

Momentum Uncertainties

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- 1 Preliminaries
 - What do I do?
 - Background
- 2 Methodology
- 3 Data
- 4 Results
 - Momentum Abnormal Returns and Macroeconomic Uncertainty
 - Momentum Moments under High and Low Uncertainty Regimes
 - Excess Returns Exposure to Momentum
 - Momentum moments and economic uncertainty
- 5 Conclusions

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- I study the relationship between **macroeconomic uncertainty** and **momentum** abnormal returns.
- I show that high levels of uncertainty in the economy:
 - ...reduces the abnormal returns of momentum below zero,
 - ...causes the Sharpe ratio of the momentum strategy to collapse, and
 - ...raises the probability of momentum crashes.
- I also document a reduction in the momentum beta, which measures the exposure of excess equity returns to the momentum factor.
- Uncertainty acts as an **economic regime** that underlies changes over the time of momentum abnormal returns, documented by the literature.

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- Uncertainty in its original formulation (Knight, 1921; Keynes, 1921, 1939) implies that probabilities are incommensurable.
- ... investment strategies such as momentum trading, which are based precisely on extrapolating the immediate past performance are likely to fail when macroeconomic uncertainty is 'high'.
- ..., when uncertainty is 'low', the usual assumption of treating uncertainty episodes as if they were risky situations works better.
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- Advances recently made by the macro-literature on appropriate measures of uncertainty (uncertainty vs risk or risk aversion):
 - A direct estimation of unexpected variations within a given system (Jurado et al., 2015; Chuliá, et al. 2017)
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- Momentum continues to be a pervasive anomaly in both the cross-section (Asness et al., 2013) and over time (Moskowitz et al., 2012). .
- Momentum imposes higher order risks to investors, such as an extremely fat-tailed and negatively-skewed distribution of gains (Daniel and Moskowitz, 2016; Barroso and Santa-Clara, 2015).
- Momentum remains as a puzzle in the explanation of excess returns. Fama and French (2016) acknowledge the importance of including momentum within the set of regressors.
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- I examine whether macroeconomic uncertainty or economic activity (NBER recessions), is the economic state that underlies changes in momentum abnormal returns and identify macroeconomic uncertainty as a major economic state underlying momentum dynamics.
- I also add to a nascent strand of the financial literature that analyzes the impact of uncertainty on stock prices (Brogaard and Detzel, 2015.; Segal et al., 2015; Bali and Zhou, 2016 ; Bali et al., 2017).

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- The modeling set up in all the sections of this study considers two extreme states: one of low uncertainty and one of high uncertainty.
- I model endogenously the probability of transition between the two states in a smooth fashion.
- The same econometric machinery is used to estimate both:
 - the changing abnormal returns of momentum over time,
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My main method is an adaptation of the smooth transition regression (STR) model due to McAleer and Medeiros (2008):

$$WML_t = \mathbf{b}_0 + \mathbf{b}_1 f(u_t; \gamma, c^*) + \mathbf{W}'_t \mathbf{b}_w + \tilde{\epsilon}_t$$

- WML_t : series of the monthly returns of the WML strategy.
- \mathbf{b}_0 : abnormal returns in a low uncertainty regime
- $\mathbf{b}_0 + \mathbf{b}_1$: abnormal returns in a high uncertainty regime.
- $f(u_t; \gamma, c^*)$:logistic function that depends on uncertainty, a slope parameter, and a threshold between the regimes.
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- Data sample: January 1927 to June 2017. 1,086 monthly observations.
- I analyze the returns of a portfolio of winners minus losers in the previous 2-12 months (difference between the highest and the lowest deciles of the portfolios).
- The portfolios constructed each month include NYSE, AMEX, and NASDAQ stocks and were retrieved from Keneth French's data library.
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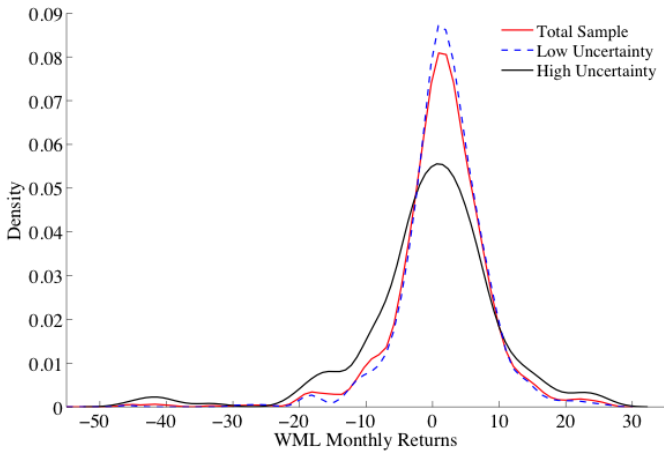
	<i>Endogenous Threshold (Percentile 80.15)</i>									
	<i>b</i>	<i>t(b)</i>	<i>b</i>	<i>t(b)</i>	<i>b</i>	<i>t(b)</i>	<i>b</i>	<i>t(b)</i>	<i>b</i>	<i>t(b)</i>
ALPHA	1.76	8.43	2.16	9.35	2.35	9.36	2.17	9.41	1.97	8.53
RMRF	-0.38	-9.19	-0.39	-9.38	-0.39	-9.53	-0.40	-9.70	-0.40	-9.61
SMB	-0.20	-2.92	-0.19	-2.88	-0.19	-2.89	-0.19	-2.90	-0.20	-2.93
HML	-0.74	-12.14	-0.74	-12.24	-0.74	-12.25	-0.74	-12.37	-0.75	-12.36
H.UNC			-2.20	-3.93	-1.99	-3.89				
REC					-0.95	-1.83				
H. GOOD UNC							-1.37	-2.42		
H. BAD UNC							-4.35	-4.29	-4.15	-4.81
L. BAD UNC									-0.13	-0.22

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The table shows standardized moments as:

$$\bar{m}^k = \bar{m}_1^k \frac{N_1}{N} + \bar{m}_2^k \frac{N_2}{N}$$

	<i>Total</i>	<i>Low Uncertainty</i>	<i>High Uncertainty</i>
<i>Maximum</i>	26.16	26.16	24.99
<i>Minimum</i>	-77.02	-77.02	-45.16
<i>Mean</i>	14.14	18.39	-3.07
<i>Standard Deviation*</i>	1.00	0.83	1.70
<i>Skewness*</i>	-2.34	-2.01	-3.66
<i>Kurtosis*</i>	17.42	16.60	20.77
<i>Sharpe ratio</i>	0.52	0.75	-0.09
<i>Num. Obs.</i>	N=1086	N ₁ =871	N ₂ =215



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- $EP = R - R_F$ are excess returns.
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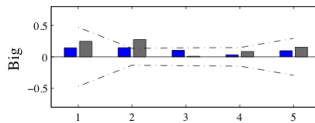
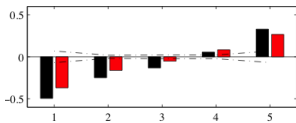
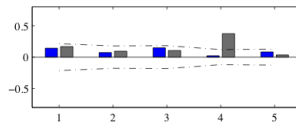
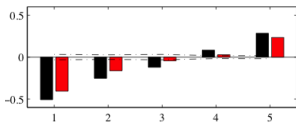
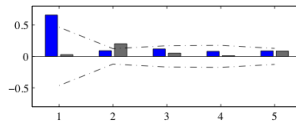
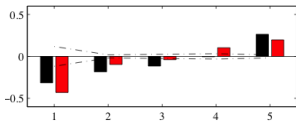
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Momentum moments and economic uncertainty



Momentum Quintiles

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Big

- I document a non-linear behavior of momentum abnormal returns and other moments of its return distribution, conditioning on the level of economic uncertainty in the economy.
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