Do technical indicators predict Risk Premiums?

Fundamental (Traditional) Indicators vs. Technical Indicators

Master's Thesis

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Abstract

I find evidence that technical indicators predict returns well in equity and commodity markets (better than fundamental indicators in-sample and out-of-sample). On the other hand, in bond returns prediction, traditional indicators (Fama and Bliss, 1987; Cochrane and Piazzesi, 2005) perform greater than typical technical indicators. Regarding their greatest performing horizons, the best results are for long horizons (at least 12 months) in equity and commodity predictions, and are for short horizons (1 year) in bond predictions. Also, findings suggest that a pooled average (POOLED AVG) method can improve forecasting power in terms of average performances. Furthermore, a cumulative difference in squared forecast error (CDSFE) plot tells us that the POOLED AVG of technical (traditional) indicators consistently outperforms the historical average forecasts (benchmark) across asset classes. The CDSFE plot also shows a relationship between recession and equity predictability. The POOLED AVG indicator for equity prediction performs well during recessions (defined by the NBER, National Bureau of Economic Research). Based on the empirical results in this thesis, I recommend technical indicators (particularly SIGN, TREND, and SMT) or the POOLED AVG of them for successful equity and commodity investments and the POOLED AVG of traditional indicators for profitable bond investments.

Keywords: Return predictability, Technical indicator, Mean reversion, Momentum, In-sample, Out-of-sample