

Subjective Risk Premia in Bond and FX Markets

Daniel Pesch¹, Ilaria Piatti² and Paul Whelan³

¹Saïd Business School

²Queen Mary University of London

³Copenhagen Business School

Abstract

This paper elicits subjective risk premia from an international survey dataset on interest rates and exchange rates. Survey implied risk premia (*i*) are unconditionally negative for bonds and positive (negative) for investment (funding) currencies; (*ii*) can be conditionally positive or negative; (*iii*) vary with subjective macro expectations; (*iv*) are positively correlated with quantities of risk; (*v*) predict future realised returns. Taking beliefs as given, we estimate an asset pricing model with time-variation in economic uncertainty which supports these findings. This demonstrates that subjective risk premia respect a risk-return trade-off regardless of whether they are rational or not, suggesting that behavioural theories of belief formation co-exist with rational theories of risk pricing.

JEL classification: D9, E3, E4, G12

Keywords: Survey data, Subjective Beliefs, Bond Risk Premia, Exchange Rate Risk Premia, International Finance, behavioural finance, rational expectations, asset pricing.

This draft: November 2022

The authors thank Diego Bonelli, Lorenzo Bretscher, Adrian Buss, Pasquale Della Corte, Bjørn Eraker, Peter Feldhütter, Alessandro Graniero, Christian Julliard, David Lando, Dmitry Orlov, Lasse Pedersen, Ivan Shaliastovich, Sang Byung Seo, André Souza, Fabrice Tourre, Andrea Vedolin, Luca Del Viva, Xiao Xiao and audiences at various conferences and seminars for their comments and suggestions. Paul Whelan gratefully acknowledges financial support from the Danish Council for Independent Research grant no. 9037-00105B. The usual disclaimer applies. Emails: daniel.pesch@sbs.ox.ac.uk, i.piatti@qmul.ac.uk, pawh.fi@cbs.dk.