MACRO-FINANCE DECOUPLING: ROBUST EVALUATIONS OF MACRO ASSET PRICING MODELS

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This paper shows that robust inference under weak identification is important to the evaluation of many influential macro asset pricing models, including (time-varying) rare-disaster risk models and long-run risk models. Building on recent developments in the conditional inference literature, we provide a novel conditional specification test by simulating the critical value conditional on a sufficient statistic. This sufficient statistic can be intuitively interpreted as a measure capturing the macroeconomic information decoupled from the underlying content of asset pricing theories. Macro-finance decoupling is an effective way to improve the power of the specification test when asset pricing theories are difficult to refute because of a severe imbalance in the information content about the key model parameters between macroeconomic moment restrictions and asset pricing cross-equation restrictions. We apply the proposed conditional specification test to the evaluation of a time-varying rare-disaster risk model and the construction of robust model uncertainty sets.

KEYWORDS: Conditional inference, information imbalance, long-run risk, rare-disasters, structural asset pricing, weak identification.

1. INTRODUCTION

Many influential macro asset pricing models have been developed and widely used by researchers, practitioners, and monetary authorities. The econometric evaluation of their specifications is important for policy analysis and forecasting, but conventional methods face severe challenges due to ubiquitous information imbalance in these models; see, among others, Campbell (2018) and Chen, Dou, and Kogan (forthcoming).
for structural models, as well as Kan and Zhang (1999), Kleibergen (2009), and Gospodinov, Kan, and Robotti (2017) for linear models with spurious factors. The econometric question of how to construct a robust and efficient evaluation of macro asset pricing models, especially nonlinear structural models, is of great importance for the asset pricing literature.

To address this crucial question, this paper proposes a specification test robust to information imbalance in a unified weak identification framework. In the generalized method of moments (GMM) setup, we show that the rare-disaster risk model (Rietz (1988), Barro (2006)), the time-varying rare-disaster risk model (Gabaix (2012), Wachter (2013)), and the long-run risk model (Bansal and Yaron (2004)) all fit in a general framework—there exists a set of baseline moments that are valid regardless of the asset pricing theory but only provide weak identification of the key model parameters, characterized by the near flatness of the baseline moments (Stock and Wright (2000)). The remainder of the moments are asset pricing moments implied by a specific macro asset pricing theory. These asset pricing moments, by design, provide tighter cross-equation restrictions and thus strongly identify the key model parameters. We propose a new conditional specification test that evaluates the validity of the asset pricing moments by effectively exploiting the noisy information embedded in the baseline moments. This approach yields substantial power improvement compared to the widely used $J$ test (Hansen (1982)) for models with information imbalance.

This new conditional specification test builds on the approach of conditional inference with a functional nuisance parameter by Andrews and Mikusheva (2016a). In our analysis, the object of interest shifts from structural parameters to model specifications. The test statistic is an incremental $J$ statistic as in the $C$ test of Eichenbaum, Hansen, and Singleton (1988). However, the critical value is simulation-based and is conditional on a sufficient statistic that captures the macroeconomic information decoupled from the underlying content of asset pricing theories. It has correct asymptotic size uniformly over the identification strength in the baseline moments. In contrast, the $C$ test, with a critical value based on the chi-square distribution, may under- or over-reject the null hypothesis because estimators for weakly identified parameters have distributions that are poorly approximated by a normal distribution even in large samples (e.g., Stock and Wright (2000), Andrews and Cheng (2012)). Our conditional specification test becomes equivalent to the optimal test in the classical scenario without weak identification (Newey (1985)). In contrast, the $J$ test based on all moment conditions neglects the valid information in the baseline moments.

This paper contributes to the connection between finance and econometrics, and makes the following methodological and empirical contributions. First, we study the identification issue in (time-varying) rare-disaster risk and long-run risk models. Our study shows how to coherently fit a structural macro asset pricing model featuring information imbalance into a formal econometric framework with both weak and strong identification, which paves the way for uniformly valid inference. Each example demonstrates how to conduct a model-specific reparameterization that exploits the major implications of the macro asset pricing model. To the best of our knowledge, the identification and robust testing problems we study here have never been explored for these macro asset pricing structural models under a formal econometric framework. Moreover, the empirical application analyzes a full-blown time-varying rare-disaster risk model. There has been little

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formal econometric study of the validity of the rare-disaster risk mechanisms in the asset pricing literature, with a few exceptions (e.g., Julliard and Ghosh (2012)). Our empirical study also fills this gap in the literature.

Second, we develop a new robust specification test and study its asymptotic properties. We consider a general GMM framework, although the applications focus on asset pricing models. The proposed conditional specification test builds on the work of Andrews and Mikusheva (2016a) and differs from it in two main ways. First, our hypothesis test is on a model rather than the value of some parameters. We estimate the model parameters instead of plugging in their true values under the null because the latter is not available for the purpose of model evaluation. Estimation of unknown parameters introduces additional technical complications for uniformly valid asymptotic analysis. Second, we explore the differences in both validity and information content across two sets of moments instead of studying inference based on one set of near-flat moments. Such imbalance in the information content is the key feature of the models we study.

Related Literature. We contribute to improving upon existing specification tests and broadening the scope of weak-identification robust inference methods. Conditional inference has been successfully applied in constructing confidence sets for weakly identified parameters, following the pioneering work of Moreira (2003) for linear instrumental variable (IV) models. Kleibergen (2005) extended its application to nonlinear GMM models. Furthermore, Andrews and Mikusheva (2016a) provided a new perspective—viewing the near-flat population moment function as a functional nuisance parameter. Standing on their shoulders, we apply the conditional inference approach to the evaluation of nonlinear structural models, a new setting with many important applications. Hahn, Ham, and Moon (2011) studied a generalized Hausman test robust to weak instruments in linear models and discussed several micro-econometric applications where our conditional specification test also applies.

A growing body of literature is concerned with the efficacy of conventional inference methods for macro asset pricing models and the development of robust methods. Using identification-robust inference methods, Stock and Wright (2000) studied the preference parameters through nonlinear Euler equations, Yogo (2004) investigated the elasticity of intertemporal substitution (EIS) parameter through linearized cross-equation restrictions, and Ascari, Magnusson, and Mavroeidis (2019) studied the preference parameters under different structural models featuring habits, hand-to-mouth consumers, or recursive preferences. Recently, a large number of papers have studied robust inference methods for linear asset pricing models (e.g., Kan and Zhang (1999), Gospodinov, Kan, and Robotti (2017), Kleibergen and Zhan (2020), Anatolyev and Mikusheva (forthcoming)). Further, in predictive models of stock returns with highly persistent predictors, standard asymptotic inference can largely fail (e.g., Elliott and Stock (1994), Stambaugh (1999)), and new valid and efficient procedures have been developed (e.g., Campbell and Yogo (2006), Elliott, Müller, and Watson (2015)). Nevertheless, the existing literature lacks reliable and powerful model evaluation methods in the presence of information imbalance.

The rest of the paper is organized as follows. Section 2 provides the general GMM setup with information imbalance and two motivating examples. Section 3 describes the conditional specification test, provides the algorithm, and illustrates its finite-sample performance through Monte Carlo simulations based on the two motivating examples. Section 4 establishes the theoretical results on the size of the proposed test and its uniform validity. Section 5 contains an empirical application of the proposed test to time-varying rare-disaster risk models. Section 6 concludes. The Appendix contains proofs of the theoretical results on the size of the test. The Supplemental Material (Cheng, Dou, and Liao...
contains proofs of the auxiliary lemmas in the Appendix, theoretical and simulation results on the power of the test, and details for the empirical application. Moreover, a note on additional materials (Cheng, Dou, and Liao (2021)) is available on the authors’ personal websites.

2. INFORMATION IMBALANCE: GENERAL SETUP AND EXAMPLES

**General Setup.** Our objective is to statistically assess the validity of a macro asset pricing model by applying specification tests to a set of model-implied cross-equation restrictions. The specification test can be formulated as below:

\[ H_0 : \mathbb{E}[\tilde{g}_1(\theta_0)] = 0_{k_1 \times 1} \quad \text{versus} \quad H_1 : \mathbb{E}[\tilde{g}_1(\theta_0)] \neq 0_{k_1 \times 1}, \tag{2.1} \]

where \( \tilde{g}_1(\theta) \equiv n^{-1} \sum_{t=1}^n g_{1,t}(\theta) \) and \( g_{1,t}(\theta) \equiv g_1(Y_t, \theta) \in \mathbb{R}^{k_1} \) depends on the data \( Y_t \) and the \( d_\theta \times 1 \) dimensional parameter \( \theta \), whose true value is denoted by \( \theta_0 \). Some additional baseline moments are always valid under both the null and the alternative,

\[ \mathbb{E}[\tilde{g}_0(\theta_0)] = 0_{k_0 \times 1}, \tag{2.2} \]

where \( \tilde{g}_0(\theta) \equiv n^{-1} \sum_{t=1}^n g_{0,t}(\theta) \) and \( g_{0,t}(\theta) \equiv g_0(Y_t, \theta) \in \mathbb{R}^{k_0} \). Under the null, the full moments are \( \mathbb{E}[\tilde{g}(\theta_0)] = 0_{k \times 1} \), where \( \tilde{g}(\theta) \equiv [\tilde{g}_0(\theta), \tilde{g}_1(\theta)]' \) is \( k \equiv k_0 + k_1 \) dimensional and differentiable in \( \theta \) almost surely. We allow the baseline moments to depend only on a subvector of \( \theta \).

The models we consider have two key features. First, the baseline moments \( \mathbb{E}[\tilde{g}_0(\theta_0)] = 0_{k_0 \times 1} \) may only weakly identify \( \theta_0 \), that is, \( \mathbb{E}[\tilde{g}_0(\theta)] \) is nearly flat in \( \theta \). Second, once the asset pricing theory is imposed, the full moments \( \mathbb{E}[\tilde{g}(\theta_0)] = 0_{k \times 1} \) strongly identify \( \theta_0 \) under the null, that is, the singular values of the associated Jacobian matrix \( Q \equiv \mathbb{E}[^T(\partial \tilde{g}(\theta_0)/\partial \theta)] \) are bounded away from zero. For moments created with IVs, the baseline moments \( \mathbb{E}[\tilde{g}_0(\theta_0)] = 0_{k_0 \times 1} \) and the additional moments \( \mathbb{E}[\tilde{g}_1(\theta_0)] = 0_{k_1 \times 1} \) are created with weak IVs and strong IVs, respectively.

**Motivating Example 1: Disaster Risk Model for Equity Premium.** We consider a simple variant of Rietz (1988) and Barro (2006, 2009) with macroeconomic disasters characterized by extremely large consumption declines. We assume that real consumption growth follows

\[ \Delta c_t \equiv \ln \left( \frac{C_t}{C_{t-1}} \right) = \sigma \varepsilon_t - \zeta_t, \tag{2.3} \]

where \( C_t \) is real consumption per capita, the consumption shock \( \varepsilon_t \) follows a standard normal distribution, and \( \zeta_t \) is a disaster variable. Particularly, the disaster variable \( \zeta_t \) is characterized by

\[ \zeta_t \equiv x_t(\nu + J_t), \tag{2.4} \]

where the variable \( x_t \sim \text{Bernoulli}(p) \) captures the occurrence of disasters, the constant \( \nu \) is the lower bound of the disaster size, and the variable \( J_t \sim \text{Exp}(\alpha) \) is a disaster shock.

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3 Throughout the paper, we suppress the dependence of \( \tilde{g}_0(\theta) \) and \( \tilde{g}_1(\theta) \) on \( n \) for notational simplicity.

4 We ignore the intercept in \( \Delta c_t \) to maintain simplicity since it plays little role in explaining equity premia.
The shocks \((e_t, J_t, x_t)\) are independently and identically distributed (i.i.d.) over \(t\) and mutually independent with each other. Specification of \(\Delta c_t\) in (2.3) provides baseline moment conditions: \(\mathbb{E}[\bar{m}_0(\alpha)] = 0\), where \(\bar{m}_0(\alpha) \equiv n^{-1} \sum_{t=1}^n m_{0,t}(\alpha)\) with

\[
m_{0,t}(\alpha) \equiv \left[ \frac{\Delta c_t + p \mu_1(\alpha)}{(\Delta c_t)^2 - \sigma^2 - p \mu_2(\alpha)} \right] \quad \text{and} \quad \mu_j(\alpha) \equiv \mathbb{E}[ (\delta_t + J_t)^j ] > 0 \quad \text{for } j = 1, 2.
\]

Specifically, \(\mu_1(\alpha) \equiv v + 1/\alpha\) and \(\mu_2(\alpha) \equiv v^2 + 2v/\alpha + 2/\alpha^2\). For illustrative purposes, we assume that the econometrician knows all parameters, except \(\alpha\), a parameter that can be only weakly identified by the moments based on \(\Delta c_t\) if \(p\) is close to 0.

The representative agent maximizes his lifetime expected utility:

\[
U_0 = \mathbb{E} \left[ \sum_{t=0}^{\infty} e^{-\delta t} \frac{C_t^{1-\gamma}}{1-\gamma} \right],
\]

where \(\delta\) is the subjective discount rate and \(\gamma\) is the relative risk aversion coefficient. The Euler equation for the utility maximization problem gives the following moment condition for excess log return of equity \(r_{m,t}^e\): \(\mathbb{E}[\bar{m}_1(\alpha)] = 0\), where \(\bar{m}_1(\alpha) \equiv n^{-1} \sum_{t=1}^n m_{1,t}(\alpha)\) with

\[
m_{1,t}(\alpha) \equiv r_{m,t}^e - \gamma \sigma^2 + \frac{1}{2} \sigma^2 + p \mu_1(\alpha) - \frac{p}{\alpha - \gamma} h(\alpha) \quad \text{and} \quad h(\alpha) \equiv \alpha \left[ e^{\gamma v} - \frac{\alpha - \gamma}{\alpha - \gamma + 1} e^{(\gamma - 1)v} \right].
\]

We call this the asset pricing moment. The model and the equilibrium condition require that \(v > 0\) and \(\alpha > \gamma > 1\), ensuring that the function \(h(\alpha)\) is positive and finite.

The asset pricing moment (2.7) clearly demonstrates the key idea of the disaster risk model: when \(p\) and \(\alpha - \gamma\) are both close to 0, the rare yet large disaster can generate a substantial equity premium as long as their ratio is a sizable loading in front of \(h(\alpha)\) to match the moment of \(r_{m,t}^e\). This parameter restriction on \(p\) and \(\alpha - \gamma\) ensures that the disaster risk is a meaningful economic mechanism for explaining the equity premium even if \(p\) is small. To utilize this key insight, we transform the parameter \(\alpha\) to \(\theta\) with

\[
\theta \equiv \frac{p}{\alpha - \gamma} \quad \text{and} \quad \theta \in \Theta \equiv [\underline{\zeta}, \overline{\zeta}],
\]

for constants \(0 < \underline{\zeta} < \overline{\zeta}\). Our analysis allows \(p\) and \(\alpha - \gamma\) to be both arbitrarily close to 0, while keeping the ratio \(\theta\) bounded from above and away from zero.

To parameterize all the moments in \(\theta\), we write

\[
\tilde{g}_0(\theta) \equiv \bar{m}_0(\theta^{-1} p + \gamma) \quad \text{and} \quad \tilde{g}_1(\theta) \equiv \bar{m}_1(\theta^{-1} p + \gamma).
\]

Let \(\mu_j^{(1)}(\alpha) \equiv (d/d\alpha) \mu_j(\alpha)\), where \(\mu_j(\alpha)\) for \(j = 1, 2\) are defined in (2.5). For the baseline moments \(\tilde{g}_0(\theta)\), simple calculations give

\[
\mathbb{E} \left[ \frac{d}{d\theta} \tilde{g}_0(\theta) \right] = - (\theta^{-1} p)^2 [\mu_1^{(1)}(\theta^{-1} p + \gamma), - \mu_2^{(1)}(\theta^{-1} p + \gamma)],\]

(2.10)
where \( \mu_j(\theta p + \gamma) \) for \( j = 1, 2 \) are positive and bounded. Because \( \theta \) is bounded, we have
\[
\lim_{\theta \to 0} E\left[\frac{d}{d\theta} \bar{g}_0(\theta)\right] = [0, 0] \quad \text{and} \quad \lim_{\theta \to 0} E\left[\frac{d}{d\theta} \bar{g}_1(\theta)\right] = -\gamma e^{\gamma \theta} \neq 0.
\]
(2.11)
The baseline moments weakly identify \( \theta \) when \( p \) is close to 0, whereas the asset pricing moment always strongly identifies \( \theta \).

Motivating Example 2: Long-Run Risk Model for Equity Premium. We consider a simple variant of the baseline model of Bansal and Yaron (2004). As shown in the literature (e.g., Müller and Watson (2008, 2018)), the time series of U.S. real output growth exhibit a long-run (low-frequency) component, denoted by \( x_t \). However, economists debate whether U.S. real consumption growth and U.S. real stock returns are significantly loaded on the long-run component, \( x_t \), of the real output growth (e.g., Beeler and Campbell (2012), Bansal, Kiku, and Yaron (2012)).

The long-run component of real output growth, \( x_t \), is latent and obeys the following autoregressive process of order 1 (i.e., AR(1) process):
\[
x_t = \rho x_{t-1} + \varepsilon_{x,t}.
\]
(2.12)
The representative agent’s consumption has the following log growth process:
\[
\Delta c_t \equiv \ln\left(\frac{C_t}{C_{t-1}}\right) = \phi x_{t-1} + \sigma_c \varepsilon_{c,t},
\]
(2.13)
where \( C_t \) is real consumption per capita. The shocks \( (\varepsilon_{x,t}, \varepsilon_{c,t}) \) follow a standard bivariate normal distribution and are i.i.d. over \( t \). By introducing parameter \( \phi \) in (2.13), we allow the expected consumption growth to be weakly dependent on or independent of the long-run component \( x_t \) as in many macro asset pricing models. Specifically, when \( \phi = 0 \), the consumption growth process is exactly i.i.d. as in Campbell and Cochrane (1999). When \( \phi > 0 \), the time series of U.S. real consumption growth share the same long-run (low-frequency) component \( x_t \), as suggested by Kandel and Stambaugh (1991), Hansen, Heaton, and Li (2008), and Schorfheide, Song, and Yaron (2018). When \( \phi \) is positive yet near zero, the consumption growth process is nearly i.i.d., as argued by Beeler and Campbell (2012). In the model of Bansal and Yaron (2004, Table I), the loading parameter \( \phi \) is effectively 0.034\% in the monthly frequency. The specification of \( \Delta c_t \) in (2.13) implies the baseline moment conditions: \( E[\bar{m}_0(\rho)] = 0 \), where \( \bar{m}_0(\rho) \equiv n^{-1} \sum_{i=1}^{n} m_{0,i}(\rho) \) with
\[
m_{0,i}(\rho) \equiv \begin{bmatrix} \Delta c_{t-1}(\Delta c_{t+1} - \rho \Delta c_t) \\ \Delta c_t(\Delta c_{t+1} - \rho \Delta c_t) + \rho \sigma_c^2 \end{bmatrix}.
\]
(2.14)
For illustrative purposes, we assume that the econometrician knows all parameters except \( \rho \), a parameter that can be only weakly identified by the moments based on \( \Delta c_t \) if \( \phi \) is close to 0.

The representative agent has recursive preferences and the agent maximizes the following lifetime utility:
\[
V_t = \left[(1 - \delta) C_t^{1-1/\phi} + \delta \left(E_t \left[V_{t+1}^{1-\gamma}\right]\right)^{1-1/\gamma}\right]^{1-1/\gamma},
\]
(2.15)
where $\delta$ is the rate of time preference, $\gamma$ is the coefficient of risk aversion for timeless gambles, $\psi$ is the EIS under certainty, and $\mathbb{E} \left[ \cdot \right]$ is the conditional expectation given the information up to the end of period $t$. The Euler equation as the first-order condition for the utility maximization problem requires that the equilibrium excess log return $r_{m,t}^e$ satisfies $\mathbb{E} \left[ \tilde{m}_1(\rho) \right] = 0$, where $\tilde{m}_1(\rho) \equiv n^{-1} \sum_{t=1}^{n} m_{1,t}(\rho)$ with

$$m_{1,t}(\rho) \equiv r_{m,t}^e - \gamma \sigma_c^2 + \frac{1}{2} \sigma_c^2 - \frac{1}{2} (2\gamma - \psi^{-1} - 1)(1 - \psi^{-1}) \frac{\phi^2}{(\delta^{-1} - \rho)^2}.$$  \hspace{1cm} (2.16)

We call this the asset pricing moment.

The key insight of the long-run risk model can be clearly seen from (2.16): when $\gamma > 1 > \psi^{-1}$, which implies that the agent has a preference for early resolution of uncertainty and the intertemporal substitution effect dominates the income effect, the equity premium is sizable if the cash flows load on the long-run component (i.e., $\phi$ is positive), the long-run component is persistent (i.e., $\rho$ is close to unity), and the representative agent’s rate of time preference is close to unity (i.e., $\delta$ is close to unity). This insight summarizes the central idea of the parameter calibrations in the works of Bansal and Yaron (2004) and Bansal, Kiku, and Yaron (2012), in which $\phi = 0.034\%$, $\rho = 0.975$, and $\delta = 0.9989$ in the monthly frequency. To ensure that the long-run risk is a meaningful economic mechanism for explaining the sizable equity premium, $\phi/(\delta^{-1} - \rho)$ must be a positive component that is bounded away from zero and from above in order to match the moment of $r_{m,t}^e$. To utilize this insight, we transform $\rho$ to $\theta$ with

$$\theta \equiv \frac{\phi}{\delta^{-1} - \rho} \quad \text{and} \quad \theta \in \Theta \equiv \left\{ \theta \in [\underline{\theta}, \overline{\theta}] \text{ and } \delta^{-1} - \theta^{-1} \phi \in [0, 1) \right\},$$  \hspace{1cm} (2.17)

for some constants $0 < \underline{\theta} < \overline{\theta}$. Our analysis focuses on $\rho < 1, 0 < \delta < 1$, and $\phi > 0$. It allows $\rho$ and $\delta$ to be both arbitrarily close to 1 and $\phi$ to be arbitrarily close to 0, while keeping the ratio between any pair of $\delta^{-1} - 1, 1 - \rho$, and $\phi$ bounded from above and away from zero.

To parameterize all the moments in $\theta$, plugging in $\rho = \delta^{-1} - \theta^{-1} \phi$, we obtain

$$\tilde{g}_0(\theta) \equiv \tilde{m}_0(\delta^{-1} - \theta^{-1} \phi) \quad \text{and} \quad \tilde{g}_1(\theta) \equiv \tilde{m}_1(\delta^{-1} - \theta^{-1} \phi).$$  \hspace{1cm} (2.18)

The Jacobian matrix for the baseline moment conditions is

$$\mathbb{E} \left[ \frac{d}{d\theta} \tilde{g}_0(\theta) \right] = -\phi^2 \left[ (1 + \delta^{-1}) \theta - \phi \right] \left[ 1 + \phi^{-1} (1 - \delta^{-1}) \theta \right] \left[ \delta^{-1} - \theta^{-1} \phi, 1 \right].$$  \hspace{1cm} (2.19)

Thus, the baseline moment restrictions are nearly flat in $\theta$ because

$$\lim_{\phi \rightarrow 0} \mathbb{E} \left[ \frac{d}{d\theta} \tilde{g}_0(\theta) \right] = [0, 0].$$  \hspace{1cm} (2.20)

However, under the reasonable calibrations in the literature (Bansal and Yaron (2004), Beeler and Campbell (2012), Bansal, Kiku, and Yaron (2012)), the preference parameters $\gamma$ and $\psi$ are well above 1, and thus the asset pricing moment condition has the unknown parameter $\theta$ well identified:

$$\lim_{\phi \rightarrow 0} \mathbb{E} \left[ \frac{d}{d\theta} \tilde{g}_1(\theta) \right] = -(2\gamma - \psi^{-1} - 1)(1 - \psi^{-1}) \theta \neq 0.$$  \hspace{1cm} (2.21)
3. CONDITIONAL SPECIFICATION TEST

Let $\Theta \in \mathbb{R}^{d_0}$ denote the parameter space that includes $\theta_0$ as an interior point. We consider the incremental $J$ statistic:

$$
\mathcal{T} \equiv J - J_0,
$$

where $J \equiv \min_{\theta \in \Theta} g(\theta)'(\hat{\Omega}(\theta))^{-1}g(\theta)$ and $J_0 \equiv \min_{\theta \in \Theta} g_0(\theta)'(\hat{\Omega}_0(\theta))^{-1}g_0(\theta),$

(3.1)

with $g_0(\theta) \equiv n^{-1/2}\sum_{t=1}^n g_{0,t}(\theta) \in \mathbb{R}^{k_0}$, $g(\theta) \equiv n^{-1/2}\sum_{t=1}^n g_t(\theta) \in \mathbb{R}^k$, $g_{1}^t(\theta) \equiv [g_{0,t}(\theta)'$, $g_{1,t}(\theta)]'$, $\hat{\Omega}(\theta, \tilde{\theta})$ is an estimator of $\Omega(\theta, \tilde{\theta}) \equiv \lim_{n \to \infty} \text{Cov}(g(\theta), g(\tilde{\theta}))$ for any $\theta, \tilde{\theta} \in \Theta$ and $\hat{\Omega}_0(\theta)$ is the leading $k_0 \times k_0$ submatrix of $\hat{\Omega}(\theta)$. Note that by definition, $g_0(\theta)$ and $g(\theta)$ rescale the sample averages $\bar{g}_0(\theta)$ and $\bar{g}(\theta)$ by $n^{1/2}$, respectively.

If the baseline moments provide strong identification of $\theta_0$, $\mathcal{T} \to_d \chi^2_{k_1}$ and a critical value from this chi-square distribution yields the $C$ test (incremental $J$ test) of Eichenbaum, Hansen, and Singleton (1988). This test is more powerful than the standard over-identification test based on the $J$ statistic because it exploits the validity of the baseline moments. When the baseline moments only provide weak identification, the chi-square distribution is no longer a good approximation for the distribution of $\mathcal{T}$.

We propose an alternative critical value based on the conditional inference approach. Following Andrews and Mikusheva (2016a), we view the rescaled baseline moment function $\mathbb{E}[g_0(\theta)] = n^{1/2}\mathbb{E}[\bar{g}_0(\theta)]$ indexed by $\theta$ as a functional nuisance parameter and obtain a simulation-based critical value by conditioning on a sufficient statistic for $\mathbb{E}[g_0(\theta)]$. Below, we describe the steps of constructing this critical value in detail.

**Step 1.** First, estimate $\theta_0$ by the continuously updated estimator (CUE) as follows:

$$
\hat{\theta} \equiv \arg\min_{\theta \in \Theta} g(\theta)'(\hat{\Omega}(\theta))^{-1}g(\theta).
$$

(3.2)

This estimator is consistent under the null, following the standard arguments (e.g., Newey and Smith (2004)). Second, let $\hat{\Omega}(\hat{\theta}, \tilde{\theta})$ be a consistent estimator of the covariance function $\Omega(\theta, \tilde{\theta})$ for any $\theta, \tilde{\theta} \in \Theta$. Specifically, $\hat{\Omega}(\theta, \tilde{\theta})$ can be a sample analog for i.i.d. data or be a heteroscedasticity and autocorrelation consistent (HAC) estimator for time series data. Given this covariance estimator, compute the test statistic $\mathcal{T}$ following (3.1). Third, let $\hat{\Omega} \equiv \hat{\Omega}(\hat{\theta}, \hat{\theta})$ and $\hat{Q} \equiv \partial \bar{g}(\hat{\theta})/\partial \theta'$.

**Step 2.** Construct a sufficient statistic $m(\tilde{\theta})$ for the rescaled baseline moments $\mathbb{E}[g_0(\theta)]$. To this end, conduct the following decomposition:

$$
g_0(\theta) = m(\theta) + V(\theta)g(\hat{\theta}), \quad \text{where } m(\theta) \equiv g_0(\theta) - V(\theta)g(\hat{\theta})
$$

(3.3)

is the residual process obtained by projecting $g_0(\theta)$ onto $g(\hat{\theta})$, and $V(\theta) = S_0\Omega(\theta, \theta_0)\Omega^{-1}$ is the projection coefficient with $S_0 = [I_{k_0}, \hat{\theta}_{k_0 \times k_1}]$ and $\Omega(\theta, \theta_0)$. Importantly, $m(\theta)$ is orthogonal to $g(\hat{\theta})$ by construction. In practice, we replace the unknown function $V(\theta)$ in the formula above with its estimator $\hat{V}(\theta) \equiv S_0\hat{\Omega}(\theta, \hat{\theta})\hat{\Omega}^{-1}$.

Here is a remark on why the residual process $m(\theta)$ is a sufficient statistic for the functional nuisance parameter $\mathbb{E}[g_0(\theta)]$ under the null hypothesis. Under the null, $g(\hat{\theta})$, the full moment function evaluated at $\hat{\theta}$, is approximately a linear function of $g(\theta_0)$:

$$
g(\hat{\theta}) = \Omega^{1/2}Mv + \epsilon_n, \quad \text{where } v \equiv \Omega^{-1/2}g(\theta_0) \to_d N(0, I_k),
$$

(3.4)
\( M \equiv I_k - \Omega^{-1/2}QQ' \Omega^{-1/2} \) is a projection matrix, and \( \varepsilon_n \) is an error term that is either zero if \( g(\theta) \) is linear in \( \theta \) or negligible asymptotically if \( g(\theta) \) is nonlinear. Because of the asymptotic normality of \( g_\theta(\theta) \) and \( g(\hat{\theta}) \), the residual process \( m(\theta) \) is a Gaussian process independent of \( g(\hat{\theta}) \) asymptotically. Conditioning on \( m(\theta) \), the distribution of \( g(\theta) \) and the test statistic \( T \) do not depend on the functional nuisance parameter \( \mathbb{E}[g(\theta)] \), meaning that \( m(\theta) \) is a sufficient statistic for \( \mathbb{E}[g(\theta)] \). The sufficient statistic \( m(\theta) \) captures the identification information of the baseline moments that is independent of randomness of the full moments in large samples. Intuitively, this is the information of the baseline moments about \( \theta_0 \) decoupled from the underlying content of the asset pricing theory.

**Step 3.** Conditioning on the sufficient statistic \( m(\theta) \) obtained in step 2, we approximate the conditional distribution of the test statistic \( T \) by replacing \( g(\cdot) \) with the decomposition in (3.3) and replacing \( g(\hat{\theta}) \) with its asymptotic approximation \( \Omega^{1/2}Mv \) in (3.4), where \( v \) is drawn from the standard \( k \)-dimensional multivariate normal distribution. Specifically, we define

\[
L(v; d_0) \equiv v'Mv - \min_{\theta \in \theta} [m(\theta) + V(\theta)\Omega^{1/2}Mv] \left( \Omega(\theta) \right)^{-1} [m(\theta) + V(\theta)\Omega^{1/2}Mv],
\]

where \( d_0 \equiv (m(\cdot), \text{vec}(V(\cdot)), \text{vech}(\Omega)^t, \text{vech}(\Omega_0(\cdot))^t, \text{vech}(M)^t) \), and \( \Omega(\theta) \) denotes the leading \( k_0 \times k_0 \) submatrix of \( \Omega(\theta) \). Conditioning on the sufficient statistic \( \theta \), the residual process \( m(\theta) \) is a projection-based subvector inference method with the weakly identified \( \psi \) being tested.

**Step 4.** Let \( \alpha \) be the nominal size of the test and \( b_0 \equiv \lceil (1 - \alpha)B \rceil \) be the smallest integer larger than or equal to \( (1 - \alpha)B \). The critical value \( c_{B,\alpha}(d) \) is the \( b \)-th smallest value among \( \{ T_b' : b = 1, \ldots, B \} \). Reject the null hypothesis in (2.1) if the statistic \( T \) in step 1 is larger than the critical value \( c_{B,\alpha}(\hat{d}) \). This completes the algorithm.

Besides \( \theta \), the moments may also depend on an unknown parameter \( \psi \), which, unlike \( \theta \), cannot be strongly identified by the asset pricing moments. In this case, we can apply the algorithm to the joint hypothesis \( H_0 : \mathbb{E}[\bar{g}_1(\theta_0, \psi_0)] = 0_{k_1 \times 1} \) and \( \psi_0 = \psi_c \), with \( \psi_c \) imposed in all the moments as if it were known. The original null hypothesis \( H_0 : \mathbb{E}[\bar{g}_1(\theta_0, \psi_0)] = 0_{k_1 \times 1} \) is rejected if the joint hypothesis is rejected for all null values \( \psi_c \) in its parameter space. This is a projection-based subvector inference method with the weakly identified nuisance parameter \( \psi \). In practice, we may consider different values \( \psi_c \) in the range of calibrations used in the literature and treat \( \psi_c \) as part of the model’s functional-form specification being tested.

**Monte Carlo Simulation.** Here, we conduct Monte Carlo simulations to compare the finite-sample size and power of the proposed conditional specification test, the \( J \) test, and the \( C \) test in the two motivating examples in Section 2. The models, moments, parameters, and notations are as described in Section 2.

We first conduct a simulation study for the disaster risk model. We generate \( \Delta t_i \) following (2.3) and (2.4), and we generate \( r_t^c \) according to the following data-generating process:

\[
r_t^c = \eta + \gamma \sigma^2 - \frac{1}{2} \sigma^2 - p\mu_1(\alpha) + \frac{p}{\alpha - \gamma} h(\alpha) + \varepsilon_{d,t}^c,
\]
where the error term \( e_{c,i}^c \equiv \sigma_c \varepsilon_i - [x_i(v + J_i) - p\mu_1(\alpha)] + \sigma_d e_{d,i} \), and the functions \( \mu_1(\cdot) \) and \( h(\cdot) \) are defined in (2.5) and (2.7), respectively. Here, \( \varepsilon_i \) is an i.i.d. standard normal variable capturing the measurement error and is independent of the other shocks. Under the null, \( \eta = 0 \), and under the alternative, we consider various values of \( \eta \) to compare the powers. The misspecification term \( \eta \) in (3.6) can be attributed to the missing risk factors or economic mechanisms if expected returns are not driven only by the disaster risk mechanism, and it can also be attributed to misspecified functional forms or restrictive parametric assumptions.

The parameters are set in the yearly frequency, similar to those set by Rietz (1988), Longstaff and Piazzesi (2004), and Wachter (2013), as follows: \( n = 150 \), \( \sigma_c = 2\% \), \( v = 7\% \), \( \gamma = 4 \), \( p = 0.5\% \), and \( \sigma_d = 15\% \). In accordance with the observed equity premium and its sampling uncertainty in the data, we set \( \theta = \rho/(\alpha - \gamma) = 0.0138 \) as the calibrated “true” value in the simulation experiment to match the annual equity premium of 6\%, and we estimate \( \theta \) using the simulated data by searching in the interval \([c, \bar{c}]\), where the bounds \( c \) and \( \bar{c} \) are calibrated to match the annual equity premium of 3\% and 9\%, respectively.

We next conduct a simulation study for the long-run risk model. We generate \( \Delta c_t \) following (2.12) and (2.13), and we generate \( r_t^c \) according to the following data-generating process:

\[
r_t^c = \eta + \gamma \sigma_c^2 - \frac{1}{2} \sigma_c^2 + \frac{1}{2}(2\gamma - \psi^{-1} - 1)(1 - \psi^{-1}) \frac{\phi^2}{(\delta^{-1} - \rho)^2} + e_{c,t}^c,
\]

where the error term \( e_{c,t}^c \equiv \sigma_c \varepsilon_i + (1 - \psi^{-1})(\delta^{-1} - \rho)^{-1}\phi e_{x,t} + \sigma_l e_{l,t} \). Here, \( e_{l,t} \) is an i.i.d. standard normal variable capturing the measurement error and is independent of the other shocks. The misspecification term \( \eta \) in (3.7) has a similar interpretation to that of the disaster risk model example. The parameters are set in the quarterly frequency, close to those set by Bansal, Kiku, and Yaron (2012), as follows: \( n = 500 \), \( \sigma_c = 0.0072 \times \sqrt{3} \), \( \delta = 0.9989^3 \), \( \gamma = 10 \), \( \psi = 1.5 \), \( \rho = 0.975^3 \), and \( \sigma_{\varepsilon} = 7.5\% \). In accordance with the observed equity premium and its sampling uncertainty in the data, we set \( \theta = \delta/(\delta^{-1} - \rho) = 0.0665 \) as the calibrated “true” value in the simulation experiment to match the annual equity premium of 6\%, and we estimate \( \theta \) using the simulated data by searching in the interval \([c, \bar{c}]\), where the bounds \( c \) and \( \bar{c} \) are calibrated to match the annual equity premium of 3\% and 9\%, respectively.

Last, we discuss the simulation results for both examples, which are based on 10,000 simulation repetitions and \( B = 2500 \) random draws for the critical value of the conditional specification test in each repetition. Figure 1 reports the finite-sample rejection probabilities of the proposed conditional specification test, the \( J \) test, and the \( C \) test in the disaster risk model (panel A) and the long-run risk model (panel B). The simulation confirms that (i) the size of the conditional specification test is at the nominal level, (ii) the power of the conditional specification test is higher than that of the \( J \) test, and (iii) the size of the \( C \) test deviates from the nominal level, severely under-rejecting the null hypothesis. In the note on additional materials, we show that these patterns are robust to a wider parameter space of \( \theta \) for both models. It is worth pointing out that the \( C \) test may over-reject for a different data-generating process. Figure 1 demonstrates that the proposed conditional specification test offers substantial improvement over the existing tests for these two prominent macro asset pricing models.

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3See Section SA of the note on additional materials for the derivation of (3.6) and (3.7).
4. THEORETICAL PROPERTIES

4.1. Finite-Sample Size Control in Linear Gaussian Models

For the test statistic and the critical value in the algorithm, there are three types of approximation errors between the finite- and large-sample distributions: (i) the linear approximation error $\epsilon_n$ in (3.4), (ii) the Gaussian approximation error for the distribution of $m(\cdot)$ and $v$, and (iii) the estimation errors in the consistent estimators of $\theta_0$, $\Omega(\cdot, \cdot)$, $V(\cdot)$, and $M$. To abstract from these approximation errors, which all vanish asymptotically under the null, below we first consider a linear Gaussian statistical experiment where all types of errors are exactly zero even in finite samples. Let $v^* \equiv \Omega^{-1/2}\psi(\theta_0)$ and $m^*(\cdot) \equiv \mathbb{E}[g_0(\cdot)] + S_0\psi(\cdot) - V(\cdot)\Omega^{1/2}M\Omega^{-1/2}\psi(\theta_0)$ denote the Gaussian counterparts of $v$ and $m(\cdot)$, respectively, where $\psi(\cdot)$ is a Gaussian process with the covariance function $\Omega(\cdot, \cdot)$. In this linear Gaussian experiment, the test statistic $T$ is exactly $L(v^*; d^*)$, where $d^*$ is the same as $d_0$ except that $m(\cdot)$ in $d_0$ is replaced by $m^*(\cdot)$. Define its conditional $1 - \alpha$ quantile as

$$c^*_\alpha(d^*) \equiv \inf\{c \in \mathbb{R} : P(L(v^*; d^*) > c|d^*) \leq \alpha\},$$

for nominal size $\alpha$, where $P(\cdot|d^*)$ denotes the conditional distribution of $L(v^*; d^*)$ given $d^*$.

**LEMMA 1:** In a linear Gaussian experiment, we have the following results under the null hypothesis:

(i) $m^*(\cdot)$ and $M v^*$ are independent;

(ii) $P(L(v^*; d^*) > c^*_\alpha(d^*)) \leq \alpha$;

(iii) if the conditional distribution of $L(v^*; d^*)$ given $d^*$ is continuous at its $1 - \alpha$ quantile almost surely, the size of the test equals the nominal level: $P(L(v^*; d^*) > c^*_\alpha(d^*)) = \alpha$.

The critical value $c^*_\alpha(d^*)$ can be simulated using the marginal distribution of $v^*$ because of the following three reasons. First, $v^*$ enters $L(v^*; d^*)$ through $M v^*$. Second,
$M^*\nu^*$ and $m^*(\cdot)$ are independent. Finally, $m^*(\cdot)$ is the only random component in $d^*$. In large samples, the simulated critical value $c_{R,a}(\hat{d})$ obtained in step 4 of the algorithm given in Section 3 approximates $c^*_a(d^*)$ with high accuracy when $B$ is a large number.

4.2. Asymptotic Uniform Validity for Nonlinear Models

We first state the assumptions that are used to derive the asymptotic size of the test. Let $P$ denote the distribution of the data $\{Y_t\}_{t=1}^n$. We allow $P$ to change with the sample size $n$ but suppress this dependence for notational simplicity. We also suppress the dependence of $E[\cdot]$ and $\theta_0$ on $P$. Let $P$ denote a family of distributions for which the baseline moments are valid. Let $P_0$ denote a subset of $P$ consistent with the null hypothesis. Both $P$ and $P_0$ are allowed to change with $n$. Let $q(\theta) \equiv \partial \bar{g}(\theta)/\partial \theta'$; then $Q(\theta) = E[q(\theta)]$. For $j = 1, \ldots, d_\theta$, let $Q_j(\theta)$ denote the $j$th column of $Q(\theta)$ and $\theta_j$ denote the $j$th component in $\theta$. Let $\lambda_{\min}(A)$ denote the minimal eigenvalue of a symmetric real matrix $A$, and $\| \cdot \|$ denote the matrix Frobenius norm.

**ASSUMPTION 1:** The following conditions hold uniformly over $P \in P$:

(i) $g(\cdot) - E[g(\cdot)]$ weakly converges to a mean-zero Gaussian process $\psi(\cdot)$ with covariance $\Omega(\cdot, \cdot)$;
(ii) $\sup_{\theta \in \Theta} \|q(\theta) - Q(\theta)\| \to_p 0$ and $Q(\theta)$ is continuous;
(iii) $\sup_{\theta \in \Theta}[\|E[\bar{g}(\theta)]\| + \|Q(\theta)\| + \sum_{j=1}^{d_\theta} \|\partial Q_j(\theta)/\partial \theta'\|] \leq C_\mu$ for some finite constant $C_\mu$.

**ASSUMPTION 2:** The following conditions hold uniformly over $P \in P_0$:

(i) There exists an estimator $\tilde{\Omega}(\cdot, \cdot)$ of $\Omega(\cdot, \cdot)$ such that $\sup_{\tilde{\theta} \in \Theta} \|\tilde{\Omega}(\theta, \tilde{\theta}) - \Omega(\theta, \tilde{\theta})\| = o_P(1)$;
(ii) $\Omega(\theta, \tilde{\theta})$ is continuous uniformly over $(\theta, \tilde{\theta}) \in \Theta \times \Theta$;
(iii) $\sup_{\tilde{\theta} \in \Theta} \|\partial \tilde{\Omega}(\theta, \tilde{\theta})/\partial \theta_j - \partial \Omega(\theta, \tilde{\theta})/\partial \theta_j\| = o_P(1)$ for $j = 1, \ldots, d_\theta$;
(iv) $\sup_{\tilde{\theta} \in \Theta}[\|\tilde{\Omega}(\theta, \tilde{\theta})\| + \sum_{j=1}^{d_\theta} \|\partial \tilde{\Omega}(\theta, \tilde{\theta})/\partial \theta_j\|] \leq C_\Omega$ for some finite constant $C_\Omega$.

**ASSUMPTION 3:** The following conditions hold uniformly over $P \in P_0$:

(i) There exists $\theta_0 \in \Theta$ such that $E[\bar{g}(\theta_0)] = 0_{k \times 1}$;
(ii) for any $\varepsilon > 0$, there exists a constant $\delta_\varepsilon > 0$ such that $\inf_{\tilde{\theta} \in B_\varepsilon(\theta_0)} \|E[\bar{g}(\theta)]\| > \delta_\varepsilon$, where $B_\varepsilon(\theta) \equiv \{\tilde{\theta} \in \Theta : \|\tilde{\theta} - \theta\| > \varepsilon\}$;
(iii) $\lambda_{\min}(Q'Q) \geq c_\lambda$ and $\inf_{\theta \in \Theta} \lambda_{\min}(\Omega(\theta)) \geq c_\lambda$ for some positive constant $c_\lambda$.

Assumption 1(i) requires that the moment is well approximated by a Gaussian limit. Its verification relies on a uniform central limit theorem, as discussed by Andrews and Mikusheva (2016a). Assumption 1(ii) follows from the uniform law of large numbers. Assumption 1(iii) imposes standard regularity conditions on uniformly bounded moment functions and their derivatives.

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6In our long-run risk example, the assumption of Gaussian approximation is innocuous even if the root of the latent autoregressive process could be arbitrarily close to unity, different from the classical near unit root analysis (e.g., Phillips (1987), Mikusheva (2007)). In this example, the stationary component always dominates the latent non-stationary component because the loading on the latent process $\phi$ shrinks to 0 proportionally as $1 - \rho$ shrinks to 0 (see Section B of the note on additional materials for details). In the disaster risk model, Assumption 1(i) holds with a non-singular covariance matrix even though the disaster occurs with a small probability because the variance of the normally distributed regular shock dominates that of the disaster shock.
Assumptions 2(i) and 2(iii) require that we have uniformly consistent estimators of the covariance function \( \Omega(\cdot, \cdot) \) and its partial derivatives. Uniform consistency can be obtained by strengthening a pointwise consistent covariance matrix estimator with standard smoothness conditions. Assumptions 2(ii) and 2(iv) impose continuity and uniform upper bounds on the covariance function \( \Omega(\cdot, \cdot) \) and its partial derivatives. Both Assumptions 1 and 2 are imposed on \( P \), not only on \( P_0 \), because they are useful for both the size and power analyses of the proposed conditional test.

Assumption 3 is used to show consistency and asymptotic normality of \( \hat{\theta} \) under the null hypothesis. Assumptions 3(i) and 3(ii) provide the identification uniqueness condition of the unknown parameter \( \theta_0 \) using all valid moments under the null hypothesis. Assumption 3(iii) includes standard full rank conditions for the Jacobian matrix and the covariance matrix of the full moments \( \bar{g}(\theta) \).

Let \( \hat{d} \) be the analog of \( d \), with \( m(\cdot), V(\cdot), \Omega, \Omega(\cdot, \cdot), \) and \( M \) all replaced by their consistent estimators, as in the practical algorithm. Given \( \hat{d} \), we simulate independent draws \( v^* \sim N(0, I_k) \) and obtain the critical value

\[
c_a(\hat{d}) \equiv \inf \{ c \in \mathbb{R} : P^*(v^* : L(v^* ; \hat{d}) > c) \leq \alpha \},
\]

where \( P^*(\cdot) \) denotes the distribution of \( v^* \).

**Theorem 1:** Suppose Assumptions 1, 2, and 3 hold. The test has correct asymptotic size, in the sense that, for any \( \varepsilon > 0 \),

\[
\limsup_{n \to \infty} \sup_{P \in \mathcal{P}_0} \mathbb{P}(T > c_a(\hat{d}) + \varepsilon) \leq \alpha.
\]

Theorem 1 implies that the conditional specification test controls the asymptotic size no matter whether the unknown parameter \( \theta_0 \) (or its subvector) is strongly identified, weakly identified, or not identified by the baseline moments \( \mathbb{E}[\bar{g}_0(\theta_0)] = 0_{k_0 \times 1}. \)

Next, we consider the behavior of the test statistic \( T \) and the conditional critical value \( c_a(\hat{d}) \) when \( \mathbb{E}[\bar{g}_0(\theta_0)] = 0_{k_0 \times 1} \) strongly identifies \( \theta_0 \).

**Assumption 4:** The following conditions hold uniformly over \( P \in \mathcal{P}_{00} \subset \mathcal{P} \): (i) for any \( \varepsilon > 0 \), there exists a constant \( \delta_\varepsilon > 0 \) such that \( \inf_{\theta \in B(\theta_0)} \mathbb{E}[\bar{g}_0(\theta)] > \delta_\varepsilon \); and (ii) \( \lambda_{\min}(Q_0, Q_0) \geq c_\lambda \) where \( Q_0 \equiv \mathbb{E}[\partial \bar{g}_0(\theta) / \partial \theta^\prime] \).

Assumption 4 is similar to Assumption 3 and is imposed on \( \mathbb{E}[g_\varepsilon(\theta)] \) for the strong identification of \( \theta_0 \) using all moments. This assumption is needed to show that the test statistic \( T \) converges to a chi-square distribution and the critical value \( c_a(\hat{d}) \) converges to the \( 1 - \alpha \) quantile of this chi-square distribution under strong identification.

**Theorem 2:** Suppose Assumptions 1, 2, 3, and 4 hold. The following results hold uniformly over \( \mathcal{P}_0 \cap \mathcal{P}_{00} \): (i) \( T \to_d \chi^2_{k_1} \); and (ii) \( c_a(\hat{d}) \to_p q_{1-\alpha}(\chi^2_{k_1}) \), where \( q_{1-\alpha}(\chi^2_{k_1}) \) denotes the \( 1 - \alpha \) quantile of a \( \chi^2_{k_1} \) distribution.

\(^7\)Under additional regularity conditions on the continuity of the distribution function of the test statistic and the critical value, the test is also asymptotically similar, as discussed in Andrews and Mikusheva (2016a); see, for example, Andrews, Cheng, and Guggenberger (2020) for discussions on asymptotic similarity.
Theorem 2 shows that the conditional specification test is equivalent to the $C$ test under the null when the baseline moments $\mathbb{E}[\bar{g}_0(\theta_0)] = 0_{k_0 \times 1}$ provide strong identification of $\theta_0$.

If the baseline moment conditions $\mathbb{E}[\bar{g}_0(\theta_0)] = 0_{k_0 \times 1}$ only depend on a subvector $\theta_{c,0}$ of $\theta_0$ with dimension $d_c$ and strongly identify $\theta_{c,0}$, arguments analogous to those used to prove Theorem 2 also give

$$T \rightarrow d \chi^2_{k_1+d_c-d_\theta} \quad \text{and} \quad c_a(d) \rightarrow_p q_{1-a}(\chi^2_{k_1+d_c-d_\theta})$$

uniformly over $\mathcal{P}_0 \cap \mathcal{P}_{00}$. In this case, $k_1 \geq d_\theta - d_c$ in (4.3) because the asset pricing moments of dimension $k_1$ must strongly identify all the parameters not in the baseline moments.

In the presence of some additional parameter $\psi$ that is only weakly identified by the asset pricing moments, we can test the joint hypothesis $H_0 : \mathbb{E}[\bar{g}_1(\theta_0, \psi_0)] = 0_{k_1 \times 1}$ and $\psi_0 = \psi_c$ for some null value $\psi_c$ as discussed in Section 3. As long as Assumptions 1 to 4 hold with $\psi_0$ fixed at $\psi_c$, the results of Theorems 1 and 2 apply to the joint test. The projection-based subvector test $H_0 : \mathbb{E}[\bar{g}_1(\theta_0, \psi_0)] = 0_{k_1 \times 1}$ also has correct asymptotic size. Since the projection-based test could be conservative, more efficient subvector tests are desirable. Developing more efficient subvector tests for the present problem is beyond the scope of this paper.

In the Supplemental Material (Cheng, Dou, and Liao (2022)), we investigate the power of the conditional specification test. We prove that (i) the test is consistent when the asset pricing moments are globally misspecified regardless of the identification strength in the baseline moments, and (ii) the conditional test shares the power optimality of the $C$ test in standard scenarios where the baseline moments provide strong identification. The optimal test in the presence of weakly identified baseline moments is beyond the scope of the paper. However, the literature has provided several encouraging power results for various conditional tests against the null hypothesis $H_0 : \theta = \theta_0$ (e.g., Andrews, Moreira, and Stock (2006), Andrews and Mikusheva (2016a, forthcoming)) and we expect the conditional specification test to inherit these good properties. One may also apply the generic methods of Elliott, Müller, and Watson (2015) to evaluate the efficiency of an ad hoc test with correct size. In the Supplemental Material, we derive some power envelopes in a Gaussian experiment as in Section 4.1 based on the observations of $g(\hat{\theta})$, under various restrictions on the alternative and the test. These power envelopes are akin to those in Section 3.4 of Andrews and Mikusheva (2016a). Simulation studies in the Supplemental Material show that the power of the conditional specification test is close to that of the infeasible uniformly most powerful unbiased test in many cases, particularly when the number of baseline moments is large or when the baseline moments are strongly correlated with the asset pricing moments.

5. EMPIRICAL APPLICATION

In this section, we consider a full-blown time-varying rare-disaster risk model similar to that of Wachter (2013), a significant extension of the static rare-disaster risk model in Section 2. The model is extended in a few crucial aspects: (i) the probability of rare disasters is time varying; (ii) the representative agent has a recursive Epstein–Zin–Weil preference;

8See, for example, Guggenberger, Kleibergen, Mavroeidis, and Chen (2012), Andrews and Mikusheva (2016b), Guggenberger, Kleibergen, and Mavroeidis (2019), Kleibergen (2021) for recent research along this line.
(iii) the government bill is defaultable; and (iv) the corporate dividend is modeled as the levered consumption. The model is able to generate a sizable equity premium, a low interest rate, a high volatility of equity returns, a low volatility of government bill returns, and predictable excess equity returns in different prediction horizons, without generating excessive volatility for the aggregate consumption and dividend.

We consider the time-varying disaster risk model for a real-data application because it has been one of the most influential macro-finance frameworks in the literature. For instance, the time-varying disaster risk mechanism has been used to explain important empirical patterns in macroeconomic quantities (e.g., Gourio (2012)), exchange rates and international capital flows (e.g., Martin (2013), Dou and Verdelhan (2017), Lewis and Liu (2017)), volatile unemployment flows (e.g., Kilic and Wachter (2018)), and prices of derivatives (e.g., Gabaix (2012)).

**Model.** We first describe the model. The log growth rate of consumption, $\Delta c_t \equiv \ln(C_t/C_{t-1})$, evolves as follows:

$$\Delta c_t = g_c + \sigma_c \varepsilon_{c,t} - \zeta_t,$$  

(5.1)

where $C_t$ is real consumption per capita at time $t$, $\zeta_t$ is the disaster variable, $g_c$ is the average growth rate conditional on no disaster in the next period (i.e., $\zeta_t = 0$), and $\varepsilon_{c,t}$ is the normal consumption shock that follows a standard Gaussian distribution. The disaster variable $\zeta_t$ is characterized by

$$\zeta_t = x_t (v + J_t),$$  

(5.2)

where the constant $v$ is the lower bound of the disaster size, the variable $J_t \sim \text{Exp}(\alpha)$ captures the disaster shock, and the variable $x_t = x_t^+ - x_t^-$ captures the occurrence of a jump, with $x_t^+$ to be a Bernoulli variable capturing the occurrence of a rare disaster with probability $\max(p_{t-1}, 0)$ and $x_t^-$ to be a Bernoulli variable capturing the occurrence of a rare boom with probability $\max(-p_{t-1}, 0)$. Under the definition of $x_t$, the expectation of $x_t$ is $p_{t-1}$ conditioning on the information up to the end of period $t$. This jump probability index $p_{t-1}$ evolves according to an AR(1) process:

$$\hat{p}_t = (1 - \rho) + \rho \hat{p}_{t-1} + \sigma_p \varepsilon_{p,t}, \quad \text{with } \hat{p}_{t-1} \equiv p_{t-1}/p, \text{ and } \rho, p \in (0, 1).$$  

(5.3)

Here, the shock $\varepsilon_{p,t}$ follows a standard Gaussian distribution. Thus, $x_t$ follows a hidden Markovian process with the latent state variable $p_{t-1}$. The evolution in (5.3) says that the long-term average jump probability is $p$ and the unconditional standard deviation of jump probability is $p \sqrt{\sigma_p^2/(1 - \rho^2)}$. Similar in spirit to our specification of (5.3), Gourio (2012) assumed that the log transformation of the normalized jump probability index $\hat{p}_{t-1} = p_{t-1}/p$ evolves as an AR(1) process.\(^9\)

We model the real dividend per capita $D_t$ as the levered consumption with the log dividend growth $\Delta d_t \equiv \ln(D_t/D_{t-1})$ evolving as follows:

$$\Delta d_t = g_d + \phi \sigma_c \varepsilon_{c,t} - \phi \zeta_t,$$  

(5.4)

\(^9\)The value of $p_{t-1}$ can go outside the interval $[-1, 1]$ with a negligible chance under the relevant calibrations. A similar situation was encountered by Gourio (2012). We set this jump probability $p_{t-1}$ to the nearest boundary once it goes outside $[-1, 1]$. We stick to the literature by assuming Gaussian shocks in (5.3) to ensure the (approximate) exponential-affine solution, summarized in (5.7)–(5.10).
similar in spirit to the works of Abel (1999) and Campbell (2003). Here, the constant $g_d$ is the average growth rate conditional on no disaster in the next period (i.e., $\zeta_t = 0$). The shocks $(e_{c,t}, e_{p,t}, J_t)$ are mutually independent with each other and i.i.d. over $t$. The Bernoulli variables $(x^+_t, x^-_t)$ are independent of the contemporaneous jump probability shock $e_{p,t}$ and its leads in the time series, but $(x^+_t, x^-_t)$ and the lags of $e_{p,t}$ are dependent through the jump probability index $p_{t-1}$. The two processes $(x^+_t, x^-_t)$ and $(e_{c,t}, J_t)$ are mutually independent.

Consider the government bill with a one-period maturity. Like in the works of Barro (2006) and Wachter (2013), we assume that the government bill may default only when a disaster occurs. The return on the defaultable government bill can be expressed as

$$r_{b,t} = y_{b,t-1} - x_{b,t}(v + J_t),$$

(5.5)

where the variable $y_{b,t-1}$ is the yield of the government bill, and the Bernoulli variable $x_{b,t} \in \{0, 1\}$ characterizes the occurrence of a government bill default. The yield $y_{b,t-1}$ is observable in the data. The government bill defaults in period $t$ if and only if $x_{b,t} = 1$. We assume that, in the event of disaster ($x_t = 1$), there will be a default on government liabilities with probability $q$. That is, $P(x_{b,t} = 1|x_t = 0$ or $x_t = -1) = 0$ and $P(x_{b,t} = 1|x_t = 1) = q$. As reflected in (5.5), we follow Barro (2006) and Wachter (2013) in assuming that the percentage loss of the government bill is equal to the percentage decline in consumption in the event of default.

The representative agent has recursive preferences with unit EIS, and maximizes her utility $V_t$ as follows:

$$\ln V_t = (1 - \delta) \ln C_t + \delta(1 - \gamma)^{-1} \ln E_t[V_{t+1}^{1-\gamma}],$$

(5.6)

where $\delta$ is the rate of time preference, and $\gamma$ is the coefficient of risk aversion for timeless gambles.

**Equilibrium.** We solve the model using the Campbell–Shiller log-linearization approximation around the steady state, where $p_{t-1}$ is close to $p > 0$. The equilibrium log return of the government bill, denoted by $r_{b,t}$, is

$$r_{b,t} - E_{t-1}[r_{b,t}] = -[x_{b,t}(v + J_t) - q p_{t-1} \mu_1(\alpha)],$$

with $E_{t-1}[r_{b,t}] = \omega_1(\vartheta) - q \mu_1(\alpha)(p_{t-1} - p) - (1 - q) h_1(\alpha, \gamma) \frac{p_{t-1} - p}{\alpha - \gamma}$.

(5.7)

where $\mu_1(\alpha)$ and $\omega_1(\vartheta)$ are defined in (2.5) and (5.13), and $h_1(\alpha, \gamma) \equiv \alpha[e_{\vartheta}^{\gamma} - e_{\vartheta}^{\gamma-1}]a_{\alpha - \gamma+1}^a$.

The equilibrium excess log return of the equity over the government bill, denoted by $r^e_{m,t}$, is

$$r^e_{m,t} - E_{t-1}[r^e_{m,t}] = \phi \sigma_c e_{c,t} + \beta p \sigma_p e_{p,t} - [(\phi x_t - x_{b,t})(v + J_t) - (\phi - q) p_{t-1} \mu_1(\alpha)],$$

with $E_{t-1}[r^e_{m,t}] = \omega_3(\vartheta) + h_3(\alpha, \gamma) \frac{p_{t-1} - p}{\alpha - \gamma}$.

(5.8)
where \( \beta_p \equiv \rho^\delta \prod_{i=0}^{\delta} h_2(\alpha, \gamma) \) with \( \tilde{\delta} \equiv \delta e^{g_d-g_c} \) and \( \lambda_p \equiv -\frac{\rho}{\delta^i-\rho} [e^{\Delta negatively one} - \frac{\alpha}{\alpha-\gamma+1}] \), and \( \omega_3(\vartheta) \) is defined in (5.13). Here, \( h_2(\alpha, \gamma) \) and \( h_3(\alpha, \gamma) \) are defined as follows:

\[
h_2(\alpha, \gamma) \equiv \alpha \left[ e^{\tilde{\gamma} - \vartheta} \frac{1}{\alpha - \gamma + \vartheta} - e^{\gamma - 1} \frac{1}{\alpha - \gamma + 1} \right],
\]

\[
h_3(\alpha, \gamma) \equiv \alpha \left[ (1 - q)e^{\tilde{\gamma} - \vartheta} - \frac{\alpha - \gamma}{\alpha - \gamma + \vartheta} + qe^{\gamma - 1} \frac{\alpha - \gamma}{\alpha - \gamma + 1} \right] - (\alpha - \gamma)(\vartheta - q)\mu_1(\alpha).
\]

The equilibrium log price-dividend ratio, denoted by \( z_{m,t} \), is

\[
z_{m,t} = z_m + h_2(\alpha, \gamma) \frac{p_t - p}{1 - \rho \tilde{\delta}}, \quad \text{where} \quad z_m \equiv \ln \left[ \frac{\tilde{\delta}}{1 - \tilde{\delta}} \right]. \tag{5.10}
\]

Here, \( z_m \) is the long-run average log price-dividend ratio. To ensure the existence of the equilibrium, we require that \( \tilde{\delta} < 1 \). As done by Barro (2009), we interpret \( \tilde{\delta} \) as the effective rate of time preference of the representative agent and require the effective rate of time preference to be less than 1. The detailed derivation of the equilibrium is relegated to the note on additional materials.

**Moments.** We consider a set of baseline moment conditions that summarize the key dynamic features of \( \Delta c_t \) and \( \Delta d_t \) specified in equations (5.1)–(5.4) as follows: \( \mathbb{E}[\tilde{m}_0(\vartheta)] = 0_{8 \times 1} \), where \( \tilde{m}_0(\vartheta) = n^{-1} \sum_{t=1}^{n} m_{0,t}(\vartheta) \) with

\[
m_{0,t}(\vartheta) \equiv \begin{bmatrix}
(\Delta c_t - g_c) + p\mu_1(\alpha) \\
(\Delta d_t - g_d) + \varphi p\mu_1(\alpha) \\
(\Delta c_t - g_c)^2 - \sigma_1^2 - p\varphi_1^2 \mu_2(\alpha) \\
(\Delta d_t - g_d)^2 - \varphi^2 \sigma_1^2 - p\varphi^2 \mu_2(\alpha) \\
\Delta c_{t+1} - \rho \Delta c_t + (1 - \rho)(p\mu_1(\alpha) - g_c) \\
\Delta d_{t+1} - \rho \Delta d_t + (1 - \rho)(\varphi p\mu_1(\alpha) - g_d) \\
\Delta c_{t+1} - \rho \Delta c_t + (1 - \rho)(p\mu_1(\alpha) - g_c) \\
\Delta d_{t+1} - \rho \Delta d_t + (1 - \rho)(\varphi p\mu_1(\alpha) - g_d)
\end{bmatrix}, \tag{5.11}
\]

where \( \mu_1(\alpha) \) is defined in (2.5). The baseline moments depend on \( (\alpha, \rho) \), but not on \( (\sigma_1^2, \gamma) \).

We next consider the six asset pricing moment conditions targeted by Wachter (2013). The asset pricing moment conditions are \( \mathbb{E}[\tilde{m}_1(\vartheta)] = 0_{6 \times 1} \), where \( \tilde{m}_1(\vartheta) = n^{-1} \sum_{t=1}^{n} m_{1,t}(\vartheta) \) with

\[
m_{1,t}(\vartheta) \equiv \begin{bmatrix}
\vartheta_1(\vartheta) \\
[\vartheta_1(\vartheta)]^2 - \vartheta_2(\vartheta) \\
[\vartheta_1(\vartheta)]^2 - \vartheta_3(\vartheta) \\
[\vartheta_1(\vartheta)]^2 - \vartheta_4(\vartheta) \\
[\vartheta_1(\vartheta)]^2 - \vartheta_5(\vartheta)(z_{m,t-1} - z_m - \vartheta_3(\vartheta)) \\
[\vartheta_1(\vartheta)]^2 - \vartheta_6(\vartheta)(z_{m,t-1} - z_m - \vartheta_3(\vartheta))
\end{bmatrix}, \tag{5.12}
\]
and the deterministic functions $\omega_i(\vartheta)$ are described in detail as follows:

$$
\omega_1(\vartheta) \equiv -\ln \delta + g_c - \frac{1}{2}(2\gamma - 1)\sigma_c^2 - q p \mu_1(\alpha) - (1 - q) h_1(\alpha, \gamma) \frac{p}{\alpha - \gamma},
$$

$$
\omega_2(\vartheta) \equiv q p \mu_2(\alpha) - q^2 p^2 \mu_1(\alpha)^2 + \left[2 q p \mu_1(\alpha) + (1 - q) h_1(\alpha, \gamma) \frac{p}{\alpha - \gamma}\right] \frac{(1 - q) h_1(\alpha, \gamma) \sigma_p^2 p}{(1 - \rho^2)(\alpha - \gamma)},
$$

$$
\omega_3(\vartheta) \equiv \phi \gamma \sigma_c^2 + \beta_p \lambda_p \sigma_p^2 - \frac{1}{2}(\phi^2 \sigma_c^2 + \beta_p^2 \sigma_p^2) + h_3(\alpha, \gamma) \frac{p}{\alpha - \gamma},
$$

$$
\omega_4(\vartheta) \equiv \phi^2 \sigma_c^2 + \beta_p^2 \sigma_p^2 + (q - 2 \phi q + \phi^2) p \mu_2(\alpha) - (q - \phi)^2 \mu_1(\alpha)^2 \left(p^2 + \frac{\sigma_p^2}{1 - \rho^2}\right) \frac{h_3(\alpha, \gamma) \sigma_p^2 p^2}{(1 - \rho^2)(\alpha - \gamma)^2},
$$

$$
\omega_5(\vartheta) \equiv \frac{(1 - \rho \delta)}{\alpha - \gamma} h_5(\alpha, \gamma)^{-1} h_3(\alpha, \gamma), \quad \text{and} \quad \omega_6(\vartheta) \equiv \rho \omega_5(\vartheta).
$$

The first two moments are about the low mean and low volatility of government bill returns, the third and fourth moments are about the high mean and high volatility of excess equity returns, and the last two moments are about the one- and two-period-ahead predictability of excess equity returns using lagged log price-dividend ratios. As demonstrated in many studies (e.g., Keim and Stambaugh (1986), Campbell and Shiller (1988)), high price-dividend ratios predict low excess returns across various horizons. Importantly, Campbell and Yogo (2006) showed that conventional tests of the predictability of stock returns can be invalid and lack power when the predictor variable is persistent and its innovations are highly correlated with returns.

We assume that the econometrician knows all parameters except $\vartheta = (\alpha, \rho, \sigma_p^2, \gamma)$, which governs the dynamics of time-varying rare-disaster risk and the agent’s risk aversion. Other parameters ($g_c, g_d, \sigma_c^2, \phi, \psi, \rho, q, \delta$) are externally calibrated, and the key asset pricing implications are not sensitive to the local perturbations in these parameters (see Wachter (2013), Chen, Dou, and Kogan (forthcoming) for sensitivity analysis). Specifically, we set $g_c = g_d = 0.02, \sigma_c^2 = 0.02^2, \phi = 3.5, \psi = 0.07, q = 0.4$, and $\delta = 0.97$, which lie within the ballpark of the calibrations used in the literature (e.g., Bansal and Yaron (2004), Longstaff and Piazzesi (2004), Wachter (2013)). We consider multiple values of $p \in \{0.3\%, 0.5\%, 0.7\%, 0.9\%, 1.1\%\}$ to focus on rare disasters following the calibrations adopted by Rietz (1988) and Longstaff and Piazzesi (2004), which are consistent with the structural estimation result from the observed equity index option prices in Backus, Chernov, and Martin (2011). The calibrated parameter values are effectively part of the functional form of the model under the examination of the specification tests, similar to those in Julliard and Ghosh (2012) who tested the rare events hypothesis using the generalized empirical likelihood methods.

**Reparameterization.** The asset pricing moments in (5.12) clearly demonstrate the key idea of the time-varying disaster risk model to simultaneously explain the sizable equity risk premium and high equity volatility: when $p, \alpha - \gamma, \sigma_p^2$, and $1 - \rho^2$ are all close to 0, the rare yet severe disaster can generate a substantial equity premium and large equity

\[ \text{returns can be invalid and lack power when the predictor variable is persistent and its innovations are highly correlated with returns.} \]

\[ \text{We assume that the econometrician knows all parameters except } \vartheta = (\alpha, \rho, \sigma_p^2, \gamma) \text{, which governs the dynamics of time-varying rare-disaster risk and the agent’s risk aversion.} \]

\[ \text{Other parameters } (g_c, g_d, \sigma_c^2, \phi, \psi, \rho, q, \delta) \text{ are externally calibrated, and the key asset pricing implications are not sensitive to the local perturbations in these parameters (see Wachter (2013), Chen, Dou, and Kogan (forthcoming) for sensitivity analysis).} \]

\[ \text{Specifically, we set } g_c = g_d = 0.02, \sigma_c^2 = 0.02^2, \phi = 3.5, \psi = 0.07, q = 0.4, \text{ and } \delta = 0.97, \text{ which lie within the ballpark of the calibrations used in the literature (e.g., Bansal and Yaron (2004), Longstaff and Piazzesi (2004), Wachter (2013)).} \]

\[ \text{We consider multiple values of } p \in \{0.3\%, 0.5\%, 0.7\%, 0.9\%, 1.1\%\} \text{ to focus on rare disasters following the calibrations adopted by Rietz (1988) and Longstaff and Piazzesi (2004), which are consistent with the structural estimation result from the observed equity index option prices in Backus, Chernov, and Martin (2011).} \]

\[ \text{The calibrated parameter values are effectively part of the functional form of the model under the examination of the specification tests, similar to those in Julliard and Ghosh (2012) who tested the rare events hypothesis using the generalized empirical likelihood methods.} \]
volatility as long as the two ratios \( \frac{\rho}{\alpha - \gamma} \) and \( \frac{\sigma_p^2}{1 - \rho^2} \) are sizable to match the equity premium and the volatility of equity excess returns. This ensures that the time-varying disaster risk is a meaningful economic mechanism for explaining the equity premium and volatility even if \( p \) is very small. To utilize this key insight, we transform the parameters \( \alpha \) and \( \rho \) to \( \theta_1 \) and \( \theta_2 \), respectively, with

\[
\begin{align*}
\theta_1 &\equiv \frac{p}{\alpha - \gamma}, & \theta_2 &\equiv \frac{\sigma_p^2}{1 - \rho^2}, & \theta_3 &\equiv \rho, & \text{and} & \theta_4 &\equiv \gamma,
\end{align*}
\]

(5.14)

with the stacked parameter vector \( \theta \in \Theta \equiv \prod_{i=1}^{4} \Theta_i \). Our analysis allows \( p, \alpha - \gamma, \sigma_p^2, \) and \( 1 - \rho^2 \) to be all close to 0, while keeping the ratios \( \theta_1 \) and \( \theta_2 \) bounded from above and below. We refer to \( \theta_1 \) and \( \theta_2 \) as the adjusted disaster size parameter and the adjusted disaster probability volatility parameter, respectively. To reparameterize all the moments from \( \theta \) into \( \bar{\theta} \), write

\[
\bar{g}_i(\theta) \equiv \bar{m}_i(\theta_1^{-1} p + \theta_4, \theta_2(1 - \theta_3^2), \theta_3, \theta_4), \quad \text{with} \ i \in \{0, 1\}.
\]

(5.15)

The asset pricing moments provide an intuitive identification structure of \( \theta \). The first and third moments on the average of (excess) returns mainly identify the adjusted disaster size parameter \( \theta_1 \). The second and fourth moments on the variance of (excess) returns mainly identify the adjusted disaster probability volatility parameter \( \theta_2 \) and the risk aversion parameter \( \theta_4 \). The last two moments on the predictability of excess equity returns identify the persistence parameter of time-varying disaster probability \( \theta_3 \).

**U.S. Data, Robust Evaluations, and Model Uncertainty Sets.** Based on the annual U.S. data of consumptions, dividends, government bill returns, equity returns, and log price-dividend ratios, we compare the \( J \) test and the proposed conditional specification test, then contrast the model uncertainty sets constructed based on the two specification tests.


Table I presents the results on the \( J \) test, the proposed conditional specification test, and the point estimation.\(^{10}\) In the benchmark calibration with \( p = 0.7\% \), the time-varying

\(^{10}\) For the results reported in Table I, we set \( \Theta_1 \equiv [0.001, 0.020], \Theta_2 \equiv [5, 12], \Theta_3 \equiv [0.950, 0.999], \) and \( \Theta_4 \equiv [3, 6], \) and conduct parameter estimation by grid search with the step size 0.001, 0.01, 0.001, and 0.01, respectively. For the results reported in Figure 2, which is more computationally intensive, we consider a smaller parameter space \( \Theta_1 \equiv [5, 8], \) which still covers the CUE estimator of \( \theta_2 \) in all of the relevant cases considered in Figure 2, a larger step size 0.1 of the grid points in \( \Theta_1 \) and \( \Theta_3 \), and maintain the rest of the parameter space specification. For a summary of the empirical implementation details, see Section SF of the Supplemental Material.
The proposed conditional specification test can improve the test power by efficiently utilizing the limited information of the baseline moment conditions, with the $p$-value dropping substantially from 0.434 to 0.102. Yet, it is interesting and reassuring to see that the time-varying rare-disaster risk model remains statistically consistent with the U.S. data at the 5% level, even under the stringent and robust examination of the proposed conditional specification test. When increasing (or decreasing) the long-run average disaster probability $p$ from 0.7% to 0.9% (or 0.5%), the test and estimation results remain nearly unchanged. By contrast, when disasters occur very rarely with $p = 0.3$% (or fairly frequently with $p = 1.1$%), the time-varying rare-disaster risk model is statistically rejected at the 5% level by the proposed conditional specification test based on the U.S. data with a $p$-value of 0.012 (or a $p$-value of 0.030), although it is still largely accepted according to the $J$ test with a $p$-value of 0.120 (or a $p$-value of 0.254). This result manifests the importance of robust procedures in evaluating macro asset pricing models, and our econometric analysis here addresses the irrebutability concern of economic mechanisms relying on extremely rare disasters (e.g., Campbell (2018), Chen, Dou, and Kogan (forthcoming)). Moreover, this result also echoes the quantitative study of Wachter (2013), showing that, unless conditioning on no disaster (i.e., the U.S. has been very lucky over the past centuries), the simulated data based on a time-varying disaster risk model with a fairly high disaster probability have a difficult time simultaneously matching all the baseline and asset pricing moment conditions in (5.11) and (5.12). Last but not least, our econometric analysis in Table I shows that the time-varying rare-disaster risk models indeed provide a potential explanation for the prominent asset pricing puzzles because, for each of the three non-rejected cases, the estimated risk aversion parameter $\gamma$ is less than 10, the upper bound of the “reasonable” range for $\gamma$ in the macroeconomics and asset pricing literature (e.g., Campbell (2003)). There has been little formal econometric analysis on (time-varying) rare-disaster risk mechanisms in the asset pricing literature. As a contribution, the test and estimation results in Table I fill this gap.

Figure 2 shows that the robust specification test can serve as a powerful tool for constructing the model uncertainty sets. The model uncertainty set consists of the moment misspecification parameter $\eta$ such that $H_0: \mathbb{E}[\hat{g}_1(\theta_0)] = \eta$ cannot be rejected by a given specification test, with the asset pricing moments $\hat{g}_1(\theta)$ defined in (5.15). In fact, the specification tests in Table I correspond to the null of $\eta = 0$. Similar to the intuitive interpreta-
FIGURE 2.—Joint model uncertainty sets based on the time-varying rare-disaster risk model. Note: Panel A plots the joint model uncertainty set for the average return of government bills ($\eta_1$) and the equity premium ($\eta_3$) by focusing on $\eta = [\eta_1, 0, \eta_3, 0, 0, 0]^\prime$. Panel B plots the joint model uncertainty set for the volatility of excess equity return ($\eta_4$) and the equity premium ($\eta_3$) by focusing on $\eta = [0, 0, \eta_3, \eta_4, 0, 0]^\prime$. Panels C and D are analogous to panels A and B, respectively, except that each uncertainty set is the union of those obtained under $p = 0.5\%, 0.7\%, 0.9\%$. The bigger “nearly-ellipse-shaped” areas are the joint model uncertainty sets constructed using the $J$ test, while the smaller darker “nearly-ellipse-shaped” areas are those constructed using the proposed conditional specification test. All the sets are calculated under the 95% confidence level. We focus on these two joint model uncertainty sets because interest rates, excess equity returns, and equity return volatilities are the most important quantities in macro asset pricing theories.

FIGURE 2.—Joint model uncertainty sets based on the time-varying rare-disaster risk model. Note: Panel A plots the joint model uncertainty set for the average return of government bills ($\eta_1$) and the equity premium ($\eta_3$) by focusing on $\eta = [\eta_1, 0, \eta_3, 0, 0, 0]^\prime$. Panel B plots the joint model uncertainty set for the volatility of excess equity return ($\eta_4$) and the equity premium ($\eta_3$) by focusing on $\eta = [0, 0, \eta_3, \eta_4, 0, 0]^\prime$. Panels C and D are analogous to panels A and B, respectively, except that each uncertainty set is the union of those obtained under $p = 0.5\%, 0.7\%, 0.9\%$. The bigger “nearly-ellipse-shaped” areas are the joint model uncertainty sets constructed using the $J$ test, while the smaller darker “nearly-ellipse-shaped” areas are those constructed using the proposed conditional specification test. All the sets are calculated under the 95% confidence level. We focus on these two joint model uncertainty sets because interest rates, excess equity returns, and equity return volatilities are the most important quantities in macro asset pricing theories.

For computational feasibility and economic interpretability, Figure 2 reports pairwise joint model uncertainty sets where only two elements of the vector $\eta$ deviate from 0 for each model uncertainty set construction. Panel A shows that the joint model uncertainty set shrinks substantially when using the proposed conditional specification test. Specifically, the model uncertainty set shrinks by about 2 and 4 percentage points along the dimensions of the average government bill return and the equity risk premium, respectively, which are comparable to the average interest rate and equity premium themselves in the data. Moreover, panel B shows that the model uncertainty set shrinks by about 3 percentage points along the dimension of the variance of equity excess returns, and the magnitude of the change is comparable to that of the variance of equity excess return itself in the data. In terms of the volume of the model uncertainty sets, the one constructed by
the conditional specification test is about 40% of that by the $J$ test. To further account for the uncertainty in the probability of rare disasters $p$, panels C and D display the unions of uncertainty sets for $p = 0.5\%, 0.7\%$, and $0.9\%$, the three cases where the asset pricing moments with $\eta = 0$ are not rejected in Table I. The model uncertainty sets naturally become larger when accounting for uncertainty of $p$. Nevertheless, in both cases, the uncertainty sets based on the conditional specification test remain substantially smaller than those based on the $J$ test. Crucially, the data-driven joint model uncertainty sets on the mean and the variance of asset returns displayed in Figure 2 play a pivotal role in robust mean-variance portfolio analysis (e.g., Garlappi, Uppal, and Wang (2007)).

6. CONCLUSION

This paper provides a robust and powerful test to evaluate macro asset pricing models. The newly proposed conditional specification test gains power by exploiting valid but noisy information in weakly identified baseline moments. To achieve robustness under weak identification, the conditional specification test decouples the useful macroeconomic information embedded in the baseline moment conditions from the additional asset pricing moment conditions. Our novel approach is particularly useful when the standard over-identification tests suffer from distorted size or poor power due to information imbalance. It can help researchers, practitioners, and monetary authorities to better understand the economic mechanisms behind the influential macro-finance models and conduct robust econometric analysis accounting for model uncertainty.

APPENDIX: PROOFS

Throughout the proofs, we use $K$ to denote a positive constant that may change from line to line. For any $x \in \mathbb{R}^{k_0}$ and any $k_0 \times k_0$ symmetric positive definite matrix $A$, $\|x\|_A \equiv (x' A^{-1} x)^{1/2}$. Let $\lambda_{\min}(A)$ and $\lambda_{\max}(A)$ denote the smallest and the largest eigenvalues of a real symmetric matrix $A$, respectively. The proofs of all auxiliary lemmas, that is, Lemmas A1–A7 below, are given in the Supplemental Material.

PROOF OF LEMMA 1: Since $M v^*$ and $m^*(\cdot)$ are mean-zero Gaussian, part (i) follows from $E[m^*(\cdot)(M v^*)] = 0$. For part (ii), by the law of iterated expectation and the definition of $c_\alpha^*(d^*)$,

$$P(L(v^*, d^*) > c_\alpha^*(d^*)) = E[P(L(v^*, d^*) > c_\alpha^*(d^*)|d^*)] \leq \alpha. \quad (A.1)$$

Part (iii) follows from $P(L(v^*, d^*) > c_\alpha^*(d^*)|d^*) = \alpha$ under the specified continuity condition. Q.E.D.

The following results hold for the CUE $\hat{\theta}$ in (3.2) and $g(\hat{\theta})$, $\hat{\Omega}$, $\hat{M}$, and $\hat{V}(\theta)$ based on $\hat{\theta}$, regardless of the identification strength in the baseline moments.

LEMMA A1: Under Assumptions 1, 2, and 3, the following results hold uniformly over $\mathbb{P} \in \mathcal{P}_0$:

(a) $n^{1/2}(\hat{\theta} - \theta_0) = - (Q' \Omega^{-1} Q)^{-1} Q' \Omega^{-1} g(\theta_0) + o_p(1) = O_p(1)$;

(b) $g(\hat{\theta}) = \Omega^{1/2} M \Omega^{-1/2} g(\theta_0) + o_p(1) = O_p(1)$;

(c) $\hat{\Omega} = \Omega + o_p(1)$ where $\Omega \equiv \hat{\Omega}(\hat{\theta})$;

(d) $\hat{M} = M + o_p(1)$;
We next present a few lemmas used in the proof of Theorem 1. For any \( x \in \mathbb{R}^k \), continuous vector function \( m_d : \Theta \mapsto \mathbb{R}^{k_0} \), continuous matrix function \( V_d : \Theta \mapsto \mathbb{R}^{k_0 \times k} \), \( k \times k \) symmetric positive definite matrix \( \Omega_d \), symmetric and continuous matrix function \( \Omega_{0,d}(\cdot) : \Theta \mapsto \mathbb{R}^{k_0 \times k_0} \) which is positive definite for any \( \theta \in \Theta \), and \( k \times k \) symmetric idempotent matrix \( M_d \), let

\[
\xi \equiv (x^*, d^*)', \quad \text{where} \ d \equiv (m_d(\cdot)', \text{vec}(V_d(\cdot)'), \text{vech}(\Omega_d)', \text{vech}(\Omega_{0,d}(\cdot)'), \text{vech}(M_d))'.
\]

Define

\[
R(\xi) \equiv \|x\|_{\Omega_d}^2 - \min_{\theta \in \Theta} \|m_d(\theta) + V_d(\theta)x\|_{\Omega_{0,d}(\theta)}^2,
\]

and

\[
L(v; d) \equiv v'M_dv - \min_{\theta \in \Theta} \|m_d(\theta) + V_d(\theta)\Omega_{0,d}^{1/2}M_dv\|_{\Omega_{0,d}(\theta)}^2.
\]

The test statistic \( T \) in (3.1) can be written as

\[
T = R(\hat{\xi}),
\]

where \( \hat{\xi} \equiv (g(\hat{\theta})', \hat{d}')' \) and

\[
\hat{d} \equiv (\hat{m}(\cdot)', \text{vec}(\hat{V}(\cdot)'), \text{vech}(\hat{\Omega})', \text{vech}(\hat{\Omega}_{0}(\cdot)'), \text{vech}(\hat{M})').
\]

Given \( \hat{d} \), the critical value \( c_a(\hat{d}) \) is simulated using \( L(v^*; \hat{d}) \) with independent draws of \( v^* \sim N(0, I_k) \). To show the bounded Lipschitz properties of functionals of \( \xi \), we use the metric

\[
\|\xi\|_s = \|x\| + \sup_{\theta \in \Theta} \|m_d(\theta)\| + \sup_{\theta \in \Theta} \|V_d(\theta)\| + \|\Omega_d\| + \sup_{\theta \in \Theta} \|\Omega_{0,d}(\theta)\| + \|M_d\|.
\]

**Lemma A2:** Under Assumptions 1, 2, and 3,

\[
\lim_{n \to \infty} \sup_{P \in \mathcal{P}_0} \|\mathbb{E}[f(\hat{\xi})] - E[f(\xi^*)]\| = 0,
\]

where \( \xi^* \equiv ((\Omega_{1/2}M v^*)', d'^*)' \) and \( BL_1 \) denotes the set of functionals with Lipschitz constant and supremum norm bounded above by 1.

To use the weak convergence of \( \hat{\xi} \) for studying the statistic \( T \), we follow Andrews and Mikusheva (2016a) and define a truncated version of \( R(\xi) \) as

\[
R_c(\xi) \equiv R(\xi)t_c(x'\Omega^{-1}x),
\]

where \( t_c(u) \equiv I\{u < C\} + (2C - u)C^{-1}I\{C \leq u < 2C\} \) for any \( u \in \mathbb{R} \) and some \( C \geq 1 \). Similarly, to study the critical value \( c_a(\hat{d}) \), we define a truncated version of \( L(v; d) \) as

\[
\bar{L}_c(v; d) \equiv L_c(v; d)I\{|\|v\|^2 \leq C\}, \quad \text{where} \ L_c(v; d) \equiv L(v; d)t_c(v'M_dv).
\]
Compared with $R_C(\xi)$, the truncation in $\overline{L}_C(v; d)$ has an extra term $I\{\|v\|^2 \leq C\}$, which is needed to show that $\overline{L}_C(v; d)$ is Lipschitz in $M_d$. Since $M_d$ may not have full rank, the truncation with $t_C(v'M_dv)$ is insufficient to bound $\|v\|$. Thus, truncation with $\|v\|^2 \leq C$ is added in $\overline{L}_C(v; d)$.

**Lemma A3:** Suppose that $\hat{\Omega}$ is symmetric and positive definite and $\hat{\Omega}_0$ is the leading $k_0 \times k_0$ submatrix of $\hat{\Omega}$. Then $R(\hat{\xi}) \geq 0$. Moreover, if $\hat{Q}'\hat{Q}$ is nonsingular, $L(v; \hat{d}) \geq 0$ for any $v \in \mathbb{R}^k$.

**Lemma A4:** Given $R(\hat{\xi}) \geq 0$, the functional $R_C(\hat{\xi})$ is bounded and Lipschitz in $\xi$.

**Lemma A5:** Let $c_{\alpha,C}(d) \equiv \inf\{c : P^*(v^* : \overline{L}_C(v^*; d) > c) \leq \alpha\}$. Given $L(v; d) \geq 0$, $c_{\alpha,C}(d)$ is bounded and Lipschitz in $d$.

The extra truncation $\|v\|^2 \leq C$ in $\overline{L}_C(v; d)$ causes a discrepancy between $c_{\alpha,C}(d^*)$ and the conditional $1 - \alpha$ quantile of $R_C(\xi^*)$ given $d^*$. Lemma A6 below shows that we can choose $C$ large enough such that the discrepancy is negligible, which is one of the key elements to show the uniform size control of the conditional specification test.

**Lemma A6:** For any $\varepsilon \in (0, 1)$ and any $\delta > 0$, there is a finite constant $C_\delta$ such that, for any $C \geq C_\delta$, $P(R_C(\xi^*) > c_{\alpha,C}(d^*) + \varepsilon) \leq \alpha + \delta/4$.

**Proof of Theorem 1:** The proof strategy follows from that for Theorem 1 of Andrews and Mikusheva (2016a). The major differences are as follows. (i) The test statistic and the critical value are defined with different functions, $R(\hat{\xi})$ and $L(v^*; \hat{d})$, respectively. These two functions have to be truncated differently, too, as in (A.6) and (A.7), respectively, to yield the bounded Lipschitz property. (ii) The additional truncation to $L(v^*; \hat{d})$ causes a discrepancy between $c_{\alpha,C}(d^*)$ and the conditional $1 - \alpha$ quantile of $R_C(\xi^*)$ given $d^*$. Lemma A6 is used to address these problems.

For notational simplicity, we assume that $\inf_{\theta \in \Theta} \lambda_{\min}(\hat{\Omega}(\theta)) \geq K^{-1}$, $\lambda_{\min}(\hat{Q}'\hat{Q}) \geq K^{-1}$, and $\sup_{\theta \in \Theta} \lambda_{\max}(\hat{\Omega}(\theta)) \leq K$ in the proof. This assumption is innocuous since the above properties hold with probability approaching 1 (wpa1) in view of Assumptions 1(ii), 2(i), (iv), and 3(iii), and the consistency of $\hat{\theta}$ under the null. Suppose that the claim of the theorem does not hold. Then

$$\limsup_{n \to \infty} P_{\theta \in \mathcal{F}_0}(R(\hat{\xi}) > c_{\alpha}(\hat{d}) + \varepsilon) > \alpha,$$

which implies that there exist $\delta > 0$ and a divergent sequence $n_i$ (indexed by $i$) such that

$$P_{n_i}(R(\hat{\xi}) > c_{\alpha}(\hat{d}) + \varepsilon) > \alpha + \delta \quad \text{for all } i.$$  \hspace{1cm} (A.9)

For any $u \in \mathbb{R}$ and any $i$, by the union bound of probability,

$$P_{n_i}(R(\hat{\xi}) > u) \leq P_{n_i}(R(\hat{\xi}) > u, g(\hat{\theta})(\hat{\Omega}^{-1})g(\hat{\theta}) \leq C) + P_{n_i}(g(\hat{\theta})(\hat{\Omega}^{-1})g(\hat{\theta}) > C).$$  \hspace{1cm} (A.10)
By the definition of $\hat{\theta}$, $g(\hat{\theta})'(\hat{\Omega}^{-1})g(\hat{\theta}) \leq g(\theta_0)'(\hat{\Omega}(\theta_0))^{-1}g(\theta_0)$, which together with Assumptions 1(i), 2(i), and 3 implies that $g(\hat{\theta})'(\hat{\Omega}^{-1})g(\hat{\theta}) = O_p(1)$ uniformly over $\mathbb{P} \in \mathcal{P}_0$. Therefore, there exists a large constant $C_{1,\delta}$ such that, for all large $n_i$,

$$
\mathbb{P}_{n_i}(g(\hat{\theta})'(\hat{\Omega}^{-1})g(\hat{\theta}) > C_{1,\delta}) \leq \delta/4,
$$

(A.11)

which together with (A.9) and (A.10) implies that

$$
\mathbb{P}_{n_i}(R(\hat{\xi}) > c_\alpha(d) + \varepsilon, g(\hat{\theta})'(\hat{\Omega}^{-1})g(\hat{\theta}) \leq C) > \alpha + 3\delta/4,
$$

(A.12)

for any $C \geq C_{1,\delta}$. By definition,

$$
I\{R_C(\hat{\xi}) > u\} \geq I\{R(\hat{\xi}) > u\}I\{g(\hat{\theta})'(\hat{\Omega}^{-1})g(\hat{\theta}) \leq C\} \quad \text{for any } u \in \mathbb{R},
$$

(A.13)

where $R_C(\hat{\xi}) \equiv R(\hat{\xi})t_C(g(\hat{\theta})'(\hat{\Omega}^{-1})g(\hat{\theta}))$ and $t_C(u) = 1$ for $u \leq C$ following its definition. By (A.12) and (A.13), we have, for any $C \geq C_{1,\delta}$,

$$
\mathbb{P}_{n_i}(R_C(\hat{\xi}) > c_\alpha(d) + \varepsilon) > \alpha + 3\delta/4.
$$

(A.14)

Since $L(v, \hat{d}) \geq 0$ for any $v \in \mathbb{R}^k$ by Lemma A3 and $t_C(u) \leq 1$ for any $u \in \mathbb{R}$, we have $L_C(v, \hat{d}) \leq L(v, \hat{d})$ for any $v \in \mathbb{R}^k$, which further implies that $c_{a,C}(\hat{d}) \leq c_{a}(\hat{d})$. Therefore, by (A.14), we deduce that for any $C \geq C_{1,\delta}$,

$$
\mathbb{P}_{n_i}(R_C(\hat{\xi}) - c_{a,C}(\hat{d}) \geq \varepsilon) > \alpha + 3\delta/4.
$$

(A.15)

Let $U_{C,n}$ be a random variable which has the same distribution as $R_C(\hat{\xi}) - c_{a,C}(\hat{d})$ under the law $\mathbb{P}_{n}$. Let $U_{\infty,C,n}$ be a random variable which has the same distribution as $R_C(\hat{\xi}^*) - c_{a,C}(d^*)$. By Lemma A4 and Lemma A5, $R_C(\hat{\xi}) - c_{a,C}(d)$ is bounded and Lipschitz in $\xi$. Therefore, by Lemma A2,

$$
\lim_{n \to \infty} \sup_{f \in \mathcal{B}_{L_1}} \|E[f(U_{C,n})] - E[f(U_{\infty,C,n})]\| = 0.
$$

(A.16)

Since $U_{\infty,C,n}$ is bounded for any $n$, by Prokhorov’s theorem, there exist a subsequence $n_j$ (of $n_i$) and a random variable $U_C$ such that $U_{\infty,C,n_j} \to_d U_C$, which together with (A.16) implies that $U_{C,n_j} \to_d U_C$. Since (A.15) can be written as $\mathbb{P}_{n_i}(U_{C,n_j} \geq \varepsilon) > \alpha + 3\delta/4$, by the Portmanteau theorem,

$$
\liminf_{n_j \to \infty} P(U_{\infty,C,n_j} > \varepsilon/2) \geq P(U_C > \varepsilon/2) \geq P(U_C \geq \varepsilon)
$$

(A.17)

$$
\geq \limsup_{n_j \to \infty} \mathbb{P}_{n_j}(U_{C,n_j} \geq \varepsilon) \geq \alpha + 3\delta/4, \quad \text{for any } C \geq C_{1,\delta}.
$$

We next show that for all large $C$, $P(U_{\infty,C,n_j} > \varepsilon/2) \leq \alpha + \delta/4$ for any $n_j$, which contradicts (A.17), and hence the claim of the theorem holds. To this end, for $C \geq C_{2,\delta}$ in Lemma A6,

$$
P(U_{\infty,C,n_j} > \varepsilon/2) = P(R_C(\hat{\xi}^*) > c_{a,C}(d^*) + \varepsilon/2) \leq \alpha + \delta/4,
$$

(A.18)

where the equality holds because $U_{\infty,C,n_j}$ and $R_C(\hat{\xi}^*) - c_{a,C}(d^*)$ have the same distribution and the inequality follows from Lemma A6.

\[\text{Q.E.D.}\]
Let \( \hat{\theta}^* \equiv \arg\min_{\theta \in \Theta} \| \hat{m}(\theta) + \hat{V}(\hat{\theta})\hat{\Omega}^{1/2}\hat{M}v^* \|^2_{\hat{\Omega}(\hat{\theta})} \) and \( \hat{M}_0 \equiv (\Omega_0^{-1/4}S_0\Omega_0^{1/2})' \times M_0(\Omega_0^{-1/4}S_0\Omega_0^{1/2}) \).

**Lemma A7:** Under Assumptions 1, 2, 3, and 4, we have uniformly over \( \mathbb{P} \in \mathcal{P}_0 \cap \mathcal{P}_{00} \):

(a) \( n^{1/2}(\hat{\theta}^* - \theta_0) = -(Q'\Omega^{-1}Q)^{-1}Q'\Omega^{-1}g(\theta_0) - (Q_0'\Omega^{-1}Q_0)^{-1}Q_0'\Omega^{-1}S_0\Omega^{1/2}Mv^* + o_p(1); \)

(b) \( L(v^*, \hat{d}) = v^*(M - \hat{M}_0)v^* + o_p(1); \)

(c) \( v^*(M - \hat{M}_0)v^* \sim \chi^2_{k_1}. \)

**Proof of Theorem 2:** (i) Under Assumptions 1–3, Lemma A1 gives

\[
g(\hat{\theta}) = \Omega^{1/2}M\Omega^{-1/2}g(\theta_0) + o_p(1) \quad \text{and} \quad \hat{\Omega} \equiv \hat{\Omega}(\hat{\theta}) = \Omega + o_p(1),
\]

(A.19)

uniformly over \( \mathbb{P} \in \mathcal{P}_0 \). Let \( \hat{\theta}_0 \equiv \arg\min_{\theta \in \Theta} g_0(\theta)'(\hat{\Omega}_0(\theta))^{-1}g_0(\theta). \) Adding Assumption 4, we have

\[
g_0(\hat{\theta}_0) = \Omega_0^{1/2}M_0\Omega_0^{-1/2}g_0(\theta_0) + o_p(1) \quad \text{and} \quad \hat{\Omega}_0 \equiv \hat{\Omega}_0(\hat{\theta}_0) = \Omega_0 + o_p(1)
\]

(A.20)

uniformly over \( \mathbb{P} \in \mathcal{P}_0 \cap \mathcal{P}_{00} \), where \( M_0 \equiv I_{k_0} - \Omega_0^{-1/4}Q_0(\Omega_0^{-1}Q_0)^{-1}Q_0'\Omega_0^{-1/4} \). Therefore, \( T \to_d \chi^2_{k_1} \), uniformly over \( \mathbb{P} \in \mathcal{P}_0 \) by the standard arguments in the literature (e.g., Eichenbaum, Hansen, and Singleton (1988), Hall (2005), Section 5).

We next prove part (ii). The critical value is simulated from

\[
L(v^*, \hat{d}) = v^*\hat{M}v^* - \| \hat{m}(\hat{\theta}^*) + \hat{V}(\hat{\theta}^*)\hat{\Omega}^{1/2}\hat{M}v^* \|^2_{\hat{\Omega}(\hat{\theta}^*)}.
\]

(A.21)

By Lemma A7(b), (c), we have, uniformly over \( \mathbb{P} \in \mathcal{P}_0 \cap \mathcal{P}_{00} \),

\[
L(v^*, \hat{d}) = L^* + o_p(1), \quad \text{where} \quad L^* \equiv v^*(M - \hat{M}_0)v^* \sim \chi^2_{k_1}.
\]

(A.22)

By (A.22), there exists a positive sequence \( \delta_n = o(1) \) such that for any \( \epsilon > 0 \),

\[
\mathbb{P}^*\left( |L(v^*, \hat{d}) - L^*| \geq \epsilon/2 \right) = o(\delta_n), \quad \text{uniformly over} \quad \mathbb{P} \in \mathcal{P}_0 \cap \mathcal{P}_{00},
\]

(A.23)

where \( \mathbb{P}^* \equiv \mathbb{P}^* \otimes \mathbb{P} \) denotes the product measure of \( v^* \) and the data. Due to the independence between \( P^* \) and \( \mathbb{P} \), for any \( \epsilon > 0 \) and for all large \( n \),

\[
\mathbb{P}^*(|L(v^*, \hat{d}) - L^*| \geq \epsilon/2|\hat{d}) \leq \delta_n \quad \text{wpa1.}
\]

(A.24)

Note that \( c_\alpha(\hat{d}) \) is the \( 1 - \alpha \) conditional quantile of \( L(v^*, \hat{d}) \) given \( \hat{d} \) and \( L^* \sim \chi^2_{k_1} \) is independent of \( \hat{d} \). Therefore, (A.24) implies

\[
q_{1-\alpha-\delta_n}(\chi^2_{k_1}) - \epsilon/2 \leq c_\alpha(\hat{d}) \leq q_{1-\alpha+\delta_n}(\chi^2_{k_1}) + \epsilon/2 \quad \text{wpa1}
\]

(A.25)

because by (A.24) and the union bound of (conditional) probability, we have

\[
\mathbb{P}^*(L(v^*, \hat{d}) > q_{1-\alpha+\delta_n}(\chi^2_{k_1}) + \epsilon/2|\hat{d}) \\
\leq \mathbb{P}^*(L^* > q_{1-\alpha+\delta_n}(\chi^2_{k_1})|\hat{d}) + \delta_n = \alpha,
\]

\[
\mathbb{P}^*(L^* > c_\alpha(\hat{d}) + \epsilon/2|\hat{d}) \\
\leq \mathbb{P}^*(L(v^*, \hat{d}) > c_\alpha(\hat{d})|\hat{d}) + \delta_n \leq \alpha + \delta_n.
\]

(A.26)
Since $\delta_n = o(1)$ and $\chi^2_{k_1}$ is continuous with a strictly increasing quantile function, for all large $n$,  
\[ q_{1-\alpha+\delta_n}(\chi^2_{k_1}) - \varepsilon/2 \leq q_{1-\alpha}(\chi^2_{k_1}) \leq q_{1-\alpha-\delta_n}(\chi^2_{k_1}) + \varepsilon/2, \]  
which together with (A.25) implies that, for any $\varepsilon > 0$,  
\[ |c_\alpha(\hat{d}) - q_{1-\alpha}(\chi^2_{k_1})| \leq \varepsilon \]  
wpa. Q.E.D.

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