The Consumption Risk of Bonds and Stocks*

Svetlana Bryzgalova† Christian Julliard‡

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Abstract

Aggregate consumption growth reacts slowly, but significantly, to bond and stock return innovations. As a consequence, slow consumption adjustment (SCA) risk, measured by the reaction of consumption growth cumulated over many quarters following a return, can explain most of the cross-sectional variation of expected bond and stock returns. Moreover, SCA shocks explain about a quarter of the time series variation of consumption growth, a large part of the time series variation of stock returns, and a significant (but small) fraction of the time series variation of bond returns, and have substantial predictive power for future consumption growth.

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†Stanford University, bryzgals@stanford.edu

‡Department of Finance, FMG, and SRC, London School of Economics, and CEPR; c.julliard@lse.ac.uk.