Stock Volatility and the War Puzzle[*]

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Abstract

U.S. stock volatility is 33 percent lower during wartime and periods of conflict. In a seminal paper, Schwert (1989) identified the "war puzzle" as a surprising fact from two centuries of realized stock volatility data. We hypothesize that firm profits become easier to forecast during wartime due to government spending. Using new data on 100 years of defense spending, we find that military spending reduces aggregate, sector-, and state-level stock volatility. An event study demonstrates that equity analysts' earnings forecasts of defense-related firms become significantly less dispersed after 9/11 and the invasions of Afghanistan (2001) and Iraq (2003).

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