CHAPTER 5
CONCLUSIONS

The usual strategy in asset pricing research is to find variables that explain movements in prices. The strategy of this paper is to take the prices as given and to try to extract some of the information that consumers use to set these prices in equilibrium. The consumption-based asset pricing model suggests that prices set today should reflect the marginal utility of consumption today relative to tomorrow. With assumptions on the form of the utility function and a model of inflation, expected real interest rate variables are examined to see if they reveal any information about future growth in the economy.

It is a controversy as to whether changes in expected real rates have any impact on consumption fluctuations. This paper has offered some new evidence by looking at multiperiod interest rates and by examining the spread between these yields. The evidence suggests that there is a link between the yield spread and consumption fluctuations. It has been suggested that using the longer term consumption growths may reduce the relative size of any errors in the consumption data. Furthermore, using the spread in a linear forecasting model will accommodate certain types of changes in the variance of the joint consumption–returns process whereas using the level of the expected real interest rate requires that the variance be constant through time.

The empirical results suggest that yield spread contains information relevant
for forecasting future consumption. The results show that the yield spread had some ability to predict future consumption growth both within-sample and out-of-sample. The power is the weakest in the mid-1960’s and the strongest in the 1970’s and 1980’s. With the annual data, most of the explanatory power follows the depression. Poor consumption data in the 1900–1929 period and large inflation forecasting errors during the depression are the most likely causes of the weak performance during this period. Evidence is also presented that shows that the yield spread performs better than two alternate predictors of consumption growth: lagged consumption and real stock returns. Furthermore, the yield spread forecasts are at least as reliable as those from the commercial econometric services.