanagh, Elliott and Stock (1995) amongst others). Specifically, the innovations v_t will be assumed to follow a general linear process we write as $v_t = \Psi(L)e_t$ where $\Psi(L) = \sum_{j=0}^{\infty}\psi_j L^j$, $\sum_{j=0}^{\infty} j|\psi_j| < \infty$ and $\Psi(1) \neq 0$ while the shocks to y_t, denoted u_t, will take the form of a martingale difference sequence with respect to an appropriately defined information set. More formally, letting $\widetilde{w}_t = (u_t, e_t)'$ and $\mathcal{F}_t^{\widetilde{w}q} = \{\widetilde{w}_s, u_{qs} | s \leq t\}$ the filtration generated by $(\widetilde{w}_t, u_{qt})$ we will operate under the following assumptions

Assumptions. A1: $E[\widetilde{w}_t|\mathcal{F}_{t-1}^{\widetilde{w}q}] = 0$, $E[\widetilde{w}_t\widetilde{w}_t'|\mathcal{F}_{t-1}^{\widetilde{w}q}] = \widetilde{\Sigma} > 0$, $\sup_t E\widetilde{w}_{it}^4 < \infty$; **A2:** *the threshold variable* $q_t = \mu_q + u_{qt}$ *has a continuous and strictly increasing distribution* $F(.)$ *and is such that* u_{qt} *is a strictly stationary, ergodic and strong mixing sequence with mixing numbers* α_m *satisfying* $\sum_{m=1}^{\infty}\alpha^{\frac{1}{m}-\frac{1}{r}} < \infty$ *for*

some $r > 2$.

One implication of assumption A1 and the properties of $\Psi(L)$ is that a functional central limit theorem holds for the joint process $w_t = (u_t, v_t)'$ (see Phillips (1987)). More formally $\sum_{t=1}^{[Tr]} w_t/\sqrt{T} \Rightarrow B(r) = (B_u(r), B_v(r))'$ with the long run variance of the bivariate Brownian Motion $B(r)$ being given by $\Omega = \sum_{k=-\infty}^{\infty} E[w_0 w_k'] = [(\omega_u^2, \omega_{uv}), (\omega_{vu}, \omega_v^2)] = \Sigma + \Lambda + \Lambda'$. Our notation is such that $\widetilde{\Sigma} = [(\sigma_u^2, \sigma_{ue}), (\sigma_{ue}, \sigma_e^2)]$ and $\Sigma = [(\sigma_u^2, \sigma_{uv}), (\sigma_{uv}, \sigma_v^2)]$ with $\sigma_v^2 = \sigma_e^2 \sum_{j=0}^{\infty} \psi_j^2$ and $\sigma_{uv} = \sigma_{ue}$ since $E[u_t e_{t-j}] = 0 \ \forall j \geq 1$ by assumption. Given our parameterisation of v_t and the m.d.s assumption for u_t we have $\omega_{uv} = \sigma_{ue}\Psi(1)$ and $\omega_v^2 = \sigma_e^2 \Psi(1)^2$. For later use we also let $\lambda_{vv} = \sum_{k=1}^{\infty} E[v_t v_{t-k}]$ denote the one sided variance so that $\omega_v^2 = \sigma_v^2 + 2\lambda_{vv} \equiv \sigma_e^2 \sum_{j=0}^{\infty} \psi_j^2 + 2\lambda_{vv}$. At this stage it is useful to note that the martingale difference assumption in A1 imposes a particular structure on Ω. For instance since serial correlation in u_t is ruled out we have $\omega_u^2 = \sigma_u^2$. It is worth emphasising however that while ruling out serial correlation in u_t our assumptions allow for a sufficiently general covariance structure linking (1)-(2) and a general dependence structure for the disturbance terms driving x_t and q_t. The martingale difference assumption on u_t is a standard assumption that has been made throughout all recent research on predictive regression models (see for instance Jansson and Moreira (2006), Campbell and Yogo (2005) and references therein) and appears to be an intuitive operating framework given that many applications take y_{t+1} to be stock returns. Writing $\Lambda = \sum_{k=1}^{\infty} E[w_t w_{t-k}'] = [(\lambda_{uu}, \lambda_{uv}), (\lambda_{vu}, \lambda_{vv})]$ it is also useful to explicitly highlight the fact that within our probabilitic environment $\lambda_{uu} = 0$ and $\lambda_{uv} = 0$ due to the m.d.s property of the $u_t's$ while λ_{vv} and λ_{vu} may be nonzero.

Regarding the dynamics of the threshold variable q_t and how it interacts with the remaining variables driving the system, assumption A1 requires q_{t-j}'s to be orthogonal to u_t for $j \geq 1$. Since q_t is stationary this is in a way a standard regression model assumption and is crucial for the development of our asymptotic theory. We note however that our assumptions allow for a broad level of dependence between the threshold variable q_t and the other variables included in the model (e.g. q_t may be contemporaneously correlated with both u_t and v_t). At this stage it is perhaps also useful to reiterate the fact that our assumption about the correlation of q_t with the remaining components of the system are less restrictive than what is typically found in the literature on marked empirical processes or functional coefficient models such as $y_{t+1} = f(q_t)x_t + u_{t+1}$ which commonly take q_t to be independent of u_t and x_t.

Since our assumptions also satisfy Caner and Hansen's (2001) framework, from their Theorem 1 we can write $\sum_{t=1}^{[Tr]} u_t I_{1t-1}/\sqrt{T} \Rightarrow B_u(r, \lambda)$ as $T \to \infty$ with $B_u(r, \lambda)$ denoting a two parameter Brownian Motion with covariance $\sigma_u^2(r_1 \wedge r_2)(\lambda_1 \wedge \lambda_2)$ for $(r_1, r_2), (\lambda_1, \lambda_2) \in [0, 1]^2$. Noting that $B_u(r, 1) \equiv B_u(r)$ we will also make use of a particular process known as a Kiefer process and defined as $G_u(r, \lambda) = B_u(r, \lambda) - \lambda B_u(r, 1)$. A Kiefer process on $[0, 1]^2$ is Gaussian with zero mean and covariance function $\sigma_u^2(r_1 \wedge r_2)(\lambda_1 \wedge \lambda_2 - \lambda_1\lambda_2)$. Finally, we introduce the diffusion process $K_c(r) = \int_0^r e^{(r-s)c} dB_v(s)$ with $K_c(r)$ such that $dK_c(r) =$

$cK_c(r) + dB_v(r)$ and $K_c(0) = 0$. Note that we can also write $K_c(r) = B_v(r) + c\int_0^r e^{(r-s)c}B_v(s)ds$. Under our assumptions it follows directly from Lemma 3.1 in Phillips (1988) that $x_{[Tr]}/\sqrt{T} \Rightarrow K_c(r)$.

3.1 Testing $H_0^A : \alpha_1 = \alpha_2, \beta_1 = \beta_2$

Having outlined our key operating assumptions we now turn to the limiting behaviour of our test statistics. We will initially concentrate on the null hypothesis given by $H_0^A : \alpha_1 = \alpha_2, \beta_1 = \beta_2$ and the behaviour of $\sup_\lambda W_T^A(\lambda)$ which is summarised in the following Proposition.

Proposition 1: *Under the null hypothesis $H_0^A : \alpha_1 = \alpha_2, \beta_1 = \beta_2$, assumptions A1-A2 and as $T \to \infty$ the limiting distribution of the SupWald statistic is given by*

$$\begin{aligned}\sup_\lambda W_T^A(\lambda) \quad &\Rightarrow \quad \sup_\lambda \frac{1}{\lambda(1-\lambda)\sigma_u^2}\left[\int_0^1 \overline{K}_c(r)dG_u(r,\lambda)\right]' \left[\int_0^1 \overline{K}_c(r)\overline{K}_c(r)'\right]^{-1} \\ &\times \quad \left[\int_0^1 \overline{K}_c(r)dG_u(r,\lambda)\right] \end{aligned} \tag{3}$$

where $\overline{K}_c(r) = (1, K_c(r))'$, $G_u(r,\lambda)$ is a a Kiefer process and $K_c(r)$ an Ornstein-Uhlenbeck process.

Although the limiting random variable in (3) appears to depend on unknown parameters such as the correlation between B_u and B_v, σ_u^2 and the near integration parameter c a closer analysis of the expression suggests instead that is equivalent to a random variable given by a quadratic form in normalised Brownian Bridges, identical to the one that occurs when testing for structural breaks in a purely stationary framework. We can write it as

$$\sup_\lambda \frac{BB(\lambda)'BB(\lambda)}{\lambda(1-\lambda)} \tag{4}$$

with $BB(\lambda)$ denoting a standard bivariate Brownian Bridge (i.e. a zero mean Gaussian process with $E[BB(\lambda_1)BB(\lambda_2)] = \lambda_1 \wedge \lambda_2 - \lambda_1\lambda_2$). This result follows from the fact that the processes $K_c(r)$ and $G_u(r,\lambda)$ appearing in the stochastic integrals in (3) are uncorrelated and thus independent since Gaussian. Indeed

$$\begin{aligned} E[G_u(r_1,\lambda_1)K_c(r_2)] &= E[(B_u(r_1,\lambda_1) - \lambda_1 B_u(r_1,1))(B_v(r_2) + \\ &\quad c\int_0^{r_2} e^{(r_2-s)c}B_v(s)ds)] \\ &= E[B_u(r_1,\lambda_1)B_v(r_2)] - \lambda_1 E[B_u(r_1,1)B_v(r_2)] + \\ &\quad c\int_0^{r_2} e^{(r_2-s)c}E[B_u(r_1,\lambda_1)B_v(s)]ds - \\ &\quad \lambda_1 c\int_0^{r_2} e^{(r_2-s)c}E[B_u(r_1,1)B_v(s)]ds \\ &= \omega_{uv}(r_1 \wedge r_2)\lambda_1 - \lambda_1\omega_{uv}(r_1 \wedge r_2) \\ &+ \quad c\lambda_1\int_0^{r_2} e^{(r_2-s)c}(r_1 \wedge s)ds - c\lambda_1\int_0^{r_2} e^{(r_2-s)c}(r_1 \wedge s)ds = 0. \end{aligned}$$

Given that $K_c(r)$ is Gaussian and independent of $G_u(r,\lambda)$ and also

$$E[G_u(r_1,\lambda_1)G_u(r_2,\lambda_2)] = \sigma_u^2(r_1 \wedge r_2)((\lambda_1 \wedge \lambda_2) - \lambda_1\lambda_2)$$

we have $\int K_c(r)dG_u(r,\lambda) \equiv N(0, \sigma_u^2\lambda(1-\lambda)\int K_c(r)^2)$ conditionally on a realisation of $K_c(r)$. Normalising by $\sigma_u^2 \int K_c^2(r)$ as in (3) gives the Brownian Bridge process in (4) which is also the unconditional distribution since it is not dependent on a realisation of $K_c(r)$ (see also Lemma 5.1 in Park and Phillips (1988)). Obviously the discussion trivially carries through to $\overline{K}_c$ and G_u since $E[\overline{K}_c(r_2)G_u(r_1,\lambda_1)]' = E[G_u(r_1,\lambda_1) \;\; K_c(r_2)G_u(r_1,\lambda_1)]' = [0 \;\; 0]'$.

The result in Proposition 1 is unusual and interesting for a variety of reasons. It highlights an environment in which the null distribution of the SupWald statistic no longer depends on any nuisance parameters as it is typically the case in a purely stationary environment and thus no bootstrapping schemes are needed for conducting inferences. In fact, the distribution presented in Proposition 1 is extensively tabulated in Andrews (1993) and Hansen (1997) also provides p-value approximations which can be used for inference purposes. More recently, Estrella (2003) provides exact p-values for the same distribution. Finally and perhaps more importantly the limiting distribution does not appear to depend on c the near integration parameter which is another unusual specificity of our framework.

All these properties are in contrast with what has been documented in the recent literature on testing for threshold effects in purely stationary contexts. In Hansen (1996) for instance the author investigated the limiting behaviour of a SupLM type test statistic for detecting the presence of threshold nonlinearities in purely stationary models. There it was established that the key limiting random variables depend on numerous nuisance parameters involving unknown population moments of variables included in the fitted model. From Theorem 1 in Hansen (1996) it is straightforward to establish for instance that under stationarity the limiting distribution of a Wald type test statistic would be given by $S^*(\lambda)'M^*(\lambda)^{-1}S^*(\lambda)$ with $M^*(\lambda) = M(\lambda) - M(\lambda)M(1)^{-1}M(\lambda)$, and $S^*(\lambda) = S(\lambda) - M(\lambda)M(1)^{-1}S(1)$. Here $M(\lambda) = E[X_1'X_1]$ and $S(\lambda)$ is a zero mean Gaussian process with variance $M(\lambda)$. Since in this context the limiting distribution depends on the unknown model specific population moments the practical implementation of inferences is through a bootstrapping methodology.

One interesting instance worth pointing out however is the fact that this limiting random variable simplifies to a Brownian Bridge type of limit when the threshold variable is taken as exogenous in the sense $M(\lambda) = \lambda M(1)$. Although the comparison with the present context is not obvious since x_t is taken as near integrated and we allow the innovations in q_t to be correlated with those of x_t the force behind the analogy comes from the fact that x_t and q_t have variances with different orders of magnitude. In a purely stationary setup, taking x_t as stationary and the threshold variable as some uniformly distributed random variable leads to results such as $\sum x_t^2 I(U_t \leq \lambda)/T \xrightarrow{p} E[x_t^2 I(U_t \leq \lambda)]$ and if x_t and U_t are independent we also have $E[x_t^2 I(U_t \leq \lambda)] = \lambda E[x_t^2]$. It is this last key simplification

which is instrumental in leading to the Brownian Bridge type of limit in Hansen's (1996) framework. If now x_t is taken as a nearly integrated process and regardless of whether its shocks are correlated with U_t or not we have $\sum x_t^2 I(U_t \leq \lambda)/T^2 \Rightarrow \lambda \int K_c^2(r)$ which can informally be viewed as analogous to the previous scenario. Heuristically this result follows by establishing that asymptotically, objects interacting $x_t/\sqrt{T}$ and $(I_{1t} - \lambda)$ such as $\frac{1}{T}\sum(\frac{x_t}{\sqrt{T}})^2(I_{1t} - \lambda)$ or $\frac{1}{T}\sum(\frac{x_t}{\sqrt{T}})(I_{1t} - \lambda)$ converge to zero (see also Caner and Hansen (2001, page 1585) and Pitarakis (2008)). This would be similar to arguing that $x_t/\sqrt{T}$ and I_{1t} are asymptotically uncorrelated in the sense that their sample covariance (normalised by T) is zero in the limit.

3.2 Testing $H_0^B : \alpha_1 = \alpha_2, \beta_1 = \beta_2 = 0$

We next turn to the case where the null hypothesis of interest tests jointly the absence of linearity and no predictive power i.e. we focus on testing $H_0^B : \alpha_1 = \alpha_2, \beta_1 = \beta_2 = 0$ using the supremum of $W_T^B(\lambda)$. The following Proposition summarises its limiting behaviour.

Proposition 2: *Under the null hypothesis $H_0^B : \alpha_1 = \alpha_2, \beta_1 = \beta_2 = 0$, assumptions A1-A2 and as $T \to \infty$, the limiting distribution of the SupWald statistic is given by*

$$\begin{aligned} \sup_{\lambda} W_T^B(\lambda) \quad \Rightarrow \quad & \frac{\left[\int K_c^*(r) dB_u(r,1)\right]^2}{\sigma_u^2 \int K_c^*(r)^2} + \\ & \sup_{\lambda} \frac{1}{\lambda(1-\lambda)\sigma_u^2} \left[\int \overline{K}_c^*(r) dG_u(r,\lambda)\right]' \left[\int \overline{K}_c^* \overline{K}_c^*(r)'\right]^{-1} \\ & \left[\int \overline{K}_c^*(r) dG_u(r,\lambda)\right]' \end{aligned} \tag{5}$$

where $\overline{K}_c^*(r) = (1, K_c^*(r))'$, $K_c^*(r) = K_c(r) - \int_0^1 K_c(r)dr$ and the remaining variables are as in Proposition 1.

Looking at the expression of the limiting random variable in (5) we note that it is made up of two components with the second one being equivalent to the limiting random variable we obtained under Proposition 1. The first component in the right hand side of (5) is more problematic in the sense that it does not simplify further due to the fact that $K_c^*(r)$ and $B_u(r,1)$ are correlated since ω_{uv} may take nonzero values. However, if we were to rule out endogeneity by setting $\omega_{uv} = 0$ then it is interesting to note that the limiting distribution of the SupWald statistic in Proposition 2 takes the following simpler form

$$\sup_{\lambda} W_T^B(\lambda) \quad \Rightarrow \quad W(1)^2 + \sup_{\lambda} \frac{BB(\lambda)' BB(\lambda)}{\lambda(1-\lambda)} \tag{6}$$

where $BB(\lambda)$ is a Brownian Bridge and $W(1)$ a standard normally distributed random variable. The first component in the right hand side of either (5) or (6) is the $\chi^2(1)$ limiting distribution of the Wald

statistic for testing $H_0 : \beta = 0$ in the linear specification

$$y_{t+1} = \alpha + \beta x_t + u_{t+1} \tag{7}$$

and the presence of this first component makes the test powerful in detecting deviations from the null (see Rossi (2005) for the illustration of a similar phenomenon in a different context).

Our next concern is to explore ways of making (5) operational since as it stands the first component of the limiting random variable depends on model specific moments and cannot be universally tabulated. For this purpose it is useful to notice that the problems arising from the practical implementation of (5) are partly analogous to the difficulties documented in the single equation cointegration testing literature where the goal was to obtain nuisance parameter free chisquare asymptotics for Wald type tests on β in (7) despite the presence of endogeneity. One could be tempted for instance to try to make inferences operational by following the intuition underlying the fully modified estimation methodology proposed in the cointegration literature by Phillips and Hansen (1990). Intuitively, we would want to modify $W_T^B(\lambda)$ in such a way that its limiting distribution no longer contains correlated processes within its stochastic integrals and thus reduces to (6) even under endogeneity. Alternatively, one could also consider using a Dynamic OLS estimation approach as described in Saikkonen (1991, 1992). Unfortunately however, since we are operating with a nearly unit root regressor none of the above mentioned methods are able to remove endogeneity and lead to a mixed normal limit for $(\hat{\beta} - \beta)$ in (7) unless $c = 0$.

This important result has been formalised in Elliott (1998) who showed that inferences about β in (7) can no longer be mixed normal when x_t is a near unit process. In fact the corresponding asymptotic distributions turn out to depend on c itself which in turn cannot be estimated consistently. Until very recently the cointegration literature provided no satisfactory solutions to this problem generated by the use of regressors of unknown degree of persistence (e.g. pure unit root versus near unit root) and this has considerably limited the practical use of parametrisations such as (2) (our result in Proposition 1 which leads to an asymptotic distribution that no longer depends on c is in fact the first one we are aware of in this literature).

In a very recent paper Phillips and Magdalinos (2009) (PM09 thereafter) reconsidered the issue of conducting inferences in an environment with possibly nearly integrated regressors and resolved the difficulties discussed in Elliott (1998) via the introduction of a new Instrumental Variable type estimator of $\hat{\beta}$ in (7). Their method is referred to as IVX estimation since the relevant IV is constructed solely via a transformation of the existing regressor x_t. It is this same method that we propose to use in our present context.

Before proceeding further however it is useful to note that $W_T^B(\lambda)$ can be expressed as the sum of the

following two components

$$W_T^B(\lambda) \equiv \frac{\hat{\sigma}_{lin}^2}{\hat{\sigma}_u^2} W_T^{\beta=0} + W_T^A(\lambda) \tag{8}$$

where $W_T^{\beta=0}$ is the standard Wald statistic for testing $H_0 : \beta = 0$ in (7). Specifically, we have

$$W_T^{\beta=0} = \frac{1}{\hat{\sigma}_{lin}^2} \frac{[\sum x_{t-1} y_t - T\bar{x}\bar{y}]^2}{[\sum x_{t-1}^2 - T\bar{x}^2]} \tag{9}$$

with $\bar{x} = \sum x_{t-1}/T$ and $\hat{\sigma}_{lin}^2$ is the residual variance obtained from the same linear specification while $\hat{\sigma}_u^2$ is the residual variance obtained from the unrestricted specification. Although not of direct interest this reformulation of $W_T^B(\lambda)$ can simplify the implementation of the IVX version of the Wald statistic since the setup is now identical to that of PM09 and involves constructing a Wald statistic for testing $H_0 : \beta = 0$ in (7) i.e we replace $W_T^{\beta=0}$ in (8) with its IVX based version which is shown to be asymptotically distributed as a $\chi^2(1)$ random variable. Note that although PM09 operated within a model without an intercept, in a recent paper Kostakis, Magdalinos and Stamatogiannis (2010) (KMS10) have also established the validity of the theory for models with a fitted constant.

The IVX methodology starts by choosing an artifical slope coefficient, say

$$R_T = 1 - \frac{c_z}{T^\delta} \tag{10}$$

for a given c_z and $\delta < 1$ and uses the latter to construct an IV generated as $\tilde{z}_t = R_T \tilde{z}_{t-1} + \Delta x_t$ or under zero initialisation $\tilde{z}_t = \sum_{j=1}^t r_T^{t-j} \Delta x_j$. This IV is then used to obtain an IV estimator of β in (7) and to construct the corresponding Wald statistic for testing $H_0 : \beta = 0$. Through this judicious choice of instrument PM09 show that it is possible to clean out the effects of endogeneity even within the near unit root case and to subsequently obtain an estimator of β which is mixed normal under a suitable choice of δ (i.e. $\delta \in (2/3, 1)$) and setting $c_z = 1$ (see PM09, pp. 7-12).

Following PM09 and KMS10 and letting y_t^*, x_t^* and $\tilde{z}_t^*$ denote the demeaned versions of y_t, x_t and $\tilde{z}_t$ we can write the IV estimator as $\tilde{\beta}^{IVX} = \sum y_t^* \tilde{z}_{t-1}^* / \sum x_{t-1}^* \tilde{z}_{t-1}^*$. Note that contrary to PM09 and KMS10 we do not need a bias correction term in the numerator of $\tilde{\beta}^{IVX}$ since we operate under the assumption that $\lambda_{uv} = 0$. The correspdonding IVX based Wald statistic for testing $H_0 : \beta = 0$ in (7) is now written as

$$W_T^{IVX}(\beta = 0) = \frac{(\tilde{\beta}^{IVX})^2 (\sum x_{t-1}^* \tilde{z}_{t-1}^*)^2}{\tilde{\sigma}_u^2 \sum (\tilde{z}_{t-1}^*)^2} \tag{11}$$

with $\tilde{\sigma}_u^2 = \sum (y_t^* - \tilde{\beta}^{IVX} x_{t-1}^*)^2 / T$. Note that this latter quantity is also asymptotically equivalent to $\hat{\sigma}_{lin}^2$ since the least squares estimator of β remains consistent. Under the null hypothesis H_0^B we also have that these two residual variances are in turn asymptotically equal to $\hat{\sigma}_u^2$.

We can now introduce our modified Wald statistic, say $W_T^{B,ivx}(\lambda)$ for testing $H_0 : \alpha_1 = \alpha_2, \beta_1 = \beta_2 = 0$ in (1):

$$W_T^{B,+}(\lambda) \quad = \quad W_T^{IVX}(\beta = 0) + W_T^A(\lambda) \tag{12}$$

and whose limiting behaviour is summarised in the following Proposition.

Proposition 3: *Under the null hypothesis* $H_0^{(B)} : \alpha_1 = \alpha_2, \beta_1 = \beta_2 = 0$*, assumptions A1-A2,* $\delta \in (2/3, 1)$ *in (10) and as* $T \to \infty$*, we have*

$$\sup_\lambda W_T^{B,ivx}(\lambda) \quad \Rightarrow \quad W(1)^2 + \sup_\lambda \frac{BB(\lambda)' BB(\lambda)}{\lambda(1-\lambda)} \tag{13}$$

with $BB(\lambda)$ *denoting a standard Brownian Bridge.*

Our result in (13) highlights the usefulness of the IVX based estimation methodology since the resulting limiting distribution of the SupWald statistic is now equivalent to the one obtained under strict exogeneity (i.e. under $\omega_{uv} = 0$) in (6). The practical implementation of the test is also straightforward, requiring nothing more than the computation of an IV estimator.

3.3 Some Remarks on a Testing Strategy

So far we have developed the distribution theory for two sets of hypotheses that we explicitly did not attempt to view as connected since both may be of interest and considered individually depending on the context of the research question. The implementation of hypotheses tests in a sequence is a notoriously difficult and often controversial endeavor which we do not wish to make a core objective of this paper especially within the nonstandard probabilistic environment we are operating under. However, it is also the case that if one wishes to uncover predictability or more specifically to distinguish between linear and nonlinear predictability it may be worthwhile implementing H_0^A and H_0^B in a sequence in the following sense.

In a first instance we could start by testing $H_0^B : \alpha_1 = \alpha_2, \beta_1 = \beta_2 = 0$ so that if this null is not rejected we stop the investigation and conclude that the data do not support the presence of any form of predictability with some confidence level. If on the other hand H_0^B is rejected we can then proceed with $H_0^A : \alpha_1 = \alpha_2, \beta_1 = \beta_2$. In this second stage if we fail to reject H_0^A we would argue that the data support the presence of linear predictability and we can then proceed estimating a linear specification as in (7). If on the other hand H_0^A is also rejected then the data would appear to support the presence of nonlinear predictability in a *broad sense*. Note however that this second rejection could be compatible with a model in which only the intercept shifts and x_t plays no role in predicting y_{t+1}. This motivates our use of the term nonlinear predictability in a *broad sense* since a specification such as

$y_{t+1} = \alpha_1 I(q_t \leq \gamma_0) + \alpha_2 I(q_t > \gamma_0) + u_{t+1}$ in which predictability is solely driven by the threshold variable q_t is compatible with the rejection of both H_0^A and H_0^B. Depending on the application in question it may also be interesting to explore this latter issue further through additional tests that focus solely on slope parameters. Unfortunately and as in Caner and Hansen (2001) the practical difficulties here may lie in the fact that a null hypothesis on the slopes may be compatible with an identified threshold (if we believe on a priori grounds that intercepts shift at some given γ_0) or a scenario where the latter remains unidentified. Alternatively and perhaps more intuitively, these issues may be adressed through standard inferences implemented on the estimated version of (1)-(2).

4 Finite Sample Analysis

4.1 Testing $H_0^A : \alpha_1 = \alpha_2, \beta_1 = \beta_2$

Having established the limiting properties of the SupWald statistic for testing $H_0^{(A)}$ our next goal is to illustrate the finite sample adequacy of our asymptotic approximation and empirically illustrate our theoretical findings. It will also be important to highlight the equivalence of the limiting results obtained in Proposition 1 to the Brownian Bridge type of limit documented in Andrews (1993) and for which Hansen (1997) obtained p-value approximations and Estrella (2003) exact p-values. Naturally, this allows us to evaluate the size properties of our tests as well.

Our data generating process (DGP) under H_0^A is given by the following set of equations

$$\begin{aligned} y_t &= \alpha + \beta x_{t-1} + u_t \\ x_t &= \left(1 - \frac{c}{T}\right) x_{t-1} + v_t \\ v_t &= \rho v_{t-1} + e_t, \end{aligned} \tag{14}$$

with u_t and e_t both $NID(0,1)$ while the fitted model is given by (1) with q_t assumed to follow the AR(1) process $q_t = \phi q_{t-1} + u_{qt}$ with $u_{qt} = NID(0,1)$. Regarding the covariance structure of the random disturbances, letting $z_t = (u_t, e_t, u_{qt})'$ and $\mathbf{\Sigma}_z = E[z_t z_t']$, we use

$$\mathbf{\Sigma}_z = \begin{pmatrix} 1 & \sigma_{ue} & \sigma_{uu_q} \\ \sigma_{ue} & 1 & \sigma_{eu_q} \\ \sigma_{uu_q} & \sigma_{eu_q} & 1 \end{pmatrix}$$

which allows for a sufficiently general covariance structure while imposing unit variances. Note also that our chosen covariance matrix parameterisation allows the threshold variable to be contemporaneously correlated with the shocks to y_t. All our experiments use normally distributed random variables, are

based on $N = 5000$ replications and set $\{\alpha, \beta, \rho, \phi\} = \{0.01, 0.10, 0.40, 0.50\}$ throughout. Since our initial motivation is to explore the theoretically documented robustness of the limiting distributions to the presence or absence of endogeneity, we consider the two scenarios given by

$$\begin{aligned} \{\sigma_{ue}, \sigma_{uu_q}, \sigma_{eu_q}\} &= \{-0.5, 0.3, 0.4\} \\ \{\sigma_{ue}, \sigma_{uu_q}, \sigma_{eu_q}\} &= \{0.0, 0.0, 0.0\} \end{aligned}$$

and referred to as DGP_1 and DGP_2 respectively. The implementation of the SupWald tests assumes 10% trimming at each end of the sample.

Table 1 below presents some key quantiles of the $SupWald^A$ distribution (see Proposition 1) simulated using a moderately small sample size of T=200 and compares them with the corresponding exact p-values from Estrella's (2003) tabulations. Note that results are displayed solely for DGP_1 since the corresponding figures for DGP_2 were almost identical.

Table 1. Critical Values of $SupWald^A$

	DGP$_1$, $T = 200$				
	$c = 1$	$c = 5$	$c = 10$	$c = 20$	*Exact*
2.5%	2.180	2.214	2.205	2.190	NA
5.0%	2.531	2.520	2.567	2.495	NA
10.0%	3.008	3.066	2.992	2.991	NA
90.0%	10.199	10.457	10.483	10.388	10.640
95.0%	12.073	12.028	12.133	12.188	12.370
97.5%	13.821	13.761	13.846	13.835	NA

Looking across the different values of c as well as the different quantiles we note an excellent adequacy of the T=200 based finite sample distribution to the asymptotic counterpart tabulated in Andrews (1993) and Estrella (2003). This also confirms our analysis of Proposition 1 and provides empirical support for the fact that inferences are robust to the magnitude of c. Note that with T=200 the values of $(1 - c/T)$ corresponding to our choices of c in Table 1 are 0.995, 0.975, 0.950 and 0.800 respectively. Thus the quantiles of the simulated distribution appear to be highly robust to a wide range of persistence characteristics.

Naturally, the fact that our finite sample quantiles match closely their asymptotic counterparts even under T=200 is not sufficient to claim that the test has good size properties. For this purpose we have computed the T=200 based empirical size of the $SupWald^A$ test making use of the *pvsup* routine of Hansen (1997). The latter is designed to provide approximate p-values for test statistics whose limiting

distribution is as in (4). Results are presented in the left panel of Table 2 below which concentrates solely on the covariance structure of DGP_1 since results under DGP_2 were quantitatively very similar.

Table 2. Finite Sample Size Properties of $SupWald^A$ and Comparison with Hansen's (1996) Simulation Method

$DGP_1, T = 200$						
	$SupWald^A$			$Hansen$ (1996)		
$Nominal$	2.5%	5.0%	10.0%	2.5%	5.0%	10.0%
$c = 1$	2.60	4.98	9.40	3.01	6.20	11.14
$c = 5$	2.54	4.82	10.34	2.98	6.36	11.86
$c = 10$	2.64	5.14	10.46	3.26	6.42	12.00
$c = 20$	2.68	5.20	10.04	3.20	6.42	11.32

From the figures presented in Table 2 we again note the robustness of the empirical size estimates of $SupWald^A$ to the magnitude of the noncentrality parameter. Overall the empirical size estimates appear to match their nominal counterparts quite accurately even under a moderately small sample size. Similar size estimates were also obtained using Estrella (2003)'s exact critical values. At this stage it is also interesting to compare the asymptotic approximation in (4) with that occuring when x_t is assumed to follow an AR(1) with $|\rho| < 1$ rather than the local to unit root specification we have adopted in this paper. Naturally, under pure stationarity the results of Hansen (1996, 1999) apply and inferences can be conducted by simulating critical values from the asymptotic distribution that is the counterpart to (3) obtained under pure stationarity and following the approach outlined in the aforementioned papers. This latter approach is similar to an external bootstrap but should not be confused with the idea of obtaining critical values from a bootstrap distribution. The obvious question we are next interested in documenting is which approximation works better when x_t is a highly persistent process? For this purpose Table 2 above also presents the corresponding empirical size estimates obtained using the asymptotic approximation and its external bootstrap style implementation developed in Hansen (1996, 1999) and justified by the multiplier central limit theorem (see Van der Vaart and Wellner (1996)). Although our comparison involves solely the size properties of the test and should therefore be interpreted cautiously the above figures suggest that the nuisance parameter free Brownian Bridge based asymptotic approximation does a good job in matching empirical with nominal sizes when ρ is close to the unit root frontier. Proceeding using Hansen (1996)'s approach on the other hand suggests a mild oversizeness of the procedure.

4.2 Testing $H_0^B : \alpha_1 = \alpha_2, \beta_1 = \beta_2 = 0$

We next turn to the null hypothesis given by $H_0^B : \alpha_1 = \alpha_2, \beta_1 = \beta_2 = 0$ and whose goal is to test the null of linearity jointly with predictive power. As documented in Proposition 2 we recall that the limiting distribution of the $SupWald^B$ statistic under this scenario is no longer free of nuisance parameters and does not take a familiar form when we operate under the set of assumptions characterising Proposition 1 (see the formulation of the limiting distribution in (5)). However, one instance under which the limiting distribution of the $SupWald^B$ statistic takes a simple form is when we impose the exogeneity assumption as for instance in DGP_2. Under this scenario the relevant limiting distribution is given by (6) and can be easily tabulated through standard simulation based methods.

Table 3 below presents some empirical quantiles obtained using $T = 200$, $T = 400$ and $T = 800$ from the DGP $y_t = 0.01 + u_t$. As can be inferred from (6) we note that the quantiles are unaffected by the chosen magnitude of c and appear sufficiently stable across the different sample sizes considered. Viewing the $T = 800$ based results as approximating the asymptotic distribution for instance the quantiles obtained under $T = 200$ and $T = 400$ match closely their asymptotic counterparts.

Table 3. Finite Sample and Asymptotic Critical Values of $SupWald^B$ under Exogeneity

	2.5%	5%	10%	90%	95%	97.5%
	c=1					
$T = 200$	2.589	3.030	3.575	11.731	13.627	15.363
$T = 400$	2.665	3.064	3.665	11.802	13.693	15.413
$T = 800$	2.669	3.148	3.783	11.707	13.419	15.345
	c=5					
$T = 200$	2.561	3.024	3.641	11.634	13.694	15.458
$T = 400$	2.645	3.057	3.685	11.969	13.787	15.853
$T = 800$	2.709	3.145	3.734	11.553	13.422	15.140

We next turn to the more general scenario in which one wishes to test H_0^B within a specification that allows for endogeneity. Taking our null DGP as $y_t = 0.01 + u_t$ and the covariance structure referred to as DGP_1 it is clear from Proposition 2 that using the critical values from Table 3 will lead to misleading results. This is indeed confirmed empirically with size estimates of about 4% to 5% under a 2.5% nominal size. Using our IVX based test statistic in (11)-(12) however ensures that the above critical values remain valid even under the presence of endogeneity. Indeed, results for this experiment are presented in Table 4 below which uses DGP_1 with $y_t = 0.01 + u_t$ and the critical values under T=800 tabulated in Table 3.

Table 4. Empirical Size of $SupWald^{B,ivx}$

	5.0%	2.5%	1.0%
c=1			
$T = 200$	5.62	2.84	1.01
$T = 400$	5.58	2.88	1.16
$T = 800$	5.22	2.58	0.09
c=5			
$T = 200$	5.10	2.86	0.88
$T = 400$	5.44	2.98	1.14
$T = 800$	4.80	2.26	1.00

Overall, we note an excellent match of the empirical sizes with their nominal counterparts as the sample size is allowed to grow. Our simulation based findings corroborate our theoretical findings and suggest that our asymptotic approximations are sufficiently accurate even under small to moderately small sample sizes.

5 Regime Specific Predictability of Returns with Valuation Ratios

One of the most frequently explored specification in the financial economics literature has aimed to uncover the predictive power of valuation ratios such as dividend yields (DY) and price-to-earnings ratios (PE) for future stock returns via significance tests implemented on simple linear regressions linking r_{t+1} to DY_t or PE_t. The econometric complications that arise due to the presence of a persistent regressor together with endogeneity issues have generated a vast methodological literature aiming to improve inferences in such models commonly referred to as predictive regressions (e.g. Valkanov (2003), Lewellen (2004), Campbell and Yogo (2006), Jansson and Moreira (2006), Ang and Bekaert (2007) among numerous others).

Given the multitude of studies conducted over a variety of sample periods, methodologies, data definitions and frequencies it is difficult to extract a clear consensus on predictability. From the recent analysis of Campbell and Yogo (2006) there appears to be statistical support for some mild PE and very mild DY based predictability with both having substantially declined in strength post 1995 (see also Lettau and Van Nieuwerburgh (2008)). Using monthly data over the 1946-2000 period Lewellen (2004) documented a rather stronger DY based predictability using a different methodology that was mainly concerned with small sample bias correction. See also Cochrane (2008) for a more general overview of this literature.

Our goal here is to reconsider this potential presence of predictability through our regime based methodology focusing on the DY predictor. More specifically, using growth in Industrial Production (IP) as our threshold variable proxying for aggregate macro conditions our aim is to assess whether the data support the presence of regime dependent predictability induced by good versus bad economic times. Theoretical arguments justifying the possible existence of episodic instability in predictability have been alluded to in the theoretical setting of Menzly, Santos and Veronesi (2004) and more recently Henkel, Martin and Nardari (2009) explored the issue empirically using Bayesian methods within a Markov-Switching setup. We will show that our approach leads to a novel view and interpretation of the predictability phenomenon and that its conclusions are robust across alternative sample periods. Moreover our findings may provide an explanation for the lack of robustness to the sample period documented in existing linearity based work. Our analysis will be based on the same CRSP data set as the one considered in the vast majority of predictability studies (value weighted returns for NYSE, AMEX and NASDAQ). Throughout all our specifications the dividend yield is defined as the aggregate dividends paid over the last 12 months divided by the market capitalisation and is logged throughout (LDY therefater). For robustness considerations we will distinguish between returns that include dividends and returns that exclude dividends. Finally, using the 90-day T-Bills all our inferences will also distinguish between raw returns and their excess counterparts. Following Lewellen (2004) we will restrict our sample to the post-war period. We will concentrate solely on monthly data since the regime specific nature of our models would make yearly or even quarterly data based inferences less reliable due to the potentially very small size of the sample. We will subsequently explore the robustness of our results to alternative sample periods.

Looking first at the stochastic properties of the dividend yield predictor over the 1950M1-2007M12 period it is clear that the series is highly persistent as judged by a first order sample autocorrelation coefficient of 0.991. A unit root test implemented on the same series unequivocally fails to reject the unit root null. The IP growth series is stationary as expected displaying some very mild first order serial correlation and clearly conforming to our assumptions about q_t in (1)-(2). Before proceeding with the detection of regime specific predictability we start by assessing return predictability within a linear specification as it has been done in the existing literature. Results across both raw and excess returns are presented in Table 5 below with VWRETD denoting the returns inclusive of dividends and VWRETX denoting the returns ex-dividends.

Table 5. Linear Predictability $r_{t+1} = \alpha_{DY} + \beta_{DY} LDY_t + u_{t+1}$

VWRETD	$\hat{\beta}_{DY}$	pvalue	R^2	**VWRETX**	$\hat{\beta}_{DY}$	pvalue	R^2
1950-2007	0.010	0.011	0.9%	1950-2007	0.008	0.054	0.4%
1960-2007	0.010	0.056	0.6%	1960-2007	0.008	0.142	0.3%
1970-2007	0.009	0.069	0.6%	1970-2007	0.007	0.170	0.2%
1980-2007	0.011	0.059	0.9%	1980-2007	0.009	0.131	0.5%
1990-2007	0.014	0.153	0.8%	1990-2007	0.001	0.207	0.5%
Excess				**Excess**			
1950-2007	0.009	0.025	0.7%	1950-2007	0.7%	0.102	0.3%
1960-2007	0.007	0.210	0.2%	1960-2007	0.4%	0.417	0.0%
1970-2007	0.006	0.269	0.1%	1970-2007	0.4%	0.665	0.0%
1980-2007	0.007	0.253	0.2%	1980-2007	0.5%	0.439	0.0%
1990-2007	0.013	0.198	0.6%	1990-2007	1.1%	0.263	0.0%

The coefficient estimates of Table 5 refer to the OLS estimates of β_{DY} in the regression $r_{t+1} = \alpha + \beta_{DY} LDY_t + u_{t+1}$. All pvalues refer to HAC t-ratios for the null hypotheis $H_0 : \beta_{DY} = 0$. Focusing first on the VWRETD series our results conform with the consensus that predictability has been vanishing from the late 80s onwards (see for instance Campbell and Yogo (2006)). The remaining pvalues suggest some mild predictability especially when considering the entire 1950-2007 sample range. Interestingly as we switch from raw to excess returns the picture changes considerably with most pvalues strongly pointing towards the absence of any predictability. Given these pvalue magnitudes it is difficult to conceive that any methodological improvements may reverse the big picture. Also worth pointing out is the fact that a conventional test for heteroskedasticity implemented on the above specifications failed to reject the null of no heteroskedasticity. This is particularly reassuring since one of our assumptions leading to our theoretical results in Propositions 1 and 2 ruled out the presence of heteroskasticity.

Next, focusing on the returns that exclude dividend payments it is again the case that with pvalues as high as 0.665 the null of no predictability cannot be rejected. Results appear to also be robust across different starting periods except perhaps under the full 1950-2007 range under which we note a mild rejection of the null. It is also important to note that all results were robust across HAC versus non-HAC standard errors. This latter point is particularly important since our assumptions surrounding (1)-(2) rule out serial correlation and heteroskedasticity in u_t.

Overall the above linearity based results corroborate the view that predictability is at best mildly present and its strength appears to have declined. Perphaps more importantly Table 5 also suggests that one should be particularly cautious and worry about robustness considerations when assessing DY induced predictability of returns since findings may be extremely sensitive to data definitions, frequency

and chosen sample period. At this stage it is also important to reiterate that our analysis in Table 5 is mainly meant to provide a comparison benchmark for our subsequent regime based inferences rather than reverse findings from the existing literature. This is also the reason why we do not explore outcomes based on alternative methodologies as developed in the recent econometric literature.

The fact that numerous studies documented a decline in predictability characterising the 90s could also be due to the fact that predictability kicks in during particular economic episodes. Table 6 below presents the results of our tests of the hypotheses $H_0^B : \alpha_1 = \alpha_2, \beta_1 = \beta_2 = 0$ followed by $H_0^A : \alpha_1 = \alpha_2, \beta_1 = \beta_2$ and applied to the VWRETD series ($**$ indicates rejection at 2.5%). Since results for the return series that exclude dividends as well as their excess counterparts were both qualitatively and quantitatively similar in what follows we concentrate solely on the VWRETD series.

Table 6. Regime Specific Predictability

VWRETD	$SupWald^{B,ivx}$	$SupWald^{A}$	pvalue
1950-2007	27.894**	20.752**	0.001
1960-2007	23.369**	18.982**	0.002
1970-2007	21.810**	17.729**	0.004
1980-2007	28.310**	24.518**	0.000
1990-2007	29.885**	28.870**	0.000

The evidence presented in Table 6 comfortably points towards the presence of regime specific predictability since both null hypotheses are strongly rejected. It is also interesting to note that unlike in the linear case inferences appear to be robust to the starting period. One should be cautious however when interpreting inferences such as the ones based on the 1990-2007 period due to sample size limitations which are further exacerbated when fitting a threshold specification.

Recalling that the R^2's characterising the various linear specifications were clustered around values close to zero (see Table 5) it is also useful to highlight the remarkable jump in goodness of fit in our proposed threshold model in (16). Our results strongly point towards the presence of very strong predictability during *bad times* when the growth in IP (variable ΔLIP_t) is negative while no or very weak predictability during expansionary periods or normal times. More specifically, over the 1950-2007 period we have

$$\hat{r}_{t+1} = \begin{cases} 0.1606_{(0.0357)} + 0.0441_{(0.0107)} LDY_t & \Delta LIP_t \leq -0.0036,\ R_1^2 = 17.47\%,\ N_1 = 131 \\ 0.0135_{(0.0161)} + 0.0010_{(0.0045)} LDY_t & \Delta LIP_t > -0.0036,\ R_2^2 = 0.00\%,\ N_2 = 564 \end{cases} \tag{15}$$

with a joint R^2 of 3.88% and estimated standard erros in parentheses. Besides being interesting in its own right this result may also help explain the conflicting results obtained in the recent literature

where the samples considered included or excluded data on the late 90s and 00s, a period with few recessions. Even with the reduction in the sample size it is quite remarkable that the goodness of fit can jump from a magnitude close to zero to about 17% in one subset. Overall our results strongly support DY based predictability in US returns but occurring solely during *bad times*. Note for instance that more than half of the periods during which $\Delta LIP_t \leq -0.0036$ coincide with the NBER recessions. The strength of this predictability is very strong and unlikely to be sensitive to the methodology or our assumptions. Interestingly and through a different methodology, our findings about the presence of strong return predictability during bad times also corroborate the findings in Henkel, Martin and Nardari (2009). Using Bayesian inference techniques on a Markov Switching VAR setup in which they consider multiple predictors in addition to the Dividend Yield the authors document a substantial jump in predictive strength of variables such as DY, short term rates, term structure etc during recessions.

6 Conclusions

The goal of this paper was to develop inference methods useful for detecting the presence of regime specific predictability in predictive regressions. We obtained the limiting distributions of two Wald statistics designed to test the null of linearity versus threshold type nonlinearity as well as the joint null of linearity and no predictability. One important feature of the limiting distribution that arises in the first case is the fact that it does not depend on any unknown nuisance parameters thus making it straightforward to use. This is an unusual occurence in this literature where under a purely stationary framework (as opposed to a nearly integrated one) it is well known that limiting distributions typically depend on unknown population moments of the underlying models.

Our empirical application also leads to the interesting result that US return series are comfortably predictable using valuation ratios such as DY but this predictability kicks in solely during bad times and would therefore be masked in studies that operate within linear specifications.

Finally, it is worth mentioning some important extensions to the present work. One key assumption under which we have operated ruled out heteroskedasticity and serial correlation in u_t. As our empirical application has documented however our results can continue to be extremely useful despite this limitation. This restriction is in fact the norm rather than the exception in any work that introduced nonlinearities parametrically or nonparametrically (e.g. functional coefficient models) in models that contain persistent variables. In the present context allowing u_t to display a more flexible stochastic structure renders the asymptotics of terms such as $\sum u_t I(q_{t-d} \leq \gamma)/T^{\delta}$ challenging to deal with and tackling such marked empirical processes can be an important research agenda in its own right. Another useful extension we are currently considering involves introducing long horizon variables to (1)-(2). This would

offer an interesting parallel to the linear predictive regression literature which has often distinguished long versus short horizon predictability. Other important extensions include extending (1)-(2) to allow for more than two regimes following some of the methods developed in Gonzalo and Pitarakis (2002) while the statistical properties of objects such as the estimated threshold parameter may be explored following Gonzalo and Wolf (2005).

APPENDIX

LEMMA 1: Under assumptions A1-A2 and as $T \to \infty$ we have (a) $\frac{\sum I_{1t}}{T} \xrightarrow{p} \lambda$, (b) $\frac{\sum x_t}{T^{\frac{3}{2}}} \Rightarrow \int_0^1 K_c(r)dr$, (c) $\frac{\sum x_t^2}{T^2} \Rightarrow \int_0^1 K_c^2(r)dr$, (d) $\frac{\sum x_{t-1}v_t}{T} \Rightarrow \int_0^1 K_c(r)dB_v(r)+\lambda_{vv}$. (e) $\frac{\sum x_{t-1}u_t}{T} \Rightarrow \int_0^1 K_c(r)dB_u(r,1)$, (f) $\frac{\sum x_t^2 I_{1t}}{T^2} \Rightarrow \lambda \int_0^1 K_c^2(r)dr$, (g) $\frac{\sum x_t I_{1t}}{T^{\frac{3}{2}}} \Rightarrow \lambda \int_0^1 K_c(r)dr$, (h) $\frac{\sum_{t=1}^{[Tr]} u_t I_{1t-1}}{\sqrt{T}} \Rightarrow B_u(r,\lambda)$, (i) $\frac{\sum x_{t-1}u_t I_{1t-1}}{T} \Rightarrow \int_0^1 K_c(r)dB_u(r,\lambda)$

PROOF OF LEMMA 1: (a) By assumptions A1-A2, I_{1t} is strong mixing with the same mixing numbers as q_t. The result then follows from a suitable law of large numbers (see White (2001, Sections 3.3-3.4)). (b)-(e) Under our assumptions A1-A2, the results follow directly from Lemma 3.1 in Phillips (1988). (f) Letting $X_{T,t} = x_t/\sqrt{T}$ and $X_T(r) = x_{[Tr]}/\sqrt{T}$ we can rewrite (f) as

$$\frac{1}{T}\sum X_{T,t}^2 I_{1t} \quad = \quad \lambda \frac{1}{T}\sum X_{T,t}^2 + \frac{1}{T}\sum X_{T,t}^2 (I_{1t} - \lambda). \tag{16}$$

Under A1-A2 and requiring $E|e_t|^p < \infty$ for some $p \geq 4$ we can make use of the strong approximation result $\sup_{r\in[0,1]} |X_T(r) - K_c(r)| = o_p(T^{-a})$ with $a = (p-2)/2p$ (see Lemma A.3 in Phillips (1998) and Phillips and Magdalinos (2007)) to obtain

$$\frac{1}{T}\sum X_{T,t}^2 \quad = \quad \int_0^1 K_c^2(r)dr + o_p(T^{-a}). \tag{17}$$

Indeed,

$$\begin{aligned}
\left| \int_0^1 X_T(r)^2 dr - \int_0^1 K_c(r)^2 dr \right| &\leq \int_0^1 \left| X_T(r)^2 - K_c(r)^2 \right| dr \\
&= \int_0^1 |X_T(r) - K_c(r)| \, |X_T(r) + K_c(r)| \, dr \\
&\leq \sup_r |X_T(r) - K_c(r)| \left(\sup_r |X_T(r)| + \sup_r |K_c(r)| \right) \\
&= o_p(T^{-a}).
\end{aligned} \tag{18}$$

The above then leads to

$$\frac{1}{T}\sum X_{T,t}^2 I_{1t} - \lambda \int_0^1 K_c(r)^2 dr \quad = \quad \frac{1}{T}\sum X_{T,t}^2 (I_{1t} - \lambda) + o_p(T^{-a}) \tag{19}$$

holding uniformly $\forall \lambda \in \Lambda$. Finally, given that $\sup_{r\in[0,1]} |X_T(r)| = O_p(1)$ together with the fact that the result in (a) also holds uniformly over λ (see Lemma 1 in Hansen (1996)) we have $\sup_\lambda |\frac{1}{T}\sum X_{T,t}^2 I_{1t} - \lambda \int_0^1 K_c(r)^2 dr| = o_p(1)$ implying the required result. (g) Follows identical lines to the proof of (f). (h)-(i) Since our assumptions satify their Assumption 2 the result in (h) is Theorem 1 of Caner and Hansen (2001) while our result in (i) follows along the same lines as Theorem 2 of Caner and Hansen (2001).

PROOF OF PROPOSITION 1: It is initially convenient to reformulate $W_T^A(\lambda)$ under H_0^A as

$$\begin{aligned} W_T^A(\lambda) &= [u'X_1 - u'X(X'X)^{-1}X_1'X_1][X_1'X_1 - X_1'X_1(X'X)^{-1}X_1'X_1]^{-1} \\ &\quad [X_1'u - (X_1'X_1)(X'X)^{-1}X'u]/\hat{\sigma}_u^2 \equiv Q^A(\lambda)/\hat{\sigma}_u^2. \end{aligned} \tag{20}$$

With $D_T = diag(\sqrt{T}, T)$ we can write

$$D_T^{-1}X_1{}'X_1D_T^{-1} = \begin{pmatrix} \frac{\sum I_{1t}}{T} & \frac{\sum x_t I_{1t}}{T^{\frac{3}{2}}} \\ \frac{\sum x_t I_{1t}}{T^{\frac{3}{2}}} & \frac{\sum x_t^2 I_{1t}}{T^2} \end{pmatrix} \tag{21}$$

and using Lemma 1 we have the following weak convergence results

$$D_T^{-1}X_1{}'X_1D_T^{-1} \Rightarrow \begin{pmatrix} \lambda & \lambda\int_0^1 K_c(r)dr \\ \lambda\int_0^1 K_c(r)dr & \lambda\int_0^1 K_c^2(r)dr \end{pmatrix} \equiv \lambda\int_0^1 \overline{K}_c(r)\overline{K}_c(r)' \tag{22}$$

and

$$D_T^{-1}X'XD_T^{-1} \Rightarrow \int_0^1 \overline{K}_c(r)\overline{K}_c(r)' \tag{23}$$

where $\overline{K}_c(r) = (1, K_c(r))$. It now follows from the continuous mapping theorem that

$$[D_T^{-1}X_1{}'X_1D_T^{-1} - D_T^{-1}X_1{}'X_1(X'X)^{-1}X_1{}'X_1D_T^{-1}]^{-1} \Rightarrow \frac{1}{\lambda(1-\lambda)}\left(\int_0^1 \overline{K}_c(r)\overline{K}_c(r)'\right)^{-1}. \tag{24}$$

We next focus on the limiting behaviour of $D_T^{-1}X'u$ and $D_T^{-1}X_1'u$. Looking at each component separately, setting $\sigma_u^2 = 1$ for simplicity and no loss of generality we have

$$D_T^{-1}X_1{}'u = \begin{pmatrix} \frac{\sum I_{1t}u_{t+1}}{\sqrt{T}} \\ \frac{\sum x_t I_{1t}u_t}{T} \end{pmatrix} \Rightarrow \begin{pmatrix} B_u(r,\lambda) \\ \int_0^1 K_c(r)dB_u(r,\lambda) \end{pmatrix} \tag{25}$$

and

$$D_T^{-1}X'u = \begin{pmatrix} \frac{\sum u_{t+1}}{\sqrt{T}} \\ \frac{\sum x_t u_t}{T} \end{pmatrix} \Rightarrow \begin{pmatrix} B_u(r,1) \\ \int_0^1 K_c(r)dB_u(r,1) \end{pmatrix}. \tag{26}$$

The above now allows us to formulate the limiting behaviour of $D_T^{-1}X_1{}'u - \lambda D_T^{-1}X'u$ as

$$D_T^{-1}X_1{}'u - \lambda D_T^{-1}X'u \Rightarrow \int_0^1 \overline{K}_c(r)dG_u(r,\lambda) \tag{27}$$

where $G_u(r,\lambda) = B_u(r,\lambda) - \lambda B_u(r,1)$. The result in (3) follows straightforwardly through the use of the continuous mapping theorem and standard algebra.

PROOF OF PROPOSITION 2: For simplicity and no loss of generality we impose zero intercepts throughout and focus on the Wald statistic $W_T^B(\lambda)$ for testing $H_0^{(B)} : \beta_1 = \beta_2 = 0$ in (1) with $\alpha_1 = \alpha_2 = 0$. The

only difference with our result in (5) will be the fact that here we will have $K_c^*(r) = K_c(r)$ since there is no needed demeaning of $K_c(r)$. For later use we also let $W_T^{lin} = u'X(X'X)^{-1}X'u/\hat{\sigma}_{lin}^2 = Q/\hat{\sigma}_{lin}^2$ denote the Wald statistic for testing $H_0 : \beta = 0$ in the linear model $y = X\beta + u$. We can now write the Wald statistic $W_T^B(\lambda)$ under $H_0^{(B)} : \beta_1 = \beta_2 = 0$ as

$$W_T^B(\lambda) = \left(u'X_1(X_1'X_1)^{-1}X_1'u + u'X_2(X_2'X_2)^{-1}X_2'u\right)/\hat{\sigma}_u^2 \equiv Q^B(\lambda)/\hat{\sigma}_u^2. \quad (28)$$

Since $X_2 = X - X_1$ we have $(X_2'X_2)^{-1} = (X'X - X_1'X_1)^{-1}$ together with $(X'X - X_1'X_1)^{-1} = [X_1'X_1 - X_1'X_1(X'X)^{-1}X_1'X_1]^{-1}X_1'X_1(X'X)^{-1}$. Plugging the relevant terms into $Q(\lambda)$ in (29), lengthy but standard algebra gives

$$\begin{aligned} Q^B(\lambda) &= [u'X_1 - u'X(X'X)^{-1}X_1'X_1][X_1'X_1 - X_1'X_1(X'X)^{-1}X_1'X_1]^{-1}[X_1'u - X_1'X_1(X'X)^{-1}X'u] \\ &+ u'X(X'X)^{-1}X'u \\ &= Q^A(\lambda) + Q \end{aligned} \quad (29)$$

with $Q^A(\lambda)$ defined as in (21). Since under the null hypothesis and as $T \to \infty$ we have $\hat{\sigma}_u^2 \approx \hat{\sigma}_{lin}^2$ both converging in probability to σ_u^2 our result above establishes the fact that the Wald statistic $W_T^B(\lambda)$ can be decomposed into the sum of the Wald statistic $W_T^A(\lambda)$ for testing $H_0 : \beta_1 = \beta_2$ and the Wald statistic W_T^{lin} for testing $H_0 : \beta = 0$ in the linear model. Next, since Q does not depend on λ we can write $\sup_\lambda W_T^B(\lambda) = Q/\hat{\sigma}_u^2 + \sup_\lambda W_T^A(\lambda)$. To obtain the limiting distribution in (5) it now suffices to use the results presented in Lemma 1 together with the continuous mapping theorem.

PROOF OF PROPOSITION 3: Follows directly from (11)-(12), Theorem 3.8 in Phillips and Magdalinos (2009), Lemma 1 and the use of the Continuous Mapping Theorem. Note that Theorem 3.8 in Phillips and Magdalinos (2009) has been obtained within a model with no fitted intercept however Kostakis, Magdalinos and Stamatogiannis (2010) and Magdalinos (2010) also established its validity in the more general setting that includes a constant term.

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