Government Debt, Dividend Growth and Stock Returns

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Abstract
This paper documents that the higher debt-to-GDP ratio can predict both higher dividend growth and higher stock returns. The finding is consistent with Lettau and Ludvigson (2005)’s argument that there exists a common component among stock returns and dividend growth which resolves the US asset pricing puzzle that the dividend-price ratio can only predict discount rates but not cash flows. To rationalize this finding, we propose a production-based asset pricing model incorporating firm’s trade-off behavior. The model can produce testable predictions that the increase in public debt moves both dividend payment and the cost of capital in the same direction, resulting in the capture of the common component.

JEL classification: G10, G12, G30, G32, C50.

Keywords: Cash holding, Dividend growth; Return predictability; Public debt.

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