Subjective Risk Premia in Bond and FX Markets

Daniel Pesch[1], Ilaria Piatti[2] and Paul Whelan[3]

[1]Saïd Business School

[2]Queen Mary University of London

[3]Copenhagen Business School

Abstract

This paper elicits subjective risk premia from an international survey dataset on interest rates and exchange rates. Survey implied risk premia are (*i*) unconditionally negative for bonds, positive for investment currencies and negative for funding currencies, (*ii*) correlated with (subjective) macro expectations, (*iii*) correlated with quantities of risk, (*iv*) mean-reverting, as opposed to extrapolative; and (*v*) predict future realised returns with a positive sign. Taking beliefs as given, we estimate a subjective asset pricing model with time-variation in economic uncertainty which supports these findings. This demonstrates that subjective risk premia respect a risk-return trade-off regardless of whether they are rational or not, suggesting that behavioural theories of belief formation can co-exist with rational theories of risk pricing.

JEL classification: D9, E3, E4, G12

Keywords: Survey Data, Subjective Beliefs, Bond Risk Premia, Exchange Rate Risk Premia, International Finance, Rational Expectations

This draft: June 2023

The authors thank Daniel Andrei, Diego Bonelli, Nina Boyachenko, Lorenzo Bretscher, Adrian Buss, Mikhail Chernov, Darwin Choi, Pasquale Della Corte, Bjørn Eraker, Peter Feldhütter, Thomas Geelen, Alessandro Graniero, Daniel Hoechle, Yan Ji, Christian Julliard, David Lando, Abraham Lioui, Ian Martin, Dmitry Orlov, George Panayotov, Lasse Pedersen, Riccardo Rebonato, Guillaume Roussellet, Ivan Shaliastovich, Kathrin Schlafmann, Paul Schneider, David Schumacher, Sang Byung Seo, André Souza, Peter Van Tassel, Katrin Tinn, Fabrice Tourre, Andrea Vedolin, Luca Del Viva, Xiao Xiao, Yizhou Xiao, Jialin Yu, Chu Zhang and audiences at various conferences and seminars for their comments and suggestions. Paul Whelan gratefully acknowledges financial support from the Danish Council for Independent Research grant no. 9037-00105B. The usual disclaimer applies. Emails: daniel.pesch@sbs.ox.ac.uk, i.piatti@qmul.ac.uk, pawh.fi@cbs.dk.