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Investor Sentiment and Evaporating Liquidity during the Financial Crisis

Junmao Chiu^a, Huimin Chung^b, Keng-Yu Ho^c, Chih-Chiang Wu^{a*}

^a Discipline of Finance, College of Management, Yuan Ze University, Taoyuan, Taiwan.

^b Department of Information Management and Finance, Hsinchu, Taiwan.

^c Department of Finance, National Taiwan University, Taipei, Taiwan.

Abstract

This study examines how investor sentiment affected equity liquidity and trading behavior during the financial crisis of 2007-2008. Using intraday data on equity index and financial ETFs, we show significant asymmetric response to investor sentiment on quoted spread, market depth, asymmetric depth, and net buying pressure. We also document that funding constraints can further increase the asymmetric impact of investor sentiment on liquidity and trading behavior. Our results can be explained by the psychological bias of negativity and help investors and risk management practitioners comprehensively understand why and how the evaporation of liquidity accelerates during the financial crisis.

Keywords: Investor sentiment; Equity liquidity; Net buying pressure; Financial crisis; Funding constraints

JEL Classification: G10; G11; G14

* Please address all correspondence to: Chih-Chiang Wu, College of Management, Yuan Ze University, 135 Yuan-Tung Road, Chungli, Taoyuan, Taiwan 320. Tel.: 886-3-4638800 ext.3661. Fax Number: 886-3-4354624. E-mail address: chihchiang@saturn.yzu.edu.tw. This research is supported in part by the Ministry of Science and Technology of Taiwan.

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