Asset Pricing with Return Extrapolation*

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ABSTRACT

We present a new model of asset prices based on return extrapolation. The model is a Lucas-type general equilibrium framework, in which the agent has Epstein-Zin preferences and extrapolative beliefs. Unlike earlier return extrapolation models, our model allows for a quantitative comparison with the data on asset prices. When the agent's beliefs are calibrated to match survey expectations of investors, the model generates excess volatility and predictability of stock returns, a high equity premium, a low and stable risk-free rate, and a low correlation between stock returns and consumption growth. We compare our model with prominent rational models and document their different implications.

JEL classification: G02, G12

Keywords: Expectations, Return Extrapolation, Stock Market Movements

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