

Market Risk Premium: A Single Optimal Predictive Factor in High Dimension*

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Abstract

We propose a novel method to extract a single optimal factor (SOF) from a predictive regression of multiple factors capture numerous economic forces that influence the stock market. We show that SOF possesses the oracle property, performing as if the true loadings on the predictors were known asymptotically. Theoretically superior to existing methods and empirically consistent in delivering strong performance, the SOF identifies key drivers of market predictability-nominal GDP growth, inflation, fiscal policy uncertainty, dividend payout, and the earnings-to-price ratio. Moreover, SOF performs as well in predicting volatility, bond excess return and macroeconomic aggregate.

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