Overview

How does share price comove with GDP?

- We extend Lucas (1978) to production economy $\Rightarrow$ **firms**
- firms are active player in macro: **investment v.s. GDP volatility**
  - corporate finance: firm debt? capital investment?
  - human resource: hiring / lay off employee?
  - international economics: multi-nation enterprise? FDI?
- To be able to reach some conclusion, we need simplification:
  - similar setting as Lucas (1978), representative HH & firm
  - firm pays dividend $\Leftarrow$ firm are **DRS**
  - labor-only technology $\Rightarrow$ no other intertemporal asset other than share.

Firm Problem

Dividend and Wage

- Production function: $y = zn^{\alpha}$, where z is TFP shock, and $\alpha \in (0, 1)$.
- Firm's profit maximization problem: $\max_{n} zn^{\alpha} - wn$
  - FOC: $w = \alpha zn^{\alpha-1}$
- Wage bill: $wn = \alpha zn^{\alpha} = \alpha y$
- Assume firm all profits as dividend, $d = y - wn = (1 - \alpha)y$

Household’s Problem

Household Problem

Assume HH value leisure, and thus

$$V(s,z) = \max_{c\geq 0, s'\geq 0, n\geq 0} \log c + \psi(1-n) + \beta \mathbb{E}_{z'|z}[V(s',z')] \tag{1}$$

$$\text{s.t.} \quad c + ps' \leq (d+p)s + wn \tag{2}$$

We know in equilibrium / steady state, three markets need to clear:

1. find w such that labor demand $=$ labor supply
2. find p such that $s = 1$
3. by Walras' law, goods market clear, implying $c = y$.

Solve Household Problem

Using the same solution technique,

$$\begin{aligned} V(s,z) = \max_{s',c,n} \log c + \psi(1-n) + \beta \mathbb{E}_{z'|z}[\log c' + \psi(1-n')] && (3) \\ + \beta^2 \mathbb{E}_{z'|z}[V(s'',z'')] && (4) \\ \text{subject to} \quad c + ps' \le (d+p)s + wn && (5) \\ c' + p's'' \le (d'+p')s' + w'n' && (6) \end{aligned}$$

Replace c and c' and get

$$\begin{aligned} V(s,z) = \max_{s',n} \log((d+p)s + wn - ps') + \psi(1-n) && (7) \\ + \beta \mathbb{E}_{z'|z}[\log((d'+p')s' + w'n' - p's'') + \psi(1-n')] && (8) \\ + \beta^2 \mathbb{E}_{z'|z}[V(s'',z'')] && (9) \end{aligned}$$

First Order Condition

$$V(s,z) = \max_{s',n} \log((d+p)s + wn - ps') + \psi(1-n) \quad (10)$$

$$+ \beta \mathbb{E}_{z'|z}[\log((d'+p')s' + w'n' - p's'') + \psi(1-n')] \quad (11)$$

$$+ \beta^2 \mathbb{E}_{z'|z}[V(s'', z'')] \quad (12)$$

FOC:

$$[n]: \quad \frac{w}{c} = \psi \quad (13)$$

$$[s']: \quad \frac{1}{c} \cdot p = \beta \mathbb{E}_{z'|z}\left[\frac{1}{c'} \cdot (d'+p')\right] \quad (14)$$

Equilibrium Outcome

Optimality Conditions

$$[n]: \quad \frac{w}{c} = \psi \Rightarrow w = \psi c \tag{15}$$

$$[s']: \quad \frac{1}{c} \cdot p = \beta \mathbb{E}_{z'|z}\left[\frac{1}{c'} \cdot (d' + p')\right] \tag{16}$$

$$[\text{Firm}]: \quad w = \alpha z n^{\alpha-1} \tag{17}$$

$w = w$, (15) equals to (17), and $c = y$ yields

$$\psi y = \alpha \frac{y}{n} \Rightarrow n = \frac{\alpha}{\psi} \Rightarrow y = zn^{\alpha} = z\left(\frac{\alpha}{\psi}\right)^{\alpha} \tag{18}$$

$$\Rightarrow w = \alpha z n^{\alpha-1} = \alpha z \left(\frac{\alpha}{\psi}\right)^{\alpha-1} \tag{19}$$

$$\Rightarrow d = (1-\alpha)y = (1-\alpha)z\left(\frac{\alpha}{\psi}\right)^{\alpha} \tag{20}$$

Share Euler Equation

Focus on (16), we can use $c' = y'$ as well as $d' = (1-\alpha)y'$ to simplify:

$$\frac{p}{y} = \beta \mathbb{E}_{z'|z}\left[\frac{p'}{y'} + \frac{(1-\alpha)y'}{y'}\right] \tag{21}$$

$$= \beta(1-\alpha) + \beta \mathbb{E}_{z'|z}\left[\frac{p'}{y'}\right] \tag{22}$$

Somehow you got a prophecy from the spirit and his/her voice tells you to guess $\frac{p}{y} \equiv \Lambda$, a constant over time regardless of TFP shock. Is that true?

$$\Lambda = \beta(1-\alpha) + \beta \mathbb{E}_{z'|z}[\Lambda] = \beta(1-\alpha) + \beta\Lambda \tag{23}$$

$$\Lambda = \frac{\beta(1-\alpha)}{1-\beta} \tag{24}$$

It true ✌✌✌

Intepretation

Stock price to GDP ratio, $\frac{p}{y}$, is constant over time, which implies

1. stock price is procyclical: ⬆ and ⬇ with TFP z,
2. the percentage std of stock price matches percentage std of dividend,
3. stock is risky: $p = \frac{\beta(1-\alpha)}{1-\beta} y \Rightarrow$ requires $(+)$ risk premium
   - $e(z, z') = \frac{d' + p'}{p} = \frac{(1-\alpha)y' + \Lambda y'}{\Lambda y} = \frac{\frac{1-\alpha}{1-\beta} y'}{\frac{\beta(1-\alpha)}{1-\beta} y} = \frac{1}{\beta} \frac{y'}{y}$
   - SDF $= \frac{\beta u'(c')}{u'(c)} = \beta \frac{y}{y'}$
   - Risk premium $= \frac{\mathbb{E}_t[e(z, z') - R_t]}{R_t} = -cov_t\left[SDF, e(z, z')\right] > 0$

The very times firm shares pay high is when your consumption is low!