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Managerial sentiment, consumer confidence and sector returns

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ABSTRACT

This paper investigates the relationship between managerial sentiment and sector returns. Using UK monthly data from January 1985 to December 2014 and a sample of consumer and business confidence indicators provided by the European Commission, we provide novel evidence on how managerial and consumer sentiment indicators affect stock returns. We find no support for consumer confidence as a predictor of stock returns. However, managerial sentiment shows a significant impact on aggregate market and sector return indices. Furthermore, we find that parameter estimates for sector groupings are not consistent, implying that the sentiment-return relationship differs across sectors. We also find parameters are sensitive to industry characteristics. Importantly, the overall sentiment-return relationship is dominated by sentiment associated with manufacturing firms.

1. Introduction

Studies in the relatively recent field of behavioural finance have identified pricing anomalies which contradict the expectations of the efficient markets hypothesis. In particular, considerable attention has focussed on how market prices are influenced by investor sentiment (Lee, Shleifer, & Thaler, 1991; Baker & Wurgler, 2006; Baker, Wurgler, & Yuan, 2012; Da, Engelberg, & Gao, 2015). Investor or market sentiment is defined in the financial literature as the prevailing attitude or feeling in the market as revealed by movements of stock prices. A large and growing literature examines the relationship between various proxies for investor sentiment and stock returns. We add to this literature in two ways. Using UK data from European Commission (EC) business and consumer surveys between January 1985 and December 2014, we analyse managerial sentiment as a proxy for investor sentiment. Further, we examine the impact of managerial sentiment and consumer confidence, a commonly used proxy for investor sentiment, on stock returns at the sectoral level.

Investment-related sentiment is not directly observable and so previous studies have used a number of proxies - including investor surveys, closed-end fund discounts, mutual fund flows and composite sentiment indices - which have been found to significantly influence stock prices (Lee et al., 1991; Frazzini & Lamont, 2008; Baker & Wurgler, 2006). In addition, various studies use information provided by consumer sentiment surveys as measure of investor sentiment (Otoo, 1999; Fisher & Statman, 2003; Jansen & Nahuis, 2003; Ferrer, Salaber, & Zalewska, 2016). However, their findings do not provide a consistent view of the association between consumer confidence and market values.

Contrary to consumer confidence studies, surveys of business confidence assess managerial sentiment regarding past and future performance. When compared to consumers, managerial access to business information allows for a more informed opinion of future market conditions. In this view, managerial sentiment informs investor sentiment and thereby stock-pricing. Baker & Wurgler (2013) include both sentiment from corporate insiders and surveys of consumer confidence in their list of potential proxies for investor sentiment. Thus, the first contribution of our study is to provide evidence on how managerial sentiment differs from consumer confidence in predicting stock returns.

Furthermore, sentiment studies predominantly examine the impact of investor sentiment proxies on aggregate market sentiment. Brown & Cliff (2004) suggest that aggregate sentiment measures are used primarily due to data limitations since sentiment measures such as surveys, advance-decline ratio and closed-end fund discounts are not commonly available at disaggregated levels. In addition, Brown and Cliff argue that aggregate sentiment effects become negligible when the number of stocks affected by high sentiment equals the number of stocks affected by low sentiment. This argument suggests that, when sentiment varies between sectors, aggregate measures of sentiment

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may not be sufficient to detect impacts on stock prices. Thus, our study also provides new evidence on the impact of investor sentiment on sector returns. Moreover, increasing attention to industry effects in the investment allocation literature provides further support for examination of sentiment at industry level. For example, Chen, Bennett, and Zheng (2006) suggest that industry-based investment strategies are more effective than country based strategies. Marcelo, Quirós, and Martins (2013) find that diversification based on industry leads to more efficient portfolios.

By examining the associations between managerial sentiment and sector returns, we provide significant evidence for investors and portfolio managers regarding which industries are most susceptible to sentiment. In addition, our findings are informative for policy-makers and regulators whose decisions affect stock prices. The rest of this paper is structured as follows. The next section reviews the existing literature. Section 3 describes the data and provides some descriptive statistics and preliminary tests. Section 4 describes the methodology used and discusses results. Section 5 concludes.

2. Literature review

There has been a long running debate in the academic literature regarding the success of the efficient market hypothesis in explaining the predictability in asset returns. The classical theory assumes financial markets are efficient; investors are rational and diversify to optimize the statistical properties of their investments. Even if some investors are irrational, prices are brought back into equilibrium by the actions of arbitrageurs (Baker & Wurgler, 2006), (Antoniou, Doukas, & Subrahmanyam, 2013). It follows then that there is no role for investor irrationality on asset pricing. However, research on behavioural finance confirms that investor sentiment affects stock prices and mispricing is persistent due to costly and non-profitable arbitrage (Lee et al., 1991).

2.1. Market-based measures of sentiment

Although the relation between investor sentiment and stock returns is well documented in numerous studies (Brown & Cliff, 2004; Baker & Wurgler, 2006; Baker & Wurgler, 2007; Schmeling, 2009; Da et al., 2015) researchers continue to debate sentiment measures and their impact on stock returns. Indeed, there is a large literature that documents the measurability of investor sentiment and its impact on stock prices. Despite using different proxies to measure sentiment, the overall conclusion is that sentiment is highly correlated with stock returns. For example, Baker and Wurgler (2006) use a group of sentiment proxies and principal component analysis to investigate the relationship between sentiment and stock returns. Their results suggest a significant correlation between sentiment and lead returns, in particular younger, smaller stocks. Such stocks are more likely to attract the attention of optimists and speculators who buy on the hype of stocks and sell after the hype is over. Similarly, using technical indicators, survey data from investor intelligence, and trading activity-related variables, Brown and Cliff (2004) find evidence supporting the co-movement of sentiment measures with market returns, particular in the long-run.

Another strand of research focuses on the predictability of sentiment to stock returns using individual sentiment proxies. For example, Fisher and Statman (2000) used Wall Street strategists' mean allocation to stocks as a proxy for sentiment of large investors and report a negative relationship with S&P 500 returns. In another key study, Lee et al. (1991) used closed-end fund discount as a proxy for investor sentiment, and argued that closed-end fund discounts and small stocks owned by individuals co-move with investor sentiment. In the same vein, Kaniel, Saar, and Titman (2004)) use the imbalances in the orders of individual stocks on the NYSE as a sentiment measure and find evidence supporting strong predicative power of future returns. Further, using net flows of mutual funds as a proxy of investor sentiment, Ben-Rephael, Kandel, and Wohl (2012) found a contemporaneous relationship between net exchanges to equity funds and changes in stock market prices. Similarly, issuing higher levels of equity shares compared to debt is believed to capture the market enthusiasm and predicts subsequent lower returns (Baker & Wurgler, 2000). (Lee et al., 1991) use the number of IPOs and average first day returns of IPOs as proxies for investor sentiment. They find that companies tend to time the market and issue IPOs during periods of positive sentiment. Consistent with Lee et al. (1991), Cornelli, Goldreich, and Ljungqvist (2006) indicate that investor sentiment can explain the underperformance of the IPOs returns.

2.2. Survey-based measures of sentiment

Due to the lack of directly-observable indicators measuring investor sentiment, a number of previous empirical studies employ consumer confidence indices to proxy for investor sentiment (Schmeling, 2009). Consumer confidence indicators (CCIs) are perceived to contain information that predicts future market conditions such as household spending, total personal consumption growth and expenditures on consumer durables (Carroll, Fuhrer, & Wilcox, 1994; Bram & Ludvigson, 1998; Throop, 1992). Furthermore, stock market studies report a contemporaneous correlation between CCIs and stock market returns. However, results vary on the direction of causality between them. For example, Fisher & Statman (2003) investigate the validity of consumer confidence as a proxy of the individual investor sentiment and its predictive power of stock returns. Overall, they find a positive contemporaneous relationship between changes in consumer confidence and S&P 500 returns. In another study, Otoo (1999) use US data and find that consumer confidence is affected by the increase in equity value. Elsewhere, using EU data, Jansen and Nahuis (2003) find evidence supporting the relationship between CCIs and stock returns, in particular in the short run. Additionally, they reported that stock returns predict consumer confidence but not vice versa. In contrast, Schmeling (2009) found that consumer confidence negatively predicts stock market return for 18 industrialized countries. Further, Charoenrook (2005)) investigate the University of Michigan Consumer Sentiment Index explanatory power for stock market return and find a positive relationship between the changes in consumer sentiment and the contemporaneous excess market returns in the long run, but negatively related to the future excess returns at one-month and one-year horizons.

Consistent with Brown and Cliff (2004), Wang, Keswani, and Taylor (2006) and Canba and Kandr (2009)) indicate that investor sentiment proxies are caused by stock returns and volatility rather than vice versa. According to Ferrer et al. (2016), the causality from stock returns to CCIs could be interpreted as an information effect (higher stock returns means good economic conditions and higher optimism) or as a wealth effect (higher value of equity leads to higher wealth). On the other hand, Lemmon & Portniaguina (2006) identified the forecasting power of investor sentiment, as measured by consumer confidence, in predicting stock market returns and find a relationship between consumer confidence and stock returns only for small stocks and stocks with low degrees of institutional ownership. Similarly, Schmeling (2009) suggests that there is two-way causality such that investor sentiment depends on previous returns and the returns depend on previous investor sentiment. For trading strategies, Antoniou et al. (2013) found that CCIs affects the profitability of momentum-based strategies but only in periods of high optimism. They argue that in periods of high sentiment, smaller investors are reluctant to sell losing stocks. Conversely, larger investors are usually ready to sell losing stocks promptly and profit from momentum strategies.

Most recently, Ferrer et al. (2016) argue for the inappropriateness of consumer confidence indicator as a proxy for investor sentiment. Using data for the EU and the US, they investigated the relationship between stock returns and CCIs around the dotcom bubble period. Their finding suggests that CCIs failed to forecast stock returns, particularly for the EU countries after the dotcom bubble. Importantly, the majority of studies