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Title: The Signaling Effect of Margin Debt on Stock Market Returns

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Abstract

The use of margin debt to exacerbate returns for investors is widely used during times of economic growth. It is also used as a tool for investors to take short positions on stocks when a decline in expected. This paper examines the relationship between the use of margin debt, labor market participation rates, Put/Call ratios, and Volatility Index as a signal for possible asset bubbles or market bottoms. By analyzing the amount of existing monthly margin debt, labor market participation rates, Put/Call ratio figures, and Volatility Index from 2003 through the present, we hypothesize that an increase in the labor market participation rate, margin debt, Put/Call ratio, Volatility Index (VIX), and Federal Funds rate will reach an equilibrium that can provide correlation to a stock market retracement. Additionally, we hypothesize that a decrease in the monthly labor participation rate, margin debt, Put/Call ratio, monthly VIX, and Federal Funds rate will reach an equilibrium that will correlate to eventual upward stock market movements. The results of our study found a statistically significant correlation between the S and P 500 directional movement change as a percentage and the amount of margin debt change as a percentage and the VIX monthly change as a percentage. There is no statistically significant correlation between the S and P 500 directional movement change as a percentage and the labor market participation rate, the Put/Call ratio, or the Federal Funds rate as percentage changes month over month. The results are consistent with previous literature related to margin debt and the VIX. Further, our results provide new foundations to work for future research related to signaling related to market-wide risks such as labor market rates, option-based analysis, and central bank policy. Finally, labor-market participation rates reflect timely employment data related to market sentiment and corporate hiring practices. As such, it serves as a better variable in this study than unemployment figures, which are not only lagging indicators but also allow for revision after the initial release. This paper will explore the seminal works with a brief, albeit thorough literature review examining several key concepts in finance, accounting, economics, and investment theory. Next, we will examine various methodologies used in the past that have explored the use of margin debt, Put/Call ratios, volatility, and labor-market participation. Then we will explain the methodology we will use in our empirical examination of data, as well as the sources of our data and rationale for its selection. Finally, analysis of our findings will be included along with a discussion of its impact.

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