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Predictability in financial markets: What do survey expectations tell us?

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There is widespread evidence of excess return predictability in financial markets. For the foreign exchange market a number of studies have documented that the predictability of excess returns is closely related to the predictability of expectational errors of excess returns. In this paper we investigate the link between the predictability of excess returns and expectational errors in a much broader set of financial markets, using data on survey expectations of market participants in the stock market, the foreign exchange market, the bond market and money markets in various countries. The results are striking. First, in markets where there is significant excess return predictability, expectational errors of excess returns are predictable as well, with the same sign and often even with similar magnitude. This is the case for foreign exchange, stock and bond markets. Second, in the only market where excess returns are generally not predictable, the money market, expectational errors are not predictable either. These findings suggest that an explanation for the predictability of excess returns must be closely linked to an explanation for the predictability of expectational errors.

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1. Introduction

There is extensive evidence in financial markets that expected returns are time varying and that excess returns are predictable. This evidence has obvious implications for portfolio allocations. From a theoretical perspective, it is important to understand the source of this predictability. Predictable excess returns run

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against some classic hypotheses made in economics like the expectations theory of the term structure of interest rates or uncovered interest parity between investments in different currencies.

For the foreign exchange market a number of studies have documented a close relationship between the predictability of excess returns and the predictability of expectational errors about excess returns, suggesting that deviations from strong rationality are behind the predictability of excess returns.¹ Since excess return predictability is a broad asset pricing phenomenon, which applies to many different types of financial markets, a natural question is whether the findings for the foreign exchange market apply to other financial markets as well. In other words, is there more generally a close link in financial markets between the predictability of excess returns and the predictability of expectational errors of excess returns? In order to address this question, we use evidence from surveys of market participants in four different financial markets: foreign exchange, stock, bond and money markets.

The results are striking. First, in markets where there is significant excess return predictability, expectational errors of excess returns are predictable as well, with the same sign and often even with similar magnitude. This is the case for foreign exchange, stock and bond markets. Second, in the only market where excess returns are generally not predictable, the money market, expectational errors are not predictable either. The obvious implication from these results is that an explanation for excess return predictability in financial markets is likely to be closely related to an explanation for the predictability of excess returns.

One always needs to be suspicious of survey data because of potential measurement problems. This will be discussed in some detail in the paper. But the pervasiveness of the evidence across countries, time periods, financial markets and market participants makes it hard to attribute all of it to measurement error. The surveys we use all involve actual market participants, either a substantial number of big financial institutions or large numbers of wealthy individual investors. It is important to focus on actual market participants. This avoids well-known biases associated with expectations by financial analysts, especially in the stock market. Moreover, it is market participants who ultimately drive asset prices through their trades.

The methodology is simple. Consider the log excess return q_{t+n} of an investment over n periods, between t and $t+n$, in an asset such as a stock, a bond, or a foreign currency investment. The following regression measures excess return predictability:

$$q_{t+n} = \alpha + \beta x_t + u_{t+n}, \quad (1)$$

where x_t is a variable or a vector of variables observable at time t . As elsewhere in the literature, β is significant in most cases. In standard asset pricing models the expected excess return is a risk premium. Therefore, if there is strong rationality, predictability in Eq. (1) can only be explained by a correlation of x_t with the risk premium.² But alternatively the predictability in Eq. (1) can be explained by deviations from strong rationality. To examine this, survey expectations on excess returns $E_t^s q_{t+n}$ are used to compute the expectational error $q_{t+n} - E_t^s q_{t+n}$.³ Its predictability is measured with the following regression:

$$q_{t+n} - E_t^s q_{t+n} = \gamma + \delta x_t + v_{t+n}. \quad (2)$$

Strong rationality implies that expectational errors are unpredictable by information at time t . But in most cases δ is significant. Moreover, δ tends to be significant precisely when β is significant and the elements of δ are of the same sign and of similar magnitude as the elements of β .

While evidence of predictability of expectational errors violates strong rationality, one needs to be careful not to necessarily interpret this evidence as a violation of more meaningful definitions of rationality. Fama (1991) suggests that “a weaker and economically more sensible version of the efficient market hypothesis says that prices reflect information to the point where the marginal benefits of acting on information do not

¹ Strong rationality is defined as the efficient use of information such that expectational errors are orthogonal to all available information.

² There is another set explanations based on “statistical” problems in estimating Eq. (1). The main problems are small sample bias and the bias caused by the persistence of the x_t variable. However, these problems usually can only explain a part of the evidence. See, for example, Stambaugh (1999), Liu and Maynard (2005) and Campbell and Yogo (2006). Moreover, persistence of x_t will not affect regressions of survey expectational errors on those variables that are discussed below. The reason is that under the null hypothesis expectational errors are white noise. Ferson et al. (2003) have shown that bias due to persistence of the right-hand side variable is only of concern when there is also persistence in the left-hand side variable.

³ We obviously assume that $E_t^s q_{t+n}$ is informative about $E_t q_{t+n}$. If $E_t^s q_{t+n} = E_t q_{t+n} + \varepsilon_{t+n}^s$, where ε_{t+n}^s is a measurement error, we assume that ε_{t+n}^s is not fully negatively correlated with $E_t q_{t+n}$.

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