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Executive Summary

The asset pricing of investment portfolio has always been one of the most important fields of financial research. Numerous papers have studied this topics from the perspective of risk and return. Markowitz(1959) uses the variance of asset prices as a proxy for risk. Sharp(1964), Lintner(1965), and Mossin(1966) separately develop the CAPM Model and use the market β, the coefficient in the regression of a security's (portfolio's) return on the market portfolio's return, to represent the systematic risk of this security (portfolio). Fama and French's (1993) three-factor model introduce size factor and book-to-market factor to explain large anomalies that cannot be explained by CAPM model. Then, Fama and French(2015) propose the five-factor model by adding profitability factor and investment factor to the three-factor model, and it turns out that the five-factor model performs better than the former one.

Merton(1973) develops an equilibrium model of multi-period and indicates that investors have a strong preference to hedge against unfavorable intertemporal shifts and changes in future investment opportunities. This implies that state variables correlated with changes in consumption and investment opportunities can influence investment decision and are related to asset expected returns in capital market. Allen, Bali, and Tang (2012), and Jurado, Ludvigson, and Ng (2015) point out that macroeconomic uncertainty is linked to real economic activity and asset returns. Bali, Brown, and Tang's (2017) article shows that uncertainty premium is driven by the outperformance by stocks with negative uncertainty beta and the underperformance by stocks with positive uncertainty beta. However, those articles only test the data of common stocks traded in the US stock market which is highly developed, and there is few empirical studies on the China's stock market in terms of economic uncertainty.

It's obvious that capital markets of emerging economies are different from these of US. As the world's largest emerging economy, China is remarkably different from the US on many aspects. China's economy is heavily dominated by the government policies and state-owned enterprises. The capital control and investment license are largely regulated by the government. Thus, China has a different economic patterns with US and the market liquidity is not as high as developed market. Besides, the marginal propensity to consume of China is much lower than that of US, indicating that Chinese people have less incentive to change consumption in terms of economic fluctuations.

The explanatory power of the asset pricing model is related to the maturity level of the capital market. Compared with mature capital market, China's A-shares market still lags in terms of the richness of financial products, the trading strategy of investors, the normativeness of information disclosure and the perfection of legal and regulatory systems. Meanwhile, the retail investors account for the largest proportion of investors in the A-shares market. Du and Xiao (2018) state that many of the retail investors prefer conceptual speculation to value investment and the herd effect is prevailing in A-shares market. Tian, Wang (2014) say that investors of A-shares market are more concerned about short-term yields and less concerned with long-term investment decisions. Morck, Yeung, and Yu(2000) prove that systematic risk is the main risk of emerging market. Tian, Wang, and Zhang(2014) prove that the empirical results of China's market is significantly different from that of US stock market. Those characteristics imply that China's economic uncertainty may have different relation with the pricing of stocks.

The fundamental objective of this thesis is to investigate the role of China's economic uncertainty in the cross-sectional pricing of stocks of A-shares market. Then, I intend to examine the relation between uncertainty premium and uncertainty beta of stocks. A further aim of this thesis is to assess the predictive power of the uncertainty betas in terms of stock returns.

My results of the data processing provide evidence of a significantly positive relation between the uncertainty beta and the next-month stock return. Besides, stocks in the highest β^{UNC} quintile generate 4.20% higher annual returns compared to stocks in the lowest β^{UNC} quintile. This positive relation is more significant in stocks with big market capitalization. My findings also suggest uncertainty beta can be a new factor in stock-selection tactics for the investors of China's stock market. The results of this thesis have certain meaning for asset allocation, risk management, market monitoring, and investment valuation in China's A-shares market.