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The information content of the Bond-Equity Yield Ratio: better than a random walk ?

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Abstract

Since the 1990's run up in stock prices and subsequent crashes, the financial community has taken a dim view of the traditional valuation ratios and has instead turned its attention to a new valuation ratio: the Bond-Equity Yield Ratio (BEYR). In this paper we provide the first comprehensive, both in-sample and out-of-sample, statistical assessment of the fundamental short-term reversion dynamics of the BEYR towards its long-term mean. Using cointegrated VAR models, we show that the BEYR can depart from its long-term relationship for an extended period of time before reversion process finally brings it back to equilibrium. The out-of-sample forecasting analysis, based on both equally and superior predictive ability tests, shows that the cointegrated VAR model does not perform better than a naive random walk. As such, we cast doubt on the ability of the BEYR to predict monthly stock return.

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