

# Uncovering Regimes in Out of Sample Forecast Errors from Predictive Regressions\*

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## Abstract

We introduce a set of test statistics for assessing the presence of regimes in out of sample forecast errors produced by recursively estimated linear predictive regressions that can accommodate multiple highly persistent predictors. Our tests statistics are designed to be robust to the chosen starting window size and are shown to be both consistent and locally powerful. Their limiting null distributions are also free of nuisance parameters and hence robust to the degree of persistence of the predictors. Our methods are subsequently applied to the predictability of the value premium whose dynamics are shown to be characterised by state dependence.

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# I Introduction

A vast body of recent empirical research documented the presence of state dependence in the forecast errors produced by models used to generate forecasts of a broad range of economic and financial variables such as stock and bond returns, commodity returns, rates of inflation, currency returns among many others. State dependence in this context takes the form of forecast errors having different quality characteristics such as lower variances in periods of economic recessions versus expansions. In Golez and Koudijs (2017) for instance the authors considered century long stock market data and documented the considerable strengthening of the in-sample and out of sample predictive power of dividend yields for stock returns during recessions. Chauvet and Potter (2013) remarked that predictability of output growth is much harder during recessions while Gargano et al. (2017) established that commodity returns are predictable using macroeconomic information but solely during recessions.

This state dependence in the behaviour of forecast errors has been typically documented through a descriptive comparison of prediction errors (e.g. lower MSEs during recessions than expansions) or the use of recession dummies within the underlying forecasting models. Numerous papers concerned with the predictability of the equity premium with valuation ratios documented important differences in out of sample goodness of fit metrics across NBER business cycle dates (see Li and Tsiakas (2016), Rapach, Strauss and Zhou (2010) amongst others).

The main goal of this paper is to introduce formal diagnostic tools for explicitly testing for the presence of broadly defined regimes in the out-of-sample prediction errors generated from predictive regression models. We are interested in both the levels of forecast errors and their squares as considering the two series can convey useful information on both misspecification issues and regime specificity in MSEs. Rather than thinking of regimes as matching business cycle dates we take a broader view of the notion of state dependence and associate regimes with observed proxies of the state of the economy exceeding or falling below particular levels. Our proposed methods require solely the computation of recursive least squares residuals which are then used within a CUSUM type construct and are therefore very easily implementable. Our operating framework is also flexible enough to accommodate predictive regressions with multiple highly persistent predictors of possibly different persistence strengths. Suppose for instance that one wishes to evaluate the predictability of the equity premium with the commonly used Goyal and Welch predictors (Welch and Goyal (2008), Goyal and Welch (2014)). These include quantities such as dividend yields, price-to-earnings ratios, interest rates all known to be highly persistent variables with potentially different degrees of persistence

and typically modelled as nearly integrated processes with a nuisance parameter that parameterises persistence strength. How does one go about formally testing whether forecasts generated from such models lead to forecast errors that behave differently across the business cycle?

The issue is of great practical importance as the presence of regime specificity in prediction errors would call for a reassessment of the models used to generate forecasts and in particular motivate a switch to nonlinear specifications that are explicitly able to capture episodic predictability as for instance in Gonzalo and Pitarakis (2012, 2017) where the authors considered the inclusion of threshold effects within predictive regressions driven by a single highly persistent predictor. Such piecewise linear structures are particularly convenient as they allow the forecaster to control the particular indicator used for proxying economic times or more generally sentiment. As such they are not necessarily restricted to a rigid regime structure dictated by formal externally provided business cycle dates. We view the testing procedures introduced in this paper as useful practical diagnostic tools that can be used to motivate the explicit inclusion of regime dependence within the predictive model itself. Although post-diagnostic re-evaluation issues are beyond the scope of this paper such specifications have been shown to lead to considerable gains in prediction accuracy as demonstrated in an in-sample and single predictor based equity premium forecasting context in Gonzalo and Pitarakis (2012, 2017). More recent research by Farmer et al. (2018) also explores the idea of *pockets of predictability* by proposing novel non-parametric methods to model and detect such behaviour and offering interesting insights and formal evidence on its causes in the context of stock returns. This notion of episodic predictability has also been recently revisited via new techniques in Demetrescu et al. (2020).

In the context of predictive regressions an important issue that has attracted considerable attention in the literature is the sensitivity of asymptotic distributions to DGP parameterisations and to the non-centrality parameter used to model high persistence in particular, rendering the conduct of inferences difficult (see for instance Campbell and Yogo (2006), Jansson and Moreira (2006), Breitung and Demetrescu (2015), Kostakis et al. (2015), Phillips (2015), Pitarakis (2017), Georgiev et al. (2018)). Although the same problem also arises in our present setting our proposed methods are able to accommodate unknown persistence in addition to being able to handle the presence of multiple predictors without the need to appeal to instrumental variable, bootstrapping or Bonferroni type methods.

The structure of the paper is as follows. Section 2 introduces our main operating model together with the proposed test statistics. Section 3 develops the asymptotic theory of our tests together with their consistency and local power properties. Section 4 investigates their finite sample size and power properties. Section 5 applies our methodology to the predictability of the value premium and Section

6 concludes. All proofs are relegated to the on-line appendix.

## II The Forecasting Model and Test Statistics

Our baseline specification is given by the following linear multiple predictive regression

$$y_{t+1} = \beta_0 + \mathbf{x}'_t \boldsymbol{\beta}_1 + u_{t+1} \quad (1)$$

where  $\mathbf{x}_t$  is a  $p$ -vector of highly persistent predictors parameterised as

$$\mathbf{x}_t = \left( I_p - \frac{\mathbf{C}}{T} \right) \mathbf{x}_{t-1} + \mathbf{v}_t \quad (2)$$

with  $\mathbf{C} = \text{diag}(c_1, \dots, c_p)$ ,  $c_i > 0$  for  $i = 1, \dots, p$  and  $u_t$  and  $\mathbf{v}_t$  denoting stationary disturbances. For subsequent notational purposes it is also convenient to reformulate (1) as  $y_{t+1} = \mathbf{w}'_t \boldsymbol{\beta} + u_{t+1}$  with  $\boldsymbol{\beta} = (\beta_0, \boldsymbol{\beta}'_1)$ ,  $\boldsymbol{\beta}_1 = (\beta_{11}, \dots, \beta_{1p})'$  and  $\mathbf{w}_t = (1, \mathbf{x}_t)'$ . In order to use (1) for out of sample forecast evaluation purposes we focus on a recursive least squares based approach whereby the model is re-estimated within an expanding window. More specifically, letting  $\hat{\boldsymbol{\beta}}_t = (\sum_{s=1}^t \mathbf{w}_{s-1} \mathbf{w}'_{s-1})^{-1} (\sum_{s=1}^t \mathbf{w}_{s-1} y_s)$  denote the least squares estimator of  $\boldsymbol{\beta}$  obtained using data up to time period  $t$  the one-step ahead forecast of  $y$  made at time  $t$  is obtained as  $\hat{y}_{t+1|t} = \mathbf{w}'_t \hat{\boldsymbol{\beta}}_t$ , leading to the forecast error sequence

$$e_{t+1|t} = y_{t+1} - \mathbf{w}'_t \hat{\boldsymbol{\beta}}_t, \quad t = k, \dots, T-1. \quad (3)$$

As it stands the above approach for generating predictions assumes an initially available training sample of say  $k$  observations used to initiate the recursions so that predictions can then be generated over the remaining  $T - k$  periods by re-estimating the model with an additional observation in each step. Given a choice of  $k$ , say  $k_0$ , recursive forecasts are obtained for  $t = k_0, k_0 + 1, \dots, T - 1$ . Throughout this paper the initial estimation sample is viewed as a fraction  $\pi \in (0, 1)$  of the full sample by setting  $k = [T\pi]$ , the largest integer smaller than  $T\pi$ , so that the sequence of out of sample forecast errors  $\{e_{t+1|t}\}_{t=k}^{T-1}$  is understood to be of length  $T - k$ .

Given our operating model in (1) our main objective is to develop a simple approach for assessing the presence of economically meaningful regimes in the forecast errors in (3) and their squares. Throughout this paper we take a broad view of the notion of state dependence, not necessarily equating it with precise business cycle phases. More specifically we will be interested in assessing the behaviour of the  $e_{t+1|t}$ 's and  $e_{t+1|t}^2$ 's across different regimes driven by an observable threshold variable lying above or below an unknown cut-off. The choice of the specific threshold variable is naturally dictated by the application of interest. Commonly used options for capturing business cycle

movements and the state of the economy include the growth rate in industrial production or GDP, diffusion indices combining multiple macroeconomic indicators, sentiment and confidence indicators etc.

Depending on the application and question of interest one may focus solely on assessing the presence of regimes in  $e_{t+1|t}$  if interest is about uncovering potential misspecification in the conditional mean of the forecasting model or alternatively the focus could be on  $e_{t+1|t}^2$  if one simply wishes to uncover potential state dependence in out of sample MSEs with both scenarios being viewed as departures of interest from (1). As an omitted regime in conditional means may contaminate forecast error variances it will also be important to assess the information provided by both tests jointly, an issue we explore comprehensively below when we evaluate the large sample properties of our tests under departures that account for regime changes in the conditional means and error variances.

Given the potential sensitivity of the accuracy of forecasts to the choice of the length  $k$  of the initial sample used for initiating the recursive forecasts, in what follows we will be interested in assessing the presence of regimes in the  $e_{t+1|t}$ 's and  $e_{t+1|t}^2$ 's under both a fixed/given  $k = k_0$  scenario commonly used in practice but also a more general setting whereby  $k = [T\pi]$  is allowed to vary over an interval  $[\pi_a, \pi_b] \subset (0, 1)$ . The motivation of this latter framework is to render inferences robust to data mining along the lines of Rossi and Inoue (2012). The practical relevance of this issue has been recently highlighted in the context of the predictability of the equity premium in Kolev and Karapandza (2017) where the authors demonstrate that for a given set of predictors alternative data splits may lead to contradictory outcomes about return predictability.

Our proposed inferences about the presence of regimes within  $e_{t+1|t}$  and  $e_{t+1|t}^2$  will rely on suitably normalised versions of functionals of the following two quantities

$$C_{1T}(k, \gamma) = \sum_{t=k}^{T-1} (e_{t+1|t} - \bar{e}_{T-k}) \mathbb{I}(q_t \leq \gamma) \quad (4)$$

$$C_{2T}(k, \gamma) = \sum_{t=k}^{T-1} (e_{t+1|t}^2 - \bar{\tau}_{T-k}^2) \mathbb{I}(q_t \leq \gamma) \quad (5)$$

where  $q_t$  denotes the threshold variable,  $\bar{e}_{T-k} = \sum_{t=k}^{T-1} e_{t+1|t} / (T - k)$  and  $\bar{\tau}_{T-k}^2 = \sum_{t=k}^{T-1} (e_{t+1|t} - \bar{e}_{T-k})^2 / (T - k)$ . Note that the quantity  $\bar{e}_{T-k}$  is maintained in (4) as the  $e_{t+1|t}$ 's should not be confused with full sample residuals which would have an exact zero mean. Throughout this paper we also write

$$q_t = \mu_q + u_{qt} \quad (6)$$

and this threshold variable is understood to be stationary with marginal distribution function  $F(\cdot)$  so that when necessary and convenient we make use of the property  $\mathbb{I}(q_t \leq \gamma) \equiv \mathbb{I}(F(q_t) \leq \lambda)$  with  $F(q_t) \sim U[0, 1]$  and refer to the threshold parameter as  $\gamma$  or  $\lambda \equiv F(\gamma)$  interchangeably.

Note that (4) and (5) are indexed by both the unknown threshold parameter  $\gamma$  as well as  $k = [T\pi]$  which captures the location of the initial sample size used to initiate the recursive forecasts. As highlighted in Rossi and Inoue (2012) forecast accuracy can vary greatly across alternative choices of  $\pi$ . Our formulations in (4)-(5) allow us to construct test statistics that take this dependence on  $\pi$  into account and hence lead to inferences that are less prone to data mining. Nevertheless in what follows we will consider both scenarios (i.e.  $\pi$  fixed and given, say  $\pi = \pi_0$  and  $\pi \in [\pi_a, \pi_b] \subset (0, 1)$ ).

We consider two alternative functionals of the  $C_{iT}(\pi, \lambda)$ 's across the two scenarios on  $\pi$  as formulated in the following test statistics. For the scenario where  $k$  is taken as given, say  $k = k_0 = [T\pi_0]$  we define

$$Sup_{iT} \equiv \sup_{\lambda \in \Lambda} \left| \frac{C_{iT}(\pi_0, \lambda)}{\sqrt{T}\hat{\phi}_i} \right| \quad i = 1, 2 \quad (7)$$

$$Ave_{iT} \equiv \mathop{ave}_{\lambda \in \Lambda} \left( \frac{C_{iT}^2(\pi_0, \lambda)}{T\hat{\phi}_i^2} \right) \quad i = 1, 2 \quad (8)$$

where the indexing  $i = 1, 2$  distinguishes between the statistic implemented on the level of the forecast errors and their squares respectively and with  $\hat{\phi}_1^2 = \sum_{t=k}^{T-1} (e_{t+1|t} - \bar{e}_{T-k})^2 / T$  and  $\hat{\phi}_2^2 = \sum_{t=k}^{T-1} (e_{t+1|t}^2 - \bar{\tau}_{T-k}^2) / T$ . Note that for notational simplicity we have suppressed the dependence of  $Sup_{iT}$  and  $Ave_{iT}$  on  $\lambda$ .

In order to robustify our inferences to the specific choice of  $k_0$  we also consider a framework where  $k$  is allowed to take a broad range of values (e.g.  $\pi \in \Pi = [0.25, 0.75]$ ) by proceeding à la Rossi and Inoue (2012). For this purpose we introduce the following alternative test statistic formulations indexed by both  $\pi$  and  $\lambda$

$$SupSup_{iT} \equiv \sup_{\pi \in \Pi} \sup_{\lambda \in \Lambda} \left| \frac{C_{iT}(\pi, \lambda)}{\sqrt{T}\hat{\phi}_i} \right| \quad i = 1, 2 \quad (9)$$

$$AveAve_{iT} \equiv \mathop{ave}_{\pi \in \Pi} \mathop{ave}_{\lambda \in \Lambda} \left( \frac{C_{iT}^2(\pi, \lambda)}{T\hat{\phi}_i^2} \right) \quad i = 1, 2. \quad (10)$$

The above statistics bear strong resemblance with traditional CUSUM (under  $i = 1$ ) and CUSUMSQ (under  $i = 2$ ) formulations commonly used in the changepoint literature and developed in the early work of Page (1954), Brown et al. (1975) amongst others. Instead of cumulating the quantity of interest up to a potential changepoint we here focus on its random sum as dictated by the magnitude of  $q_t$ . Although such test statistics have often been viewed as exploratory tools for assessing parameter stability in regression models and were developed with no particular alternative in mind we have here adapted them to our specific context of threshold effects in forecast errors and their variances and therefore expect them to display good power properties against such scenarios.

More specifically, the model against which we will be interested in confronting the out of sample forecast errors estimated from (1) is given by

$$y_{t+1} = \beta' \mathbf{w}_t + \delta_0 \mathbb{I}(q_t > \gamma_0) + \delta_1' \mathbf{x}_t \mathbb{I}(q_t > \gamma_0) + u_{t+1} \quad (11)$$

where  $\delta_0$  and  $\delta_1$  capture the presence of threshold effects associated with the intercept and slope parameters respectively. We initially concentrate on departures from (1) towards instabilities induced solely by conditional mean parameters as in (11) but subsequently also explore scenarios where the variance of the  $u_t$ 's is itself characterised by threshold effects triggered by  $q_t$ . This variance based state-dependence may occur in isolation or in conjunction with state-dependence in the slope parameters.

### III Limiting Distributions and Asymptotic Power Properties

#### Limiting Distributions

Our main objective here is to obtain the limiting distributions of the test statistics based on  $C_{1T}(\pi, \lambda)$  and  $C_{2T}(\pi, \lambda)$  when the underlying model is given by the linear predictive regression in (1). As our inferences involve both the level and squares of forecast errors we formulate our operating assumptions accordingly as the latter scenario requires further restrictions on the dynamics of the  $u_t^2$  sequence. Assumption A1 below outlines the probabilistic environment under which we establish the large sample properties of (7)-(10) for  $i = 1$ .

*Assumption A1* (i)  $\mathbf{v}_t = \Psi(L)\epsilon_{vt}$  with  $\Psi(L) = \sum_{j=0}^{\infty} \Psi_j L^j$  such that  $\sum_{j=0}^{\infty} \Psi_j$  has full rank,  $\Psi_0 = I_p$  and  $\sum_{j=0}^{\infty} \|\Psi_j\| < \infty$ . (ii)  $\boldsymbol{\eta}_{1t} = (u_t, \epsilon_{vt})'$  is a martingale difference sequence with respect to the filtration  $\mathcal{F}_{1,t} = \sigma(\boldsymbol{\eta}_{1s}, u_{qs} | s \leq t)$  satisfying  $E[\boldsymbol{\eta}_{1t} \boldsymbol{\eta}_{1t}' | \mathcal{F}_{1,t-1}] = \boldsymbol{\Sigma}_{\eta_1} > 0$  and  $E\|\boldsymbol{\eta}_{11}\|^4 < \infty$ . (iii) The probability density function  $f_q(\cdot)$  of the threshold variable  $q_t = \mu_q + u_{qt}$  is bounded away from zero and  $\infty$  over each bounded set. (iv) The zero mean sequence  $\{u_{qt}\}$  is strictly stationary, ergodic, strong mixing with mixing numbers  $\alpha_m$  such that  $\sum_{m=1}^{\infty} \alpha^{\frac{1}{2} - \frac{1}{r}} < \infty$  for some  $r > 2$ .

Assumption A1 mimics closely the environment considered in Gonzalo and Pitarakis (2012, 2017) and excluding the probabilistic properties of  $q_t$  has been the operating standard in the linear predictive regression literature. Both  $\mathbf{v}_t$  and  $q_t$  are allowed to display a rich dependence structure while  $u_t$  is restricted to be a conditionally homoskedastic martingale difference sequence. The threshold

variable is assumed to be stationary throughout and its innovations possibly contemporaneously correlated with the shocks driving the predictive regression in (1). The strong mixing assumption on  $q_t$  is in line with Caner and Hansen (2001) and allows the sequence to follow very general stationary ARMA type specifications. As our focus is on using  $q_t$  to capture business cycle movements stationarity of  $q_t$  is naturally intuitive in the context of this paper. Finally, it is also important to point out that the covariance between the  $u_t$ 's and the shocks  $\epsilon_{vt}$  associated with the predictors, say  $\Sigma_{\eta_1} = \{\{\sigma_u^2, \sigma'_{u\epsilon_v}\}, \{\sigma_{u\epsilon_v}, \Sigma_{\epsilon_v\epsilon_v}\}\}$ , can be non-diagonal allowing them to be correlated as it is commonly observed in applications involving returns and dividend yields for instance.

An implication of the above assumptions is that a functional central limit theorem (FCLT) holds for  $\mathbf{z}_t = (u_t, u_t I(q_{t-1} \leq \lambda), \mathbf{v}_t)'$  which we write as

$$T^{-\frac{1}{2}} \sum_{t=1}^{[Tr]} \mathbf{z}_t \Rightarrow (B_1(r), B_1(r, \lambda), \mathbf{B}_v(r))' \equiv BM(\Omega) \quad (12)$$

where  $\Omega = \sum_{k=-\infty}^{\infty} E[\mathbf{z}_0 \mathbf{z}'_k] > 0$ . Here  $B_1(r, \lambda)$  is a two-parameter Brownian Motion i.e. a zero mean Gaussian process with covariance kernel  $\sigma_u^2(r_1 \wedge r_2)(\lambda_1 \wedge \lambda_2)$  as introduced in a related context in Caner and Hansen (2001). Our assumptions under *A1(ii)* also imply a particular structure for  $\Omega$  without forcing it to be diagonal as both serial correlation and heteroskedasticity are ruled out from the dynamics of the  $u_t$ 's. More specifically we can formulate  $\Omega$  as

$$\Omega = \begin{bmatrix} \sigma_u^2 & \lambda \sigma_u^2 & \sigma'_{u\epsilon_v} \Psi(1) \\ \lambda \sigma_u^2 & \lambda \sigma_u^2 & \lambda \sigma'_{u\epsilon_v} \Psi(1) \\ \sigma_{u\epsilon_v} \Psi(1) & \lambda \sigma_{u\epsilon_v} \Psi(1) & \Psi(1) \Sigma_{\epsilon_v\epsilon_v} \Psi(1)' \end{bmatrix} \quad (13)$$

and for later use we also write  $B_1(r, \lambda) = \phi_1 W_1(r, \lambda)$  with  $\phi_1^2 \equiv \sigma_u^2 \equiv E[u_t^2]$  and  $W_1(r, \lambda)$  a two parameter standard Brownian Motion.

Assumption *A2* below introduces the conditions under which we obtain the limiting distributions of (7)-(10) for  $i = 2$  based on the squared forecast errors. In order to handle the asymptotics associated with the use of squared CUSUMs as in (5) we supplement Assumption *A1* with additional restrictions involving the dynamics of the  $u_t^2$  sequence and its interactions with the remaining random disturbances in the system.

*Assumption A2* Assumption *A1* continues to hold with  $\boldsymbol{\eta}_{1t}$  replaced with  $\boldsymbol{\eta}_{2t} = (u_t, u_t^2 - \sigma_u^2, \epsilon_{vt})'$ .

We note that Assumption *A2* essentially imposes further conditional and unconditional moment restrictions on the  $u_t$  sequence. This is needed to ensure that an FCLT type result holds for the marked empirical process  $Y_T(r, \lambda) = T^{-1/2} \sum_{t=1}^{[Tr]} (u_t^2 - \sigma_u^2) I(q_t \leq \lambda)$ . Assumption *A2* ensures for instance that  $E[(u_t^2 - \sigma_u^2) I(q_t \leq \lambda)] = \lambda \phi_2^2$  for  $\phi_2^2 = E[(u_t^2 - \sigma_u^2)]^2$  while the finiteness of the fourth



moments of  $(u_t^2 - \sigma^2)$  is needed to establish the stochastic equicontinuity of  $Y_T(r, u)$  (see Caner and Hansen (2001)). These assumptions ensure for instance that

$$T^{-\frac{1}{2}} \sum_{t=1}^{\lfloor Tr \rfloor} (u_t^2 - \sigma_u^2) \mathbb{I}(q_{t-1} \leq \lambda) \Rightarrow B_2(r, \lambda) \equiv \phi_2 W_2(r, \lambda) \quad (14)$$

where  $W_2(r, \lambda)$  is a two parameter standard Brownian Motion.

We initially focus on the large sample behaviour of (7)-(8) for  $\pi = \pi_0$ , taking the starting point of the expanding window used to initiate forecasts as given. Their limiting behaviour is summarised in Proposition 1 below.

*Proposition 1* Under assumptions A1 for  $i = 1$  and under assumptions A2 for  $i = 2$  we have as  $T \rightarrow \infty$

$$Sup_{iT} \Rightarrow \sup_{\lambda \in \Lambda} |W_i^0(\lambda)| \quad i = 1, 2 \quad (15)$$

$$Ave_{iT} \Rightarrow \int_0^1 W_i^0(\lambda)^2 d\lambda \quad i = 1, 2 \quad (16)$$

with  $W_i^0(\lambda)$  denoting a standard Brownian Bridge process.

It is here interesting to note that given our operating model in (1)-(2) the above limiting distributions are free of any nuisance parameters, including the magnitudes of the underlying non-centrality parameters appearing in  $\mathbf{C}$ . This is quite a unique outcome in the time series literature involving nearly integrated processes where the handling of the unknown  $c_i$ 's has become an important topic in itself. Also noteworthy is the fact that the limiting distributions are the same regardless of whether we implement our tests on the  $e_{t+1|t}$ 's or  $e_{t+1|t}^2$ 's.

Another important and convenient feature of (15)-(16) is that their tabulations are readily available in the literature, including the possibility of obtaining exact p-values. These distributions are well defined for  $\lambda \in [0, 1]$  (see Billingsley (1986)). In the case of (15) the 10%, 5% and 1% cutoffs are given by 1.224, 1.358 and 1.628. For the distribution in (16) the corresponding cutoffs are 0.347, 0.461 and 0.744. It is also worth pointing out that restricting mildly the  $[0, 1]$  intervals by taking the supremum in (15) over a subset such as  $[0.1, 0.9]$  or  $[0.2, 0.8]$  leads to almost identical critical values (e.g. the 1.224 cut-off decreases to 1.222 under  $\lambda \in [0.2, 0.8]$  while under  $[0.1, 0.9]$  it remains unchanged at the chosen precision level).

Next, we focus on the case where the practitioner does not wish to take a stance on where to start the build-up of the recursive forecast errors. The parameter  $\pi$  is now allowed to be such that  $\pi \in \Pi$  so that the test statistics are evaluated for each possible magnitude of  $\pi$  (or  $k$ ), say for instance

starting from the 25% of the sample up to 75% of the sample. The test statistics are now given by (9)-(10) and their limiting distribution is summarised in Proposition 2 below.

*Proposition 2* Under Assumptions A1 for  $i = 1$  and under Assumptions A2 for  $i = 2$  we have as  $T \rightarrow \infty$

$$SupSup_{iT} \Rightarrow \sup_{\pi \in \Pi} \sup_{\lambda \in [0,1]} \left| \frac{W_i(1 - \pi, \lambda) - \lambda W_i(1 - \pi, 1)}{\sqrt{1 - \pi}} \right| \quad i = 1, 2 \quad (17)$$

$$AveAve_{iT} \Rightarrow \frac{1}{\pi_b - \pi_a} \int_{\Pi} \int_0^1 \left( \frac{W_i(1 - \pi, \lambda) - \lambda W_i(1 - \pi, 1)}{\sqrt{1 - \pi}} \right)^2 d\pi d\lambda \quad i = 1, 2 \quad (18)$$

with  $W_i(1 - \pi, \lambda)$  denoting a two-parameter standard Brownian Motion.

As in Proposition 1 and for notational simplicity we have here suppressed the dependence of  $SupSup_{iT}$  and  $AveAve_{iT}$  on  $\lambda$  and  $\pi$ . We continue to note that the limiting distributions in (17)-(18) are free of nuisance parameters. Both distributions are functionals of a process of the type  $K(\zeta, \lambda) = W(\zeta, \lambda) - \lambda W(\zeta, 1)$  commonly known as a Kiefer-Müller process which is a zero mean Gaussian processes with covariance kernel  $Cov[K(\zeta_1, \lambda_1), K(\zeta_2, \lambda_2)] = (\zeta_1 \wedge \zeta_2)(\lambda_1 \wedge \lambda_2 - \lambda_1 \lambda_2)$ .

Although free of nuisance parameters it is clear that critical points of these distributions will depend on the interval  $\Pi = [\pi_a, \pi_b]$ . Tabulations of (17)-(18) are to our knowledge not available in the literature. To approximate these distributions we have generated a sequence of i.i.d random variables of length  $T = 500$  that are uniformly distributed on  $[0, 1]$ .  $K(1 - \pi, \lambda)$  is then approximated by  $\sum_{t=[T\pi]}^T (\mathbb{I}(\mathcal{U}_t \leq \lambda) - \lambda) / \sqrt{T}$ . Equivalently,  $K(1 - \pi, \lambda) / \sqrt{1 - \pi}$  is approximated via  $\sum_{t=[T\pi]}^T (\mathbb{I}(\mathcal{U}_t \leq \lambda) - \lambda) / \sqrt{T - [T\pi]}$ . The supremum and average of the approximating process is obtained by maximising over  $\pi$  and  $\lambda$  with the process being repeated across  $N = 10000$  replications. Key quantiles of (17)-(18) are presented in Table 1 across a selection of  $\Pi$  intervals.

**Table 1 about here**

## Consistency and Local Power Properties

Having established the asymptotic distributions of our test statistics when the underlying model is given by (1) we next assess their ability to detect fixed as well as local departures from (1) driven by the presence of threshold effects as in (11). In the case of local departures  $\boldsymbol{\delta}$  is understood to be parameterised as  $\boldsymbol{\delta}_T = (\delta_{0T}, \boldsymbol{\delta}'_{1T})'$  with  $\boldsymbol{\delta}_T \rightarrow 0$  at suitable rates as  $T \rightarrow \infty$ .

We initially focus on the consistency properties of our four test statistics establishing their large sample behaviour under a fixed magnitude of  $\boldsymbol{\delta}$ . The main result is summarised in Proposition 3

below.

*Proposition 3* Under (11) with  $\boldsymbol{\delta}_T = \boldsymbol{\delta} \neq 0$  and the same assumption structure as in Propositions 1-2  $\{Sup_{iT}, Ave_{iT}, SupSup_{iT}, AveAve_{iT}\}$  diverge to infinity for  $i = 1$  and provided that  $\lambda_0 \neq 0.5$  for  $i = 2$ .

Proposition 3 establishes the consistency of all four test statistics, noting also that their stated divergence occurs regardless of whether solely the intercept  $\delta_0$ , the slopes  $\boldsymbol{\delta}_1$  or both are allowed to shift. There is one instance however under which our squared error based statistics (i.e. for  $i = 2$ ) will display little power. This happens when the true threshold parameter is such that  $P(q_t \leq \gamma_0) = P(q_t > \gamma_0)$ , equivalently when  $\lambda_0 = 0.5$ . A similar phenomenon has also been documented in the context of the changepoint literature and inferences based on CUSUMSQ type statistics (see for instance Theorem 1 in Deng and Perron (2008)). It is also important to point out that the power loss that occurs under  $\lambda_0 = 0.5$  when dealing with test statistics involving squared forecast errors is not unique to our CUSUMSQ type formulations as the same phenomenon will also occur if one were to use a Wald type statistic instead (e.g. a Wald statistic for detecting shifts in the mean of the  $e_{t+1|t}^2$  sequence).

We next focus on the local power properties of our test statistics. For the simplicity of the exposition and with no loss of generality we concentrate our attention on the quantities  $|C_{iT}(\pi_0, \lambda)|/\sqrt{T}\hat{\phi}_i$  for  $i = 1, 2$  in (7) as the supremum and average functionals of the resulting limits as well as those associated with  $C_{iT}(\pi_0, \lambda)^2/T\hat{\phi}_i^2$  would follow straightforwardly.

*Proposition 4* (i) Suppose model (11) holds with  $\boldsymbol{\delta}_T = (\delta_0/\sqrt{T}, \mathbf{0}')$  (intercept shifts). Under assumption A1,  $\lim_{|\delta_0| \rightarrow \infty} \lim_{T \rightarrow \infty} |C_{1T}(\pi_0; \lambda, \lambda_0)/\sqrt{T}\hat{\phi}_1| = \infty$  in probability. (ii) Suppose model (11) holds with  $\boldsymbol{\delta}_T = (0, \boldsymbol{\delta}'_1/T')$  (slope shifts). Under assumption A1,  $\lim_{\|\boldsymbol{\delta}_1\| \rightarrow \infty} \lim_{T \rightarrow \infty} |C_{1T}(\pi_0; \lambda, \lambda_0)/\sqrt{T}\hat{\phi}_1| = \infty$  in probability.

*Proposition 5* (i) Suppose model (11) holds with  $\boldsymbol{\delta}_T = (\delta_0/T^{1/4}, \mathbf{0}')$  (intercept shifts). Under assumption A2,  $\lim_{|\delta_0| \rightarrow \infty} \lim_{T \rightarrow \infty} |C_{2T}(\pi_0; \lambda, \lambda_0)/\sqrt{T}\hat{\phi}_2| = \infty$  in probability. (ii) Suppose model (11) holds with  $\boldsymbol{\delta}_T = (0, \boldsymbol{\delta}'_1/T^{3/4})$  (slope shifts). Under assumption A2,  $\lim_{\|\boldsymbol{\delta}_1\| \rightarrow \infty} \lim_{T \rightarrow \infty} |C_{2T}(\pi_0; \lambda, \lambda_0)/\sqrt{T}\hat{\phi}_2| = \infty$  in probability. (iii) Suppose model (11) holds with  $\boldsymbol{\delta}_T = (\delta_0/\sqrt{T}, \mathbf{0}')$  and/or  $\boldsymbol{\delta}_T = (0, \boldsymbol{\delta}'_1/T)$  then  $C_{2T}(\pi_0; \lambda, \lambda_0)/\sqrt{T}\hat{\phi}_2 \Rightarrow W_2^0(\lambda)$  as  $T \rightarrow \infty$ .

Proposition 4 focused on the local power properties of our test statistics associated with the levels of the forecast errors while Proposition 5 focused on the corresponding outcomes for the test statistics based on squared forecast errors instead. We note that  $C_{1T}$  based inferences are able to detect local departures of the type  $(\delta_0/\sqrt{T}, \boldsymbol{\delta}'_1/T)$  while  $C_{2T}$  based statistics require the mildly slower vanishing rates of  $(\delta_0/T^{1/4}, \boldsymbol{\delta}'_1/T^{3/4})$  in order to be able to detect them as otherwise their power will equal their

size as implied by Proposition 5(iii).

Overall our proposed tests statistics based on either  $C_{1T}$  or  $C_{2T}$  are expected to display good power properties provided that the presence of regimes comes from the slope parameters while  $C_{2T}$  based inferences are unlikely to pickup regimes if the latter are solely originating from small shifts in intercepts. This distinct behaviour of  $C_{1T}$  and  $C_{2T}$  will also be particularly important when it comes to detecting departures from (1) that also include the potential presence of threshold effects in the variances of the  $u_t$ 's. Before proceeding with such generalisations it is instructive to also present the explicit form of the limiting random variables associated with the large sample behaviour of  $C_{iT}(\pi_0; \lambda, \lambda_0)/\sqrt{T}\hat{\phi}_i$  in Propositions 4 and 5 as this will help to explicitly highlight the key parameters affecting the power properties of our tests.

Focusing first on the  $C_{1T}$  based inferences as in Proposition 4 we have

$$\left| \frac{C_{1T}(\pi_0; \lambda, \lambda_0)}{\sqrt{T}\hat{\phi}_1} \right| \Rightarrow \left| W_1^0(\lambda) - \frac{\sqrt{1-\pi_0}(\lambda \wedge \lambda_0 - \lambda\lambda^0)\delta_0}{\sigma_u} \right| \text{ for } \boldsymbol{\delta}_T = (\delta_0/\sqrt{T}, \mathbf{0}')', \quad (19)$$

$$\left| \frac{C_{1T}(\pi_0; \lambda, \lambda_0)}{\sqrt{T}\hat{\phi}_1} \right| \Rightarrow \left| W_1^0(\lambda) - \frac{(\lambda \wedge \lambda_0 - \lambda\lambda^0)}{\sigma_u\sqrt{1-\pi_0}} \boldsymbol{\delta}_1' \int_{\pi_0}^1 \mathbf{J}_c \right| \text{ for } \boldsymbol{\delta}_T = (0, \boldsymbol{\delta}_1'/T)' \quad (20)$$

as  $T \rightarrow \infty$ . As stated in Proposition 4 we note that both quantities in the right hand side of (19)-(20) diverge with  $\delta_0$  and  $\boldsymbol{\delta}_1$  respectively. Similarly under the setting of Proposition 5 for  $C_{2T}$  we have

$$\left| \frac{C_{2T}(\pi_0; \lambda, \lambda_0)}{\sqrt{T}\hat{\phi}_1} \right| \Rightarrow \left| W_2^0(\lambda) - \frac{\sqrt{1-\pi_0}(1-2\lambda_0)(\lambda \wedge \lambda_0 - \lambda\lambda^0)\delta_0^2}{\phi_2} \right| \text{ for } \boldsymbol{\delta}_T = (\delta_0/T^{1/4}, \mathbf{0}')', \quad (21)$$

$$\left| \frac{C_{2T}(\pi_0; \lambda, \lambda_0)}{\sqrt{T}\hat{\phi}_1} \right| \Rightarrow \left| W_2^0(\lambda) - \frac{(\lambda \wedge \lambda_0 - \lambda\lambda^0)(1-2\lambda_0)}{\phi_2\sqrt{1-\pi_0}} \boldsymbol{\delta}_1' \int_{\pi_0}^1 \mathbf{J}_c \mathbf{J}_c' \boldsymbol{\delta}_1 \right| \text{ for } \boldsymbol{\delta}_T = (0, \boldsymbol{\delta}_1'/T^{3/4})' \quad (22)$$

as  $T \rightarrow \infty$ .

The results in (19)-(20) indicate that the power of  $C_{1T}$  based inferences are affected by  $(\pi_0, \lambda_0, \sigma_u, \delta_0)$  under intercept shifts only scenarios and by  $(\pi_0, \lambda_0, \sigma_u, \delta_0, c_1, \dots, c_p)$  under slope shifts. For both scenarios power is expected to improve for lower magnitudes of  $\sigma_u$  (holding all else equal), larger magnitudes of  $\delta_0$  and/or  $\boldsymbol{\delta}_1$  and a smaller fraction of the sample size used to initiate the recursive forecasts. Power is of course also expected to be more favourable under slope shifts than it is under intercept shifts alone as the tests can detect departures from (1) that are *more local* (e.g.  $\delta_0/\sqrt{T}$  vs  $\boldsymbol{\delta}_1/T$  for  $C_{1T}$  based inferences).

The results in (21)-(22) indicate that inferences based on  $C_{2T}$  will be affected by  $(\pi_0, \lambda_0, \sigma_u, E[u_t^4], \delta_0)$  and  $(\pi_0, \lambda_0, \sigma_u, E[u_t^4], \boldsymbol{\delta}_1, c_1, \dots, c_p)$  so that all other things being equal a high kurtosis in the  $u_t$ 's is expected to also deteriorate power via  $\phi_2^2 = E[u_t^2 - \sigma_u^2]^2$ . It is also clear that  $C_{2T}$  based tests will have no meaningful power when  $\lambda_0 = 0.5$  due to the appearance of the  $(1-2\lambda_0)$  factor on both numerators.

Another important point that follows from the above outcomes is related to the role played by the non-centrality parameter  $c$  on the power properties of the tests. From (19) and (21) we note that the degree of persistence of the predictors is not expected to have any influence on the detection ability of our tests when the models under consideration have intercept shifts only. In contrast, persistence is expected to play an important role when it comes to detecting slope shifts as can be seen from the distinct appearance of the  $\mathbf{J}_c$  process in (20) versus (22).

It is here also interesting to point out that although  $C_{1T}$  based inferences are able to detect less distant slope departures than  $C_{2T}$  based inferences (i.e.  $\delta_1/T$  versus  $\delta_1/T^{3/4}$ ) it is not clear whether this will necessarily translate into better finite sample power properties for the associated statistics (provided that  $\lambda_0 \neq 0.5$ ). Indeed, comparing (20) with (22) and focusing on a single predictor scenario we note the presence of the term  $\delta_1 \int J_c$  in (20) versus  $\delta_1^2 \int J_c^2$  in (22). Depending on the magnitude of  $\delta_1$  this distinction introduces a degree of ambiguity on whether  $C_{1T}$  or  $C_{2T}$  based statistics should lead to more favourable power outcomes.

## The Case of Variance Shifts

An issue we hinted at earlier and which we may be confronted with in applied work is the possibility that the shocks driving the predictive regression in (1) may themselves be subject to regime specific volatility. An important issue that arises in this context is the behaviour of our  $C_{1T}$  and  $C_{2T}$  based statistics under such a scenario and whether our current toolkit can help detect such occurrences and possibly be used to disentangle between regimes induced by the conditional mean and regimes induced by threshold effects in variances. To explore these issues we consider a setting where  $u_{t+1}$  in (1) is now formulated as

$$u_{t+1} = \sigma_1 \epsilon_{t+1} + (\sigma_2 - \sigma_1) \epsilon_{t+1} \mathbb{I}(q_t > \gamma_{v0}) \quad (23)$$

where the threshold parameter  $\gamma_{v0}$  may or may not equal the threshold parameter  $\gamma_0$  associated with (potential) changes in the intercept/slope parameters of the forecasting model in (11). The  $\epsilon_{t+1}$ 's are here understood to satisfy assumptions *A1* and/or *A2* with  $\epsilon_t$  replacing  $u_t$  in  $\boldsymbol{\eta}_{1t}$  and  $\boldsymbol{\eta}_{2t}$  respectively as summarised under Assumptions *B1* and *B2* below.

*Assumption B1* Assumption *A1* holds with  $\boldsymbol{\eta}_{1t} = (\epsilon_t, \epsilon_{vt})'$  and where  $E[\epsilon_t^2 | \mathcal{F}_{1,t-1}] = 1$  in  $\boldsymbol{\Sigma}_{\eta_1}$ .

*Assumption B2* Assumption *A2* holds with  $\boldsymbol{\eta}_{2t} = (\epsilon_t, \epsilon_t^2 - 1, \epsilon_{vt})'$  and where  $E[\epsilon_t^2 | \mathcal{F}_{2,t-1}] = 1$ ,  $E[(\epsilon_t^2 - 1)^2 | \mathcal{F}_{2,t-1}] = \kappa_4$ ,  $E[\epsilon_t(\epsilon_t^2 - 1) | \mathcal{F}_{2,t-1}] = \kappa_3$  in  $\boldsymbol{\Sigma}_{\eta_2}$ .

The formulation in (23) imposes a piecewise linear structure on the variances of the  $u_t$ 's and has

been a commonly used parameterisation considered in the structural break literature where  $q_t$  is typically given by a deterministic time trend. Despite its simplicity the piecewise linear structure of  $u_t$  is able to capture very rich dynamics including serial correlation in the  $u_t^2$ . It is indeed straightforward to observe from (23) that although  $u_{t+1}$  continues to be a martingale difference sequence, unlike the  $\epsilon_{t+1}$ 's, it no longer satisfies assumptions *A1(ii)* or *A2* as it is no longer conditionally homoskedastic. Using (23) we note for instance that  $E[u_{t+1}^2|\mathcal{F}_{i,t}] = \sigma_1^2 + (\sigma_2^2 - \sigma_1^2)I(q_t > \gamma_{v0})$ . As a consequence the null limiting distributions of our test statistics as stated in Propositions 1 and 2 will no longer hold.

Before proceeding further it is useful to recall that the main objective behind our proposed tests is to detect the presence of state dependence in forecast errors. This state dependence may originate from omitted regimes in conditional mean parameters as in (11), from variances as in (23) or from both. Although our main concern is for our inferences based on  $C_{1T}$  and  $C_{2T}$  to be able to detect such departures from (1) regardless of where they originate, it may also be possible to disentangle between the two through the joint use of both statistics. We may for instance want our  $C_{1T}$  based inferences not to be sensitive to the presence of variance shifts so that a non-rejection based on  $C_{1T}$  followed by a rejection based on  $C_{2T}$  may be used to argue that state dependence originates in the variances.

Borrowing from the changepoint literature where it is customary to explore test properties within small shift asymptotic frameworks we adapt the same idea to (23), parameterising it as

$$u_{t+1} = \sigma_1\epsilon_{t+1} + \frac{(\sigma_2 - \sigma_1)}{T^\theta}\epsilon_{t+1}\mathbb{I}(q_t > \gamma_{v0}) \quad (24)$$

for some  $0 < \theta \leq 1/2$ . We can interpret (24) as a *limited* heterogeneity framework similar to that considered in a different context in Steland (2020). The formulation in (24) is essentially saying that the difference in variances across the two regimes gets small as the sample size increases. Differently put we operate under an asymptotic approximation that is valid for small magnitudes of the spread  $(\sigma_2 - \sigma_1)$  with the parameter  $\theta$  controlling the rate at which this spread decreases to zero, i.e., how small we are forcing  $(\sigma_2 - \sigma_1)$  to be. Smaller values of  $\theta$  are thus less restrictive.

We next focus on the limiting behaviour of our test statistics based on  $C_{1T}$  and  $C_{2T}$  under Assumptions *B1* and *B2* respectively. Model (1) is understood to hold with  $u_{t+1}$  as in (24) so that the forecasting regression is characterised by threshold effects in the variance of its innovations while having a correctly specified conditional mean.

*Proposition 6* (i) Suppose model (1) holds with  $u_{t+1}$  as in (24) and  $\theta > 0$ . As  $T \rightarrow \infty$  we have  $|C_{1T}(\pi_0; \lambda, \lambda_{v0})/\sqrt{T}\hat{\phi}_1| \Rightarrow |W_1^0(\lambda)|$ . (ii) Suppose model (1) holds with  $u_{t+1}$  as in (24) and  $0 < \theta < 1/2$ , then  $|C_{2T}(\pi_0; \lambda, \lambda_{v0})/\sqrt{T}\hat{\phi}_2|$  diverges to infinity in probability as  $T \rightarrow \infty$ . (iii) Suppose model (1) holds with  $u_{t+1}$  as in (24) and  $\theta = 1/2$ , then  $\lim_{|\sigma_2 - \sigma_1| \rightarrow \infty} \lim_{T \rightarrow \infty} |C_{2T}(\pi_0; \lambda, \lambda_{v0})/\sqrt{T}\hat{\phi}_2| = \infty$ .

The results in Proposition 6 are particularly important as they imply that inferences based on  $C_{1T}$  will remain as in Proposition 1, unaffected by the presence of regime specific heteroskedasticity. On the other hand under the same setting,  $C_{2T}$  based inferences should be able to detect departures from (1) as in (24) due to our results in Proposition 6(ii)-(iii). This suggests for instance that a scenario whereby  $C_{1T}$  based test statistics fail to reject the null while  $C_{2T}$  based inferences lead to rejections would indicate that state dependence in forecast errors originates solely in the variances. Our Monte-Carlo based results do indeed demonstrate that even under large spreads in variances (i.e. large magnitudes of  $|\sigma_2 - \sigma_1|$ ),  $C_{1T}$  based inferences remain very close to their nominal size as expected from Proposition 6(i).

If  $C_{1T}$  based inferences result in rejections due to shifts in slopes then from our result in Proposition 5(ii) it is also almost certainly the case that  $C_{2T}$  based inferences should also follow suit. A rejection by both statistics would then indicate that state dependence in forecast errors originates from shifts in the slopes of (1) and potentially also shifts in variances, the latter being picked up by  $C_{2T}$ . Finally if  $C_{1T}$  based inferences lead to rejections while  $C_{2T}$  based inferences do not then based on our results in Propositions 5(iii) such a scenario is likely to indicate that state dependence originates solely from intercept shifts.

## IV Experimental Evidence

Our initial objective is to document the finite sample adequacy of the distributions presented in (15)-(18) when the DGP is given by (1)-(2). We subsequently assess the ability of our test statistics to reject the null of a linear predictive regression when the true specification is given by the threshold model in (11), illustrating our key outcomes presented in Propositions 4 and 5. In analogy to the structure of Section 3 above these size and power properties of our tests are in a first instance evaluated in the context of conditionally homoskedastic  $u_t$ 's satisfying Assumptions A1 and A2. We subsequently concentrate on the case of variance shifts as in (24) and illustrate our key results in Proposition 6 within a DGP given by (1)-(2) but with the  $u_t$ 's characterised by threshold effects in their variances. In this latter context we are particularly interested in documenting the ability of our test statistics to disentangle between threshold effects in the slopes and threshold effects in variances.

## DGPs

The main DGP for our size experiments is given by (1)-(2) with  $x_{it} = (1 - c_i/T)x_{it-1} + v_{it}$ ,  $v_{it} = 0.5v_{it-1} + \epsilon_{ivt}$ ,  $\epsilon_{ivt} \sim (0, \sigma_{\epsilon_{iv}}^2 = 1)$  for  $i = 1, 2, 3$  so as to accommodate up to three predictors. This allows us to explore the robustness of our limiting distributions in Propositions 1-2 to alternative magnitudes of the  $c_i$ 's and the influence of the latter on test powers. Throughout both our size and power experiments the threshold variable as described in (6) is taken to follow the centered AR(1) process  $u_{qt} = 0.5u_{qt-1} + \epsilon_{qt}$ ,  $\epsilon_{qt} \sim (0, \sigma_{\epsilon_q}^2 = 1)$ . The random disturbance driving (1) is such that  $u_t \sim (0, \sigma_u^2 = 1)$ .

The covariance matrix of the  $(p + 2)$  dimensional vector  $(u_t, \epsilon_{1vt}, \epsilon_{2vt}, \dots, \epsilon_{pvt}, \epsilon_{qt})$  collecting all random disturbances driving the system allows for non-zero contemporaneous correlations between these disturbances. In line with the empirical literature on the predictability of returns with valuation ratios the covariances between the  $u_t$ 's in (1) and the  $\epsilon_{ivt}$ 's are chosen to ensure a strong negative correlation between the shocks to the  $y$ 's and the shocks to the predictors. For the single predictor case ( $p = 1$ ) we set  $\sigma_{u, \epsilon_{1v}} = -0.7$ ,  $\sigma_{u, \epsilon_q} = 0.4$  and  $\sigma_{\epsilon_{1v}, \epsilon_q} = 0.2$ . For  $p = 2$  we set  $\sigma_{u, \epsilon_{1v}} = -0.7$ ,  $\sigma_{u, \epsilon_{2v}} = -0.5$ ,  $\sigma_{u, \epsilon_q} = 0.3$ ,  $\sigma_{\epsilon_{1v}, \epsilon_{2v}} = 0.3$ ,  $\sigma_{\epsilon_{2v}, \epsilon_q} = 0.2$  and  $\sigma_{\epsilon_{1v}, \epsilon_q} = 0.2$ . Finally for  $p = 3$  we use the same covariances as under  $p = 2$  together with  $\sigma_{u, \epsilon_{3v}} = -0.2$ ,  $\sigma_{\epsilon_{1v}, \epsilon_{3v}} = 0.3$ ,  $\sigma_{\epsilon_{2v}, \epsilon_{3v}} = 0.3$ ,  $\sigma_{\epsilon_{2v}, \epsilon_q} = 0.3$  and  $\sigma_{\epsilon_{3v}, \epsilon_q} = 0.4$ . Throughout this paper all simulations are conducted using normally distributed random variables across  $N = 5000$  replications.

Our power experiments are conducted with a DGP as in (11), distinguishing between intercept shifts only scenarios ( $\delta_1 = 0$ ) and slope shifts only scenarios ( $\delta_0 = 0$ ) for  $\gamma_0 = \{-0.5, 0\}$ . Here we note that the case  $\gamma_0 = 0$  corresponds to a regime structure with a 50/50 split between the  $q_t$  observations that lie above and below  $\gamma_0$  so that  $\lambda_0 = 0.5$ . Such a parameterisation is important for illustrating the power failures affecting inferences based on  $e_{t+1|t}^2$ 's when  $\lambda_0 = 0.5$  as theoretically established in (21)-(22).

## Size experiments

We initially focus on the  $Sup_{iT}$  and  $Ave_{iT}$  statistics in (7)-(8) which assume a given/known starting point for the start of the recursions to generate the out of sample forecast errors (say  $k_0 = [T\pi_0]$  with  $\pi_0 = 0.25$ ). For each generated  $(y_t, \mathbf{x}'_t, q_t)$ , the sequence of forecast errors and their squares is first obtained as in (3). These sequences are subsequently used to construct the test statistics in (7)-(8). Results are presented in Tables 2-3 which compare empirical sizes with the chosen nominal size of



5%. Table 2 presents results for predictive regressions with  $p = 1, 2, 3$  predictors when the latter are constrained to have the same degree of persistence. Table 3 provides additional outcomes when each predictor has a different non-centrality parameter.

**Tables 2-3 around here**

Empirical sizes are seen to match their nominal counterparts closely across all sample sizes except perhaps for a very mild undersizeness under  $T = 400$  characterising the  $Sup_{2T}$  based tests that rely on the squared forecast errors. It is also generally the case that the  $Sup_{iT}$  based tests display mildly lower empirical sizes compared to the  $Ave_{iT}$  based statistics which marginally overshoot the nominal size of 5%. Overall our proposed tests can be seen to be accurately sized across a rich set of alternative scenarios and sample sizes. As expected from our asymptotics it is also particularly important to note the robustness of outcomes to alternative choices of the non-centrality parameters and the number of predictors included in the predictive regressions.

We next consider the case of the  $SupSup_{iT}$  and  $AveAve_{iT}$  statistics in (9)-(10) which are designed to robustify inferences to the chosen starting period of the recursions. Our experiments use the range  $\Pi = [0.50, 0.75]$  for scanning across recursion starting points. The corresponding 5% quantile cut-offs of the two test statistics are given by 1.573 and 0.415 respectively (see Table 1) and results on specifications with  $p = 1, 2, 3$  predictors are presented in Table 4. We continue to note good to excellent matches of nominal sizes across all parameterisations. Empirical sizes associated with the  $SupSup_{iT}$  statistics typically lie mildly below those associated with the  $AveAve_{iT}$  statistics as documented previously. Also noteworthy is the robustness of finite sample sizes to the number of predictors and their associated non-centrality parameters as it was the case for the  $Sup_{iT}/Ave_{iT}$  statistics above.

**Table 4 around here**

**Power experiments**

We next explore the power properties of our test statistics under intercept only and slope shift only scenarios. Our empirical results in Tables 5-8 are designed to illustrate both the correct decision frequencies associated with each statistic as  $T$  grows but also the evolution of power for fixed  $T$  as the parameterisations of the DGP move further away from linearity.

Tables 5-6 focus on the power of the  $Sup_{iT}$  and  $Ave_{iT}$  statistics across intercept shift only and

slope shift only scenarios. Focusing first on the case of intercept shifts (Table 5) we note empirical correct decision frequencies at or very near 100% for samples of size  $T = 400$  or above when inferences are based on the  $Sup_{1T}/Ave_{1T}$  statistics under moderately large departures such as  $\delta_0 \geq 0.5$ . Even under  $\delta_0 = 0.25$  we note empirical powers above 80% for  $T = 1000$ . These outcomes are in line with our results in Proposition 4 where we documented the ability of  $C_{1T}$  based statistics to detect local intercept departures of the type  $\delta_0/\sqrt{T}$ . Table 5 also highlights the robustness of power outcomes to the magnitude of non-centrality parameters as expected from (19) and (21) where  $c$  is seen not to play any role under intercept shift only scenarios.

### Tables 5-6 around here

The empirical power outcomes associated with intercept shifts only change significantly when inferences are based on the squared forecast errors via the  $Sup_{2T}/Ave_{2T}$  statistics. These squared forecast error based statistics are unable to detect intercept shifts unless the latter are very large and  $\lambda_0 \neq 0.5$ . This is in total agreement with our result in Proposition 5(i) from which we note that to be detectable by  $Sup_{2T}/Ave_{2T}$ , local departures should be of the form  $\delta_0/T^{1/4}$  as opposed to  $\delta_0/\sqrt{T}$  in the case of the  $Sup_{1T}/Ave_{1T}$  statistics.

Table 6 repeats the same exercise for slope shifts only. The first two vertical panels distinguish between  $p=1$  and  $p=2$  predictor scenarios while the third panel reconsiders the case of  $p=2$  predictors but with only one of the two associated slopes shifting. As in the intercept shift only case,  $Sup_{1T}/Ave_{1T}$  based tests display correct decision frequencies either close to 100% or quickly converging to 100% as  $\delta_1$  increases. Power is also seen to improve with the degree of persistence of predictors with the most favourable outcomes occurring under  $c = 1$ . This is in total agreement with our result in (20) which documents the explicit role played by the non-centrality parameter  $c$  on the local power properties of the tests.

In this context of slope shifts and unlike the earlier intercept shift only scenarios, the squared forecast errors based statistics  $Sup_{2T}/Ave_{2T}$  also display good power properties provided that  $\lambda_0 \neq 0.5$ . They can in fact also be seen to dominate  $Sup_{1T}/Ave_{1T}$  based inferences in many instances (under  $c = 20$  and  $c = 40$  in particular) despite the fact that the latter are able to detect departures of the type  $\delta_1/T$  versus  $\delta_1/T^{3/4}$  for the former. Our results in (20) and (22) and the terms involving  $\int J_c$  versus  $\int J_c^2$  in particular provide the intuition for these empirical occurrences. It is also interesting to observe that the power properties of the  $Sup_{2T}/Ave_{2T}$  based tests appear to deteriorate much less compared with  $Sup_{1T}/Ave_{1T}$  when the predictors move closer to the stationarity region (e.g. under  $c = 20$  and  $c = 40$ ).

Tables (7)-(8) extend the above analysis to our class of  $SupSup_{iT}/AveAve_{iT}$  based tests and broadly corroborate our findings based on the  $Sup/Ave$  statistics. The use of  $SupSup/AveAve$  based tests does not appear to lead to any meaningful finite sample power losses relative to the  $Sup/Ave$  statistics which were based on a fixed recursion starting point.

**Tables 7-8 around here**

## Variance shifts

The last set of experiments focuses on the behaviour of our  $C_{1T}$  and  $C_{2T}$  based statistics under variance shifts and aim to illustrate our key results in Proposition 6. Specifically, we expect that provided the shifts in variance are not too large,  $C_{1T}$  based statistics will maintain their correct size. At the same time we expect  $C_{2T}$  based tests to display good power properties for either small or large variance shifts. We view these features as particularly useful as they may resolve the issue of identifying whether state dependence originates from conditional mean parameters or variances (e.g. if  $C_{1T}$  based inferences fail to reject while  $C_{2T}$  based inferences lead to rejections).

**Table 9 around here**

Results are presented in Table 9. As expected from Proposition 6(ii) we note that the  $C_{2T}$  based statistics display excellent power to detect variance shifts even under moderately sized samples while  $C_{1T}$  based inferences tend to remain close to nominal size even for moderately large shifts, as expected from Proposition 6(i). Thus although rejections by  $C_{2T}$  may be caused by either variance shifts and/or slope parameter shifts, a non-rejection by  $C_{1T}$  followed by a rejection by  $C_{2T}$  would indicate state dependence induced solely by variance shifts.

## V Application: Regime Specificity in the Value Premium

In this section we use our methods to assess the potential presence of state dependence in the forecasts of the value premium, a series which has been the subject of considerable research in the asset pricing literature and which refers to the commonly observed out-performance of cheap/value stocks (e.g. stocks having high Book-to-Market value (BM), high Earnings-to-Price ratios) relative to more expensive growth stocks (e.g. low Book-to-Market stocks). Although there is broad consensus on its existence across most developed and emerging markets the debate on whether this premium reflects

compensation for risk or a behavioural anomaly is still very much on-going (see Lakonishok et al. (1994) , Fama and French (2012) and references therein). A related agenda that parallels our own objectives here has also been concerned with establishing whether such risk premiums are time varying and their relationship with the business cycle (see Petkova and Zhang (2005), Long et al. (2008), Gülen et al. (2011)).

Although there is no unique way of defining the value premium a standard approach in the literature has involved forming decile or quintile portfolios on firm specific characteristics such as Book-to-Market Value, Dividend Yields, Earnings-to-Price ratios and evaluating the return spreads between upper and lower deciles in each time period and for a broad cross-section. This is also the approach we adopt here using Kenneth French’s publicly available data library. More specifically we focus on monthly US data covering the period 1930-2017 and construct our value premium series as the difference between the top and bottom decile portfolios formed on Book-to-Market (D10BM-D1BM). In addition to this decile based series we also consider the well-known value premium factor known as HML (High minus Low) and which is one of the three factors used in Fama and French’s three factor model (see Fama and French (2012)) to capture the sensitivity and exposure of a given portfolios or individual stock to value. Our choice of predictors is based on a selection of variables that have been commonly considered in the equity premium forecasting literature and given by the well known Goyal and Welch data set (see Goyal and Welch (2014)). We restrict our analysis to a selection of these variables which have been commonly found to play a significant role in the predictability of the equity premium. These are the log dividend yield (LDY), the treasury bill rate (TBL), the term spread (TMS), the long term government bond returns (LTR) and the default yield spread (DEF). Finally our choice of threshold variable (and business cycle proxy)  $q_t$  is given by the monthly growth rate in the US index of industrial production (IPGR). A standard ADF test applied to this series led to a strong rejection of the unit root hypothesis, supporting our setting that operates under a stationary threshold variable. As our test statistics are able to accommodate predictive regressions with both single and multiple predictors our empirical analysis considers the above variables both individually and in a selection of groups. All our inferences that are based on a given  $\pi_0$  use  $\pi_0 = 0.25$  throughout while our  $SupSup_{iT}$  and  $AveAve_{iT}$  based outcomes use the range  $\Pi = [0.25, 0.75]$ .

Results are presented in Table 10. Focusing first on the single predictor based specifications we note that our empirical results provide a consistent picture for the two series both across the selection of predictors and the two types of test statistics being considered. The big picture that comes across is the obvious absence of any threshold effects induced by our business cycle proxy on the level of the out of sample forecast errors suggesting no evidence of state dependence in the conditional mean

specifications. This finding is supported by both our  $Sup_{iT}$  and  $Ave_{iT}$  based statistics across all predictors as well as our  $SupSup_{iT}$  and  $AveAve_{iT}$  based inferences. Indeed we can note that none of the inferences based on  $Sup_{1T}/Ave_{1T}$  and  $SupSup_{1T}/AveAve_{1T}$  lead to any significant rejections at or above a 5% nominal level.

**Table 10 around here**

Perhaps more interestingly our inferences strongly and convincingly point to the presence of state dependence in the volatility of the value premium instead which in turn leads to distinct MSEs in good versus bad times, a phenomenon also pointed out in Gülen et al. (2011). In the context of the HML sequence we note that inferences based on  $Sup_{2T}/Ave_{2T}$  and  $SupSup_{2T}/AveAve_{2T}$  fully coincide across all predictors, leading to strong rejections of linearity. For the D10BM-D1BM sequence it continues to be the case that both  $Ave_{2T}$  and  $AveAve_{2T}$  lead to strong rejections with consistent outcomes throughout. The stronger power properties of  $AveAve_{iT}$  based statistics relative to their  $SupSup_{iT}$  versions may also explain the inability of  $SupSup_{2T}$  to point to threshold effects for this series when  $AveAve_{2T}$  based inferences point to strong rejections.

More generally our results highlight the need for inferences about predictability to account for the possibility of regime specific heteroskedasticity. Although predictability is often assessed via the statistical significance of estimated slope coefficients and the use of standard heteroskedasticity consistent standard errors the latter are not necessarily able to correct for such effects as documented for instance in Pitarakis (2002).

## VI Conclusions and Discussion

The goal of this paper was to propose a set of diagnostic tools for assessing the presence of regimes in the out of sample forecast errors generated by commonly used predictive regressions. An important motivation for this research was driven by the observation in numerous empirical studies that predictability may often be a cyclical phenomenon kicking in during particular periods while vanishing in other times. The tests developed in this paper were therefore designed to provide a simple toolkit for formally assessing the occurrence of such phenomena.

Unique features of our methods include their ability to accommodate multiple predictors with varying persistence strengths and their ability to robustify inferences to the size of the starting sample used to initiate the recursive forecasts. Equally importantly, the practical implementation of these

methods is particularly straightforward as inferences rely on nuisance parameter free distributions whose critical values are available. This, despite the fact that predictors are parameterised with unknown persistence parameters in the underlying DGP. Finally, another particularly noteworthy feature of our tests is their ability, under certain circumstances, to identify whether state-dependence originates in the mean or variance related parameters of the process.

The recent literature on predictive regressions has devoted considerable attention to the issue of time variation in the conditional mean parameters of such specifications. These developments have typically differed in the type of parameterisations used to capture parameter instability with an important emphasis placed on traditional structural breaks and more recently on more general forms of time variation via random coefficient models specified in a way that accommodates slowly evolving changes as for instance in Georgiev et al. (2018) or smoothly varying coefficients as in Farmer et al. (2018). A common objective behind the bulk of this research agenda has been the development of in-sample tests of linearity (i.e. parameter stability) against such time-varying alternatives with a particular effort devoted to robustifying inferences to unknown forms of conditional and/or unconditional heteroskedasticity via bootstrap based approaches. In contrast to this rich agenda our own interest has instead been on using out of sample forecast errors *and* their squares to uncover the presence of regimes in their respective dynamics. This has also allowed us to explicitly address the important issue of distinguishing between time variation driven by conditional mean parameters and/or error variances which is of interest in its own right. Another distinctive feature of our environment stems from our use of threshold effects to capture parameter variation. This freedom to place a cause to what drives regimes via a user-selected threshold variable enhances the scope of our proposed methods and depending on its dynamics can accommodate both noisy and smoother parameter variations.

## TABLES

TABLE 1

*Quantiles of the Asymptotic Distributions of SupSup and AveAve statistics*

	10%	5%	2.5%	1%
$\pi \in [0.25, 0.75]$				
SupSup	1.504	1.632	1.736	1.874
AveAve	0.317	0.412	0.518	0.638
$\pi \in [0.50, 0.75]$				
SupSup	1.446	1.573	1.684	1.816
AveAve	0.325	0.415	0.517	0.658
$\pi \in [0.50, 0.90]$				
SupSup	1.550	1.670	1.785	1.916
AveAve	0.315	0.392	0.484	0.603

TABLE 2

*Empirical sizes of  $Sup_i$  and  $Ave_i$  statistics under single and multiple predictors (5% Nominal)*

	p=1				p=2				p=3			
	$Sup_1$	$Sup_2$	$Ave_1$	$Ave_2$	$Sup_1$	$Sup_2$	$Ave_1$	$Ave_2$	$Sup_1$	$Sup_2$	$Ave_1$	$Ave_2$
	c=1											
T=400	4.68	4.22	6.26	5.06	4.96	3.88	6.62	5.38	5.78	3.48	7.28	5.92
T=600	4.42	4.18	5.78	5.20	5.16	4.86	5.78	6.16	5.68	4.20	6.98	5.46
T=1000	5.22	4.30	6.08	5.32	4.92	4.22	5.58	4.88	4.96	4.26	6.22	5.52
	c=20											
T=400	4.18	4.06	5.24	5.60	4.90	4.18	6.42	5.62	5.26	3.54	6.80	5.40
T=600	4.86	3.92	5.64	5.06	4.90	4.26	5.62	5.60	4.60	3.88	6.04	5.08
T=1000	4.24	4.28	5.52	5.62	4.42	4.52	5.34	5.68	5.10	3.80	6.24	4.70
	c=40											
T=400	4.36	3.66	5.74	4.84	4.46	3.90	6.00	5.62	4.74	3.92	6.10	5.26
T=600	4.18	3.96	5.16	5.26	4.58	4.30	6.08	5.22	4.80	4.16	6.10	5.34
T=1000	4.42	4.18	5.38	5.20	4.56	4.46	5.76	5.54	4.52	4.06	5.44	4.92



TABLE 3

*Empirical sizes of  $Sup_i$  and  $Ave_i$  with heterogeneous predictors (5% Nominal)*

	p=2				p=3			
	$Sup_1$	$Sup_2$	$Ave_1$	$Ave_2$	$Sup_1$	$Sup_2$	$Ave_1$	$Ave_2$
	$(c_1, c_2) = (1, 20)$				$(c_1, c_2, c_3) = (1, 1, 20)$			
T=400	5.20	3.62	6.74	5.76	4.72	3.94	6.68	5.62
T=600	4.86	4.14	6.22	5.30	5.44	3.78	6.44	4.82
T=1000	4.94	3.88	5.84	5.08	4.88	4.24	5.94	5.24
	$(c_1, c_2) = (1, 40)$				$(c_1, c_2, c_3) = (1, 20, 40)$			
T=400	4.68	3.96	5.92	5.32	5.08	4.34	6.70	5.80
T=600	4.34	4.16	5.84	5.50	4.88	4.52	5.72	5.70
T=1000	4.56	4.14	5.52	4.74	4.76	4.38	5.68	5.50
	$(c_1, c_2) = (20, 40)$				$(c_1, c_2, c_3) = (20, 20, 40)$			
T=400	4.44	3.84	5.86	5.00	4.94	3.90	6.68	5.20
T=600	5.06	4.18	5.92	5.82	4.74	4.22	6.26	5.74
T=1000	4.82	4.14	5.92	5.08	4.76	4.76	6.08	5.32

TABLE 4

*Empirical sizes of  $SupSup_i$  and  $AveAve_i$  under  $\Pi = [0.50, 0.75]$  (5% nominal)*

	p=1				p=2				p=3			
	$SupSup_1$	$SupSup_2$	$AveAve_1$	$AveAve_2$	$SupSup_1$	$SupSup_2$	$AveAve_1$	$AveAve_2$	$SupSup_1$	$SupSup_2$	$AveAve_1$	$AveAve_2$
	c=1											
T=400	3.86	3.50	5.56	6.30	4.74	3.86	6.32	6.70	4.12	3.80	6.02	6.82
T=600	4.52	4.22	5.94	6.24	4.94	4.44	5.80	5.86	4.76	4.48	6.02	6.70
T=1000	5.22	4.44	6.42	6.00	4.94	4.76	6.04	6.40	5.04	4.08	5.90	5.66
	c=20											
T=400	4.26	3.68	6.68	6.30	3.62	3.62	6.02	5.98	4.30	3.36	6.04	6.30
T=600	4.64	3.54	5.72	5.46	5.46	3.60	6.66	5.74	5.08	4.02	6.42	5.74
T=1000	4.96	4.20	5.80	5.46	4.98	4.48	5.60	5.76	4.98	4.58	5.92	6.30
	c=40											
T=400	4.16	4.02	5.44	6.82	4.18	3.50	5.78	5.62	4.54	3.14	6.22	5.64
T=600	4.94	3.88	6.20	5.82	4.38	3.60	5.94	6.14	4.64	3.62	6.04	5.78
T=1000	4.74	4.62	6.18	6.08	5.12	4.78	5.84	6.26	5.24	4.36	6.38	5.70

TABLE 5

*Empirical power of  $Sup_i$  and  $Ave_i$  under intercept shifts of magnitude  $\delta_0$* 

	$\gamma_0 = 0$						$\gamma_0 = -0.5$					
$\delta_0$	0.25	0.50	0.75	1.00	1.25	1.50	0.25	0.50	0.75	1.00	1.25	1.50
<b>c=1</b>	T=400											
Sup <sub>1</sub>	0.37	0.95	1.00	1.00	1.00	1.00	0.38	0.86	1.00	1.00	1.00	1.00
Sup <sub>2</sub>	0.04	0.05	0.06	0.09	0.13	0.18	0.06	0.04	0.08	0.34	0.40	0.60
Ave <sub>1</sub>	0.40	0.95	1.00	1.00	1.00	1.00	0.40	0.90	1.00	1.00	1.00	1.00
Ave <sub>2</sub>	0.06	0.06	0.09	0.12	0.16	0.22	0.00	0.06	0.14	0.40	0.46	0.64
	T=600											
Sup <sub>1</sub>	0.58	1.00	1.00	1.00	1.00	1.00	0.46	1.00	1.00	1.00	1.00	1.00
Sup <sub>2</sub>	0.04	0.05	0.07	0.10	0.14	0.18	0.02	0.06	0.18	0.48	0.54	0.64
Ave <sub>1</sub>	0.60	1.00	1.00	1.00	1.00	1.00	0.52	1.00	1.00	1.00	1.00	1.00
Ave <sub>2</sub>	0.06	0.06	0.09	0.12	0.16	0.21	0.04	0.06	0.20	0.48	0.62	0.74
	T=1000											
Sup <sub>1</sub>	0.83	1.00	1.00	1.00	1.00	1.00	0.68	1.00	1.00	1.00	1.00	1.00
Sup <sub>2</sub>	0.04	0.05	0.07	0.10	0.15	0.19	0.04	0.02	0.30	0.58	0.80	0.96
Ave <sub>1</sub>	0.84	1.00	1.00	1.00	1.00	1.00	0.68	1.00	1.00	1.00	1.00	1.00
Ave <sub>2</sub>	0.06	0.06	0.08	0.12	0.17	0.22	0.00	0.10	0.32	0.60	0.74	0.96
<b>c=20</b>	T=400											
Sup <sub>1</sub>	0.38	0.95	1.00	1.00	1.00	1.00	0.20	0.82	1.00	1.00	1.00	1.00
Sup <sub>2</sub>	0.04	0.04	0.06	0.08	0.10	0.14	0.02	0.02	0.16	0.36	0.50	0.70
Ave <sub>1</sub>	0.41	0.95	1.00	1.00	1.00	1.00	0.24	0.82	1.00	1.00	1.00	1.00
Ave <sub>2</sub>	0.06	0.06	0.08	0.10	0.12	0.17	0.00	0.06	0.20	0.34	0.52	0.78
	T=600											
Sup <sub>1</sub>	0.58	1.00	1.00	1.00	1.00	1.00	0.46	1.00	1.00	1.00	1.00	1.00
Sup <sub>2</sub>	0.04	0.04	0.06	0.07	0.10	0.15	0.02	0.12	0.14	0.24	0.64	0.76
Ave <sub>1</sub>	0.61	0.99	1.00	1.00	1.00	1.00	0.50	1.00	1.00	1.00	1.00	1.00
Ave <sub>2</sub>	0.06	0.06	0.07	0.09	0.13	0.17	0.02	0.10	0.16	0.28	0.66	0.80
	T=1000											
Sup <sub>1</sub>	0.84	1.00	1.00	1.00	1.00	1.00	0.84	1.00	1.00	1.00	1.00	1.00
Sup <sub>2</sub>	0.04	0.04	0.06	0.08	0.11	0.16	0.02	0.04	0.28	0.62	0.78	0.90
Ave <sub>1</sub>	0.85	1.00	1.00	1.00	1.00	1.00	0.80	1.00	1.00	1.00	1.00	1.00
Ave <sub>2</sub>	0.05	0.06	0.08	0.10	0.13	0.17	0.02	0.06	0.34	0.70	0.76	0.94
<b>c=40</b>	T=400											
Sup <sub>1</sub>	0.39	0.95	1.00	1.00	1.00	1.00	0.32	0.78	1.00	1.00	1.00	1.00
Sup <sub>2</sub>	0.04	0.04	0.05	0.07	0.10	0.14	0.06	0.06	0.12	0.28	0.44	0.64
Ave <sub>1</sub>	0.42	0.95	1.00	1.00	1.00	1.00	0.36	0.82	1.00	1.00	1.00	1.00
Ave <sub>2</sub>	0.05	0.07	0.07	0.09	0.12	0.16	0.12	0.06	0.18	0.30	0.48	0.70
	T=600											
Sup <sub>1</sub>	0.57	1.00	1.00	1.00	1.00	1.00	0.40	0.98	1.00	1.00	1.00	1.00
Sup <sub>2</sub>	0.04	0.05	0.05	0.07	0.11	0.14	0.00	0.10	0.14	0.40	0.66	0.84
Ave <sub>1</sub>	0.60	1.00	1.00	1.00	1.00	1.00	0.40	0.98	1.00	1.00	1.00	1.00
Ave <sub>2</sub>	0.06	0.06	0.07	0.09	0.13	0.17	0.04	0.12	0.14	0.44	0.70	0.90
	T=1000											
Sup <sub>1</sub>	0.84	1.00	1.00	1.00	1.00	1.00	0.70	1.00	1.00	1.00	1.00	1.00
Sup <sub>2</sub>	0.04	0.04	0.06	0.08	0.11	0.16	0.04	0.06	0.22	0.52	0.72	0.96
Ave <sub>1</sub>	0.84	1.00	1.00	1.00	1.00	1.00	0.72	1.00	1.00	1.00	1.00	1.00
Ave <sub>2</sub>	0.05	0.05	0.08	0.10	0.13	0.18	0.06	0.08	0.20	0.58	0.82	0.96

TABLE 6

*Empirical power of Sup<sub>i</sub> and Ave<sub>i</sub> under slope shifts of magnitude  $\delta_1$* 

$\delta_1$	$\gamma_0 = 0$			$\gamma_0 = -0.5$			$\gamma_0 = 0$			$\gamma_0 = -0.5$			$\gamma_0 = 0$			$\gamma_0 = -0.5$		
	p=1						p=2						p=2 (one slope shift)					
	0.50	0.75	1.00	0.50	0.75	1.00	0.50	0.75	1.00	0.50	0.75	1.00	0.50	0.75	1.00	0.50	0.75	1.00
<b>c=1</b>	T=400																	
Sup <sub>1</sub>	0.93	0.93	0.94	0.92	0.93	0.94	0.93	0.93	0.94	0.93	0.94	0.94	0.92	0.94	0.94	0.91	0.94	0.93
Sup <sub>2</sub>	0.44	0.54	0.56	0.96	0.99	0.99	0.51	0.55	0.56	0.98	0.99	0.99	0.44	0.51	0.56	0.95	0.98	0.99
Ave <sub>1</sub>	0.93	0.94	0.94	0.92	0.93	0.94	0.93	0.94	0.94	0.93	0.94	0.94	0.93	0.95	0.94	0.92	0.94	0.93
Ave <sub>2</sub>	0.46	0.56	0.58	0.97	0.99	0.99	0.53	0.57	0.58	0.98	0.99	0.99	0.47	0.54	0.58	0.96	0.99	0.99
	T=600																	
Sup <sub>1</sub>	0.94	0.95	0.95	0.94	0.95	0.95	0.95	0.95	0.95	0.94	0.95	0.95	0.95	0.95	0.95	0.94	0.95	0.95
Sup <sub>2</sub>	0.49	0.56	0.59	0.99	1.00	1.00	0.55	0.57	0.59	1.00	1.00	1.00	0.48	0.56	0.58	0.99	1.00	1.00
Ave <sub>1</sub>	0.94	0.95	0.95	0.94	0.95	0.95	0.95	0.95	0.95	0.95	0.95	0.95	0.95	0.95	0.95	0.95	0.95	0.96
Ave <sub>2</sub>	0.51	0.57	0.60	0.99	1.00	1.00	0.57	0.59	0.61	1.00	1.00	1.00	0.50	0.58	0.60	0.99	1.00	1.00
	T=1000																	
Sup <sub>1</sub>	0.96	0.96	0.97	0.95	0.96	0.96	0.96	0.96	0.96	0.96	0.96	0.96	0.95	0.96	0.97	0.96	0.96	0.96
Sup <sub>2</sub>	0.54	0.58	0.59	1.00	1.00	1.00	0.57	0.58	0.60	1.00	1.00	1.00	0.54	0.57	0.59	1.00	1.00	1.00
Ave <sub>1</sub>	0.96	0.96	0.97	0.95	0.97	0.96	0.96	0.96	0.96	0.96	0.96	0.97	0.96	0.97	0.97	0.96	0.96	0.96
Ave <sub>2</sub>	0.55	0.59	0.60	1.00	1.00	1.00	0.58	0.59	0.61	1.00	1.00	1.00	0.55	0.58	0.60	1.00	1.00	1.00
<b>c=20</b>	T=400																	
Sup <sub>1</sub>	0.57	0.68	0.73	0.56	0.66	0.70	0.67	0.72	0.74	0.64	0.71	0.72	0.56	0.69	0.72	0.54	0.66	0.70
Sup <sub>2</sub>	0.13	0.32	0.41	0.59	0.91	0.95	0.26	0.41	0.46	0.86	0.95	0.96	0.14	0.32	0.41	0.59	0.91	0.95
Ave <sub>1</sub>	0.59	0.70	0.74	0.58	0.68	0.71	0.68	0.74	0.75	0.65	0.72	0.73	0.58	0.70	0.74	0.56	0.68	0.71
Ave <sub>2</sub>	0.16	0.35	0.44	0.63	0.92	0.95	0.30	0.44	0.48	0.87	0.95	0.96	0.17	0.34	0.43	0.62	0.92	0.95
	T=600																	
Sup <sub>1</sub>	0.68	0.76	0.78	0.67	0.75	0.76	0.75	0.78	0.79	0.73	0.76	0.77	0.69	0.76	0.78	0.66	0.74	0.77
Sup <sub>2</sub>	0.20	0.40	0.46	0.86	0.98	0.99	0.34	0.47	0.50	0.96	0.99	0.99	0.18	0.40	0.44	0.85	0.98	0.99
Ave <sub>1</sub>	0.69	0.77	0.79	0.68	0.76	0.76	0.76	0.79	0.80	0.74	0.76	0.77	0.69	0.77	0.79	0.67	0.75	0.78
Ave <sub>2</sub>	0.22	0.43	0.48	0.87	0.98	0.99	0.36	0.49	0.52	0.97	0.99	0.99	0.21	0.41	0.46	0.86	0.98	0.99
	T=1000																	
Sup <sub>1</sub>	0.78	0.84	0.84	0.76	0.81	0.83	0.81	0.84	0.84	0.80	0.82	0.82	0.79	0.83	0.83	0.77	0.81	0.83
Sup <sub>2</sub>	0.29	0.45	0.50	0.99	1.00	1.00	0.42	0.51	0.52	1.00	1.00	1.00	0.28	0.45	0.48	0.99	1.00	1.00
Ave <sub>1</sub>	0.78	0.84	0.84	0.77	0.82	0.84	0.82	0.84	0.85	0.81	0.82	0.83	0.79	0.83	0.84	0.78	0.82	0.84
Ave <sub>2</sub>	0.31	0.47	0.51	0.99	1.00	1.00	0.43	0.52	0.53	1.00	1.00	1.00	0.30	0.46	0.50	0.99	1.00	1.00
<b>c=40</b>	T=400																	
Sup <sub>1</sub>	0.35	0.52	0.59	0.32	0.52	0.57	0.47	0.61	0.62	0.46	0.60	0.62	0.35	0.51	0.58	0.31	0.51	0.56
Sup <sub>2</sub>	0.07	0.23	0.34	0.30	0.82	0.92	0.16	0.35	0.44	0.68	0.92	0.94	0.07	0.21	0.34	0.28	0.80	0.92
Ave <sub>1</sub>	0.37	0.53	0.61	0.35	0.53	0.58	0.49	0.62	0.64	0.48	0.61	0.62	0.36	0.53	0.60	0.33	0.52	0.58
Ave <sub>2</sub>	0.09	0.27	0.37	0.35	0.83	0.93	0.19	0.38	0.46	0.72	0.93	0.95	0.09	0.24	0.37	0.33	0.82	0.93
	T=600																	
Sup <sub>1</sub>	0.49	0.64	0.67	0.47	0.62	0.66	0.60	0.68	0.71	0.58	0.67	0.70	0.50	0.63	0.67	0.46	0.62	0.66
Sup <sub>2</sub>	0.12	0.31	0.40	0.63	0.95	0.98	0.24	0.42	0.47	0.91	0.98	0.99	0.12	0.30	0.40	0.60	0.95	0.98
Ave <sub>1</sub>	0.52	0.65	0.68	0.48	0.63	0.66	0.61	0.69	0.73	0.59	0.68	0.70	0.51	0.64	0.68	0.48	0.63	0.66
Ave <sub>2</sub>	0.14	0.34	0.43	0.66	0.96	0.98	0.26	0.44	0.48	0.92	0.98	0.99	0.14	0.33	0.43	0.64	0.96	0.98
	T=1000																	
Sup <sub>1</sub>	0.65	0.74	0.77	0.63	0.73	0.74	0.72	0.76	0.78	0.71	0.75	0.76	0.65	0.74	0.75	0.63	0.72	0.75
Sup <sub>2</sub>	0.19	0.38	0.46	0.94	0.99	1.00	0.34	0.47	0.50	0.99	1.00	1.00	0.18	0.40	0.44	0.94	1.00	1.00
Ave <sub>1</sub>	0.66	0.75	0.77	0.63	0.73	0.75	0.73	0.77	0.78	0.71	0.76	0.76	0.66	0.75	0.76	0.64	0.73	0.76
Ave <sub>2</sub>	0.21	0.40	0.48	0.95	1.00	1.00	0.37	0.49	0.50	0.99	1.00	1.00	0.21	0.42	0.46	0.95	1.00	1.00

TABLE 7

*Empirical power of SupSup<sub>i</sub> and AveAve<sub>i</sub> under intercept shifts of magnitude  $\delta_0$  and  $\Pi = [0.50, 0.75]$*

$\delta_0$	$\gamma_0 = 0$						$\gamma_0 = -0.5$					
	0.25	0.5	0.75	1	1.25	1.5	0.25	0.5	0.75	1	1.25	1.5
<b>c=1</b>	T=400											
SupSup <sub>1</sub>	0.22	0.77	1.00	1.00	1.00	1.00	0.17	0.67	0.96	1.00	1.00	1.00
SupSup <sub>2</sub>	0.04	0.05	0.06	0.08	0.11	0.16	0.04	0.06	0.10	0.20	0.32	0.47
AveAve <sub>1</sub>	0.27	0.79	0.99	1.00	1.00	1.00	0.23	0.68	0.95	1.00	1.00	1.00
AveAve <sub>2</sub>	0.06	0.07	0.10	0.11	0.14	0.19	0.07	0.09	0.15	0.26	0.38	0.52
	T=600											
SupSup <sub>1</sub>	0.37	0.94	1.00	1.00	1.00	1.00	0.27	0.88	1.00	1.00	1.00	1.00
SupSup <sub>2</sub>	0.04	0.06	0.07	0.09	0.11	0.16	0.05	0.07	0.13	0.25	0.43	0.65
AveAve <sub>1</sub>	0.40	0.94	1.00	1.00	1.00	1.00	0.31	0.87	1.00	1.00	1.00	1.00
AveAve <sub>2</sub>	0.06	0.08	0.09	0.12	0.14	0.18	0.07	0.10	0.17	0.31	0.48	0.68
	T=1000											
SupSup <sub>1</sub>	0.61	1.00	1.00	1.00	1.00	1.00	0.50	0.99	1.00	1.00	1.00	1.00
SupSup <sub>2</sub>	0.04	0.06	0.07	0.09	0.13	0.17	0.05	0.08	0.18	0.40	0.64	0.83
AveAve <sub>1</sub>	0.61	1.00	1.00	1.00	1.00	1.00	0.52	0.99	1.00	1.00	1.00	1.00
AveAve <sub>2</sub>	0.06	0.08	0.09	0.11	0.15	0.18	0.07	0.10	0.22	0.42	0.66	0.83

TABLE 8

*Empirical power of SupSup<sub>i</sub> and AveAve<sub>i</sub> under slope shifts of magnitude  $\delta_1$  and  $\Pi = [0.50, 0.75]$*

$\delta_1$	$\gamma_0 = 0$				$\gamma_0 = -0.5$				$\gamma_0 = 0$				$\gamma_0 = -0.5$			
	p=1								p=2							
	0.50	0.75	1.00	1.25	0.50	0.75	1.00	1.25	0.50	0.75	1.00	1.25	0.50	0.75	1.00	1.25
<b>c=1</b>	T=400															
SupSup <sub>1</sub>	0.99	0.99	0.99	0.99	0.98	0.99	0.99	0.99	0.99	0.99	0.99	0.99	1.00	0.98	0.99	0.99
SupSup <sub>2</sub>	0.48	0.62	0.63	0.69	0.92	0.98	0.98	0.99	0.60	0.69	0.70	0.72	0.96	0.98	0.99	0.99
AveAve <sub>1</sub>	0.97	0.98	0.98	0.98	0.96	0.98	0.98	0.99	0.98	0.99	0.99	0.99	0.97	0.98	0.98	0.98
AveAve <sub>2</sub>	0.46	0.57	0.59	0.64	0.92	0.97	0.98	0.99	0.56	0.63	0.64	0.64	0.95	0.98	0.99	0.99
	T=600															
SupSup <sub>1</sub>	1.00	1.00	1.00	1.00	0.99	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	0.99	1.00	1.00
SupSup <sub>2</sub>	0.52	0.65	0.67	0.70	0.97	1.00	1.00	1.00	0.65	0.72	0.73	0.76	0.99	1.00	1.00	1.00
AveAve <sub>1</sub>	0.99	0.99	0.99	0.99	0.98	0.99	0.99	0.99	0.99	0.99	0.99	0.99	0.98	0.99	0.99	0.99
AveAve <sub>2</sub>	0.47	0.59	0.61	0.63	0.97	0.99	1.00	1.00	0.60	0.64	0.67	0.69	0.99	0.99	1.00	1.00
	T=1000															
SupSup <sub>1</sub>	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
SupSup <sub>2</sub>	0.62	0.70	0.72	0.72	1.00	1.00	1.00	1.00	0.72	0.75	0.77	0.77	1.00	1.00	1.00	1.00
AveAve <sub>1</sub>	0.99	0.99	1.00	1.00	0.99	1.00	1.00	1.00	1.00	1.00	1.00	1.00	0.99	1.00	0.99	1.00
AveAve <sub>2</sub>	0.54	0.60	0.62	0.64	1.00	1.00	1.00	1.00	0.63	0.66	0.67	0.68	1.00	1.00	1.00	1.00

TABLE 9

*Empirical size ( $Sup_1, Ave_1$ ) and power ( $Sup_2, Ave_2$ ) under variance shifts*

$\sigma_2 - \sigma_1$	$\gamma_{0v} = 0$					$\gamma_{0v} = -0.5$					$\gamma_{0v} = 0.5$				
	0.00	1.00	2.00	3.00	4.00	0.00	1.00	2.00	3.00	4.00	0.00	1.00	2.00	3.00	4.00
<b>c=1</b>															
T=400															
Sup <sub>1</sub>	0.04	0.07	0.08	0.09	0.09	0.04	0.06	0.06	0.06	0.07	0.05	0.05	0.06	0.06	0.06
Sup <sub>2</sub>	0.04	1.00	1.00	1.00	1.00	0.05	1.00	1.00	1.00	1.00	0.04	1.00	1.00	1.00	1.00
Ave <sub>1</sub>	0.06	0.06	0.06	0.06	0.07	0.05	0.05	0.05	0.05	0.04	0.06	0.04	0.04	0.04	0.04
Ave <sub>2</sub>	0.05	1.00	1.00	1.00	1.00	0.06	1.00	1.00	1.00	1.00	0.06	1.00	1.00	1.00	1.00
T=600															
Sup <sub>1</sub>	0.04	0.07	0.09	0.09	0.10	0.04	0.05	0.06	0.06	0.07	0.05	0.06	0.07	0.06	0.07
Sup <sub>2</sub>	0.04	1.00	1.00	1.00	1.00	0.04	1.00	1.00	1.00	1.00	0.04	1.00	1.00	1.00	1.00
Ave <sub>1</sub>	0.05	0.06	0.07	0.06	0.06	0.05	0.04	0.04	0.04	0.04	0.06	0.04	0.05	0.04	0.05
Ave <sub>2</sub>	0.06	1.00	1.00	1.00	1.00	0.05	1.00	1.00	1.00	1.00	0.05	1.00	1.00	1.00	1.00
T=1000															
Sup <sub>1</sub>	0.05	0.07	0.09	0.09	0.10	0.05	0.05	0.06	0.07	0.07	0.05	0.05	0.06	0.07	0.06
Sup <sub>2</sub>	0.04	1.00	1.00	1.00	1.00	0.05	1.00	1.00	1.00	1.00	0.04	1.00	1.00	1.00	1.00
Ave <sub>1</sub>	0.06	0.06	0.06	0.06	0.06	0.05	0.04	0.04	0.04	0.04	0.06	0.04	0.04	0.04	0.04
Ave <sub>2</sub>	0.05	1.00	1.00	1.00	1.00	0.06	1.00	1.00	1.00	1.00	0.05	1.00	1.00	1.00	1.00
<b>c=20</b>															
T=400															
Sup <sub>1</sub>	0.04	0.07	0.09	0.09	0.10	0.04	0.06	0.06	0.05	0.06	0.05	0.05	0.06	0.06	0.06
Sup <sub>2</sub>	0.04	1.00	1.00	1.00	1.00	0.04	1.00	1.00	1.00	1.00	0.04	1.00	1.00	1.00	1.00
Ave <sub>1</sub>	0.06	0.05	0.06	0.06	0.06	0.05	0.05	0.04	0.04	0.04	0.06	0.04	0.04	0.04	0.04
Ave <sub>2</sub>	0.05	1.00	1.00	1.00	1.00	0.06	1.00	1.00	1.00	1.00	0.05	1.00	1.00	1.00	1.00
T=600															
Sup <sub>1</sub>	0.05	0.07	0.09	0.09	0.10	0.05	0.05	0.06	0.07	0.06	0.05	0.05	0.06	0.06	0.06
Sup <sub>2</sub>	0.04	1.00	1.00	1.00	1.00	0.04	1.00	1.00	1.00	1.00	0.04	1.00	1.00	1.00	1.00
Ave <sub>1</sub>	0.06	0.06	0.07	0.06	0.06	0.06	0.05	0.04	0.04	0.04	0.05	0.04	0.04	0.04	0.04
Ave <sub>2</sub>	0.05	1.00	1.00	1.00	1.00	0.05	1.00	1.00	1.00	1.00	0.06	1.00	1.00	1.00	1.00
T=1000															
Sup <sub>1</sub>	0.04	0.07	0.08	0.09	0.10	0.05	0.05	0.06	0.06	0.06	0.05	0.06	0.06	0.06	0.06
Sup <sub>2</sub>	0.05	1.00	1.00	1.00	1.00	0.05	1.00	1.00	1.00	1.00	0.04	1.00	1.00	1.00	1.00
Ave <sub>1</sub>	0.05	0.06	0.06	0.05	0.06	0.06	0.04	0.04	0.03	0.04	0.05	0.04	0.04	0.04	0.03
Ave <sub>2</sub>	0.06	1.00	1.00	1.00	1.00	0.06	1.00	1.00	1.00	1.00	0.05	1.00	1.00	1.00	1.00
<b>c=40</b>															
T=400															
Sup <sub>1</sub>	0.05	0.06	0.08	0.09	0.09	0.05	0.05	0.06	0.07	0.06	0.04	0.05	0.06	0.06	0.07
Sup <sub>2</sub>	0.04	1.00	1.00	1.00	1.00	0.03	1.00	1.00	1.00	1.00	0.04	1.00	1.00	1.00	1.00
Ave <sub>1</sub>	0.06	0.05	0.06	0.06	0.06	0.06	0.05	0.04	0.05	0.04	0.05	0.04	0.04	0.04	0.04
Ave <sub>2</sub>	0.05	1.00	1.00	1.00	1.00	0.05	1.00	1.00	1.00	1.00	0.05	1.00	1.00	1.00	1.00
T=600															
Sup <sub>1</sub>	0.05	0.07	0.08	0.09	0.10	0.04	0.06	0.06	0.07	0.07	0.05	0.06	0.06	0.06	0.06
Sup <sub>2</sub>	0.04	1.00	1.00	1.00	1.00	0.04	1.00	1.00	1.00	1.00	0.04	1.00	1.00	1.00	1.00
Ave <sub>1</sub>	0.06	0.06	0.06	0.06	0.06	0.05	0.05	0.03	0.05	0.04	0.06	0.05	0.04	0.04	0.04
Ave <sub>2</sub>	0.05	1.00	1.00	1.00	1.00	0.05	1.00	1.00	1.00	1.00	0.05	1.00	1.00	1.00	1.00
T=1000															
Sup <sub>1</sub>	0.04	0.07	0.10	0.09	0.10	0.05	0.06	0.06	0.07	0.07	0.05	0.05	0.06	0.06	0.07
Sup <sub>2</sub>	0.04	1.00	1.00	1.00	1.00	0.04	1.00	1.00	1.00	1.00	0.05	1.00	1.00	1.00	1.00
Ave <sub>1</sub>	0.05	0.05	0.06	0.05	0.06	0.05	0.05	0.04	0.04	0.04	0.06	0.04	0.04	0.03	0.04
Ave <sub>2</sub>	0.05	1.00	1.00	1.00	1.00	0.06	1.00	1.00	1.00	1.00	0.05	1.00	1.00	1.00	1.00

TABLE 10

*State Dependence in Value Premium Forecasts (\*\*\*, \*\* and \* indicate significance at 2.5%, 5% and 10% levels respectively)*

	<i>Value Premium (D10BM-D1BM)</i>				<i>Value Premium (HML)</i>			
	<i>Sup<sub>1</sub></i>	<i>Sup<sub>2</sub></i>	<i>Ave<sub>1</sub></i>	<i>Ave<sub>2</sub></i>	<i>Sup<sub>1</sub></i>	<i>Sup<sub>2</sub></i>	<i>Ave<sub>1</sub></i>	<i>Ave<sub>2</sub></i>
LDY	0.693	1.287*	0.104	0.594***	0.930	1.713***	0.268	0.773***
TBL	0.721	1.274*	0.119	0.556**	0.893	1.714***	0.278	0.746***
TMS	0.661	1.311*	0.071	0.606***	0.824	1.678***	0.194	0.763***
DEF	0.879	1.407**	0.225	0.723***	1.078	1.734***	0.452*	0.838***
LTR	0.717	1.256*	0.153	0.557**	1.091	1.694***	0.387*	0.787***
INFL	0.712	1.253*	0.117	0.545**	0.979	1.655***	0.307	0.713***
LDY+TBL	0.805	1.211	0.130	0.516***	0.960	1.663***	0.296	0.692***
LDY+TMS	0.823	1.215	0.117	0.492**	0.981	1.620***	0.291	0.663***
LDY+INFL	0.686	1.291*	0.098	0.598***	0.916	1.713***	0.259	0.772***
LDY+TBL+LTR	0.799	1.244*	0.139	0.549**	1.025	1.712***	0.335	0.756***
	<i>SupSup<sub>1</sub></i>	<i>SupSup<sub>2</sub></i>	<i>AveAve<sub>1</sub></i>	<i>AveAve<sub>2</sub></i>	<i>SupSup<sub>1</sub></i>	<i>SupSup<sub>2</sub></i>	<i>AveAve<sub>1</sub></i>	<i>AveAve<sub>2</sub></i>
LDY	1.106	1.392	0.100	0.594***	0.953	1.764***	0.076	0.627***
TBL	1.118	1.388	0.102	0.583***	0.931	1.774***	0.079	0.610***
TMS	1.179	1.417	0.122	0.622***	0.841	1.743***	0.052	0.643***
DEF	0.986	1.455	0.095	0.694***	1.097	1.795***	0.139	0.697***
LTR	1.065	1.370	0.090	0.583***	1.104	1.793***	0.116	0.659***
INFL	1.090	1.397	0.095	0.589***	1.001	1.749***	0.086	0.613***
LDY+TBL	1.117	1.392	0.108	0.582***	0.989	1.742***	0.084	0.605***
LDY+TMS	1.162	1.411	0.121	0.600***	0.986	1.725**	0.076	0.614***
LDY+INFL	1.108	1.392	0.100	0.596***	0.940	1.764***	0.074	0.623***
LDY+TBL+LTR	1.095	1.377	0.099	0.592***	1.050	1.789***	0.102	0.646***



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### **Supporting Information**

Additional supporting information may be found in the online supplementary appendix of this article:

**Appendix A.** Proofs of Propositions 1-6.