A Sentiment-based Explanation of the Forward Premium Puzzle: discussion

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  - provide theoretical framework to explain $\beta << 1$;
  - provide empirical evidence to support this theory.
Main idea with log-preferences.

Sentiment vs Long-Run Risks?

Alternative interpretation of the model.

Empirical evidence: Should we worry about sentiment spread?
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**Ex ante** UIP regression slope equals 1
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Ex post UIP regression slope is less than 1
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The recipe:

1. Epstein and Zin preferences
2. Consumption growth is predictable (through sentiment)
3. High correlation of predictable components
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The paper considers a version with long-run risks and sentiment:

\[ \Delta c_{t+1} = \mu_c + S_t + x_t + \varepsilon_{t+1} \]

- \( S_t \): sentiment
- \( x_t \): long-run risk
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Can sentiment act as the long-run risk?
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with \( R^2 = 0.052 \).
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Annual persistence = 0.737 \Rightarrow Monthly persistence \approx 0.975.
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Empirical Evidence

- Empirical predictions are tested through regressions on US sentiment alone and not on cross country sentiment spread.
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Should we worry about this?
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Omitted variables literature: the answer depends on

1. $\text{corr}(s_t, s_t^*)$
2. $\sigma(s_t^*)/\sigma(s_t)$
### Results: \( t - \text{stat} \left( \hat{\beta} \right) \)

<table>
<thead>
<tr>
<th>corr( (s_t, s_{t}^{*}) )</th>
<th>( \sigma(s_{t}^{*})/\sigma(s_t) )</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1.00</td>
</tr>
<tr>
<td>0.50</td>
<td>(-37.96)</td>
</tr>
<tr>
<td>0.60</td>
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</tr>
<tr>
<td>0.90</td>
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What matters is the volatility of the extent to which sentiment predicts consumption!

This could be an issue: why keep us wondering about it?

Use international sentiment data in Baker, Wurgler, and Yuan (2009) to test the actual prediction of the model!

The data are available: just do it!
Concluding remarks

- A very nice paper!

- Be more ambitious: the paper doesn’t have to be about sentiment!

- Empirical evidence should focus on the cross-country spread of predictable components!