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The dynamics of international equity market expectations ☆

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Abstract

This paper develops a noisy rational expectations model of the way in which international investors adjust their expectations of asset payoffs in a given country in response not only to public information signals but also to private information signals whose precision differs across investors. The model predicts that the perceptions of investors in one country about the future market returns in another country are related differently to realized past returns depending on their informational disadvantage relative to other investors: the greater is that informational disadvantage, the greater is the change in perception associated with returns.

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The predictions are confirmed by monthly survey data of institutional money managers investing in developed markets from 1995 to 2000.

JEL classification: F3

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1. Introduction

There is now extensive evidence that international flows of equity capital are positively correlated with the returns on the markets of the destination countries. Brennan and Cao (1997) have shown that this positive correlation can be due to an asymmetry of information between foreign and domestic investors. According to this asymmetric information theory, the expectations of less well-informed foreigners respond more elastically to economic news than do the expectations of better-informed domestic investors. Good news for example, which is associated with positive stock returns, leads foreigners to purchase stock from domestic investors, creating a positive association between foreigners' purchases of domestic stocks and domestic stock returns.

In this paper we develop the implications of the asymmetric information theory for changes in the degree of bullishness reported by domestic and foreign investors. Consistent with the theory, we find that there is a strong tendency for foreign institutional investors to become more bullish about a given national market following a positive return on that market. Thus, our evidence provides further support for the hypothesis that information asymmetry is an important determinant of international capital flows.

The framework for our analysis is a dynamic version of the multi-asset noisy rational expectations model of Admati (1985), which we use to analyze the determinants of the proportion of investors in country m who are bullish and bearish about the equity market in country k. The basic assumption underlying the model is that domestic investors are better informed about the payoffs on domestic assets than are foreign investors. This causes the beliefs of foreign investors to be more sensitive to new public information than are the beliefs of domestic investors. As a result, foreign investors buy from domestic investors when there is good news and asset prices rise, and sell to domestic investors when there is bad news and asset prices fall, which can account for the observed trend-following behavior of foreign investors. In order to focus attention on the role of information asymmetry, exchange rate risk and interest rate differentials are ignored, and the analysis is conducted in a model with many trading periods but only a single terminal consumption period.

The implications of the model are tested using survey data on the perceptions of institutional investors about the future returns on the stock markets of various