International portfolio diversification and macroeconomic fluctuations when preferences are time-varying

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Abstract

We propose a 2-country asset pricing model where agents' preferences change endogenously as a function of the popularity of internationally traded goods. When agents are more sensitive to changes in the popularity of domestic goods than to changes in the popularity of foreign goods, the local stock market reacts more to changes in preferences of local agents than to changes in preferences of foreign agents. Therefore, the home bias arises because the home-country stock represents a better investment opportunity to hedge against future preference fluctuations. We test our model and find that preference evolution is a plausible driver of key macroeconomic variables and stock returns.