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How Do Stocks React to Extreme Market Events?

Evidence from Brazil

Pedro Piccoli¹, Mo Chaudhury² and Alceu Souza³

ABSTRACT

This paper studies the short-term (21 trading days) behavior of Brazilian stocks in the event of extreme movements in the Brazilian market index. Using cumulative abnormal returns, we find that stocks tend to overreact after both positive and negative events, as well as global and domestic shocks. Interestingly, this behavior is particularly intense when the events are not clustered. This counterintuitive finding can be explained by the Contrast Hypothesis, since shocks during calm circumstances can be viewed by investors as more surprising. In fact, when we split events according to market volatility, we document a stronger overreaction when volatility is low.

Keywords: Overreaction, extreme events, Contrast Hypothesis, Brazilian market.

JEL Classification: G14, G15.

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