Executive Summary

This thesis investigates the influence of Policy Uncertainty on stock prices in the US. Pástor and Veronesi (2012, 2013) set the first and maybe most important base for predictions about the influence of policy changes and policy uncertainty on stock prices. Many authors after their paper used it as principal reference, as we do in this one.

Pástor and Veronesi (2012) state that policy changes have principally two effects: increased expected profitability, which pushes stock prices up, and higher discount rates, which pushes them down. Usually the second effect is stronger than the first. Pástor and Veronesi (2013) analyse how stock prices should respond to political signals about the future policy decisions. The unpredictability about these decisions is what we call Policy Uncertainty.

Baker et al. (2016a) find a very interesting way to measure Policy Uncertainty. They analyse ten leading US newspapers and find how many times determined combination of words, such as "uncertainty" or "economic", have been written each month. They normalize this number and obtain a News Base Policy Uncertainty Index.

In this thesis we find that the correlation between such index and stock returns is significantly negative. We take the Fama French five factor model and add a variable called PU, which describes monthly returns of the News Based Policy Uncertainty Index. In this model, our results indicate that, PU has generally a small negative effect on excess returns. The standard deviation of our new variable is higher than the one of the other factors and this shows that it is possible that the return on Policy Uncertainty is really high or low: this results in a noticeable effect on stock prices, if we believe in our model.

A monthly doubling of the Policy Uncertainty Return would cause excess returns to drop by about 4.5% on a yearly basis (about 0.37% monthly). If, for instance, we take a closer look to the beginning of the great recession in September 2008, our dataset shows an average drop in excess returns of about -10%, while Policy Uncertainty return increases by 193%. This means that PU could explain about 7% of the monthly stock market drop.