Journal of Applied Economics. Vol XX, No. 1 (May 2017), 49-73

CONVENTIONAL VIEWS AND ASSET PRICES: WHAT TO EXPECT AFTER TIMES OF EXTREME OPINIONS?

J. Daniel Aromí *

IIEP Universidad de Buenos Aires

Submitted April 2015; accepted March 2016

This study evaluates the performance of stock market indices after times of extreme opinions. The underlying conjecture is that extreme opinions are associated to overreactions in the perception of wealth. The analysis covers 34 countries from 1988 through 2013. In a novel approach, views regarding economic performance are approximated using content in the global economic press. Consistent with the overreaction conjecture, stock market indices are shown to under-perform following extreme optimistic views and over-perform after pessimistic views. A long-short contrarian portfolio earns 11% annually over the next five years. This persistent and predictable difference in returns cannot be explained by risk considerations and cannot be replicated using alternative strategies based on past returns or past economic growth.

JEL classification codes: G12, G17, D84

Key words: asset prices, opinions, expectations, overreaction.

I. Introduction

In November 2009, the weekly magazine *The Economist* ran a cover in which the title "Brazil takes off" was accompanied by a *statue* of Christ the Redeemer ascending like a rocket from Rio de Janeiro's Corcovado mountain. This strong sign of optimism was later reversed in September 2013 when the cover asked "Has Brazil blown it?"

---

* Daniel Aromí: Universidad de Buenos Aires, Facultad de Ciencias Económicas, Instituto Interdisciplinario de Economia Política (IIEP-BAIRES), Av. Córdoba 2122 - 2do (C1120 AAQ), Ciudad Autónoma de Buenos Aires, Argentina; email aromi.daniel@gmail.com. We would like to thank Daniel Heymann for generous and fruitful discussions. Also, we would to thank Daniel Chodos for providing data and Marcos Dal Bianco, Luciano Del Corro, and participants at the 2014 AAEP meeting and the seminars held at IIEP-Baires, UCEMA and Universidad del Sur for helpful comments.

together with a picture of a collapsing statue-rocket.[1] As eloquently exemplified by the pair of covers, opinions regarding economic prospects are regularly seen to enter stages of high hopes or, in other occasions, periods of intense gloom. Determining the accuracy of these emergent judgments is a matter of interest. This is because important economic decisions by private and public actors can benefit from a better understanding of the information conveyed by conventional views.

Conventional views are understood as a set of beliefs that are broadly shared, are known to be shared and so on. In this work, the focus is placed on broadly shared views regarding economic conditions. For example, beliefs regarding future economic prosperity or the evolution of aggregate productivity. Importantly, the public condition of this set of beliefs implies that they are observable and can be approximated, for example, analyzing contents in the economic press.

The underlying assumption behind this work is that the evolution of these public beliefs are strongly linked to the path of asset prices in an economy. More specifically, one plausible conjecture is that extreme conventional assessments are associated to excessive responses. Under this conjecture, the occasional emergence of extreme shared opinions could be linked to mispricing of broad classes of assets and predictable errors in saving and investment decisions. Despite its relevance, formal empirical evidence of this conjecture is hindered by lack of sufficiently comprehensive and precise measures of conventional views.

In this work, this conjecture is empirically evaluated for the case of financial assets. The performance of stock market indices is evaluated after times of extreme optimism and extreme pessimism. The study covers 34 countries from 1988 through 2013. One distinctive aspect of this work is the approximation of conventional views using content published in the international economic press.

Consistent with the postulated conjecture, the results show that optimism is followed by lower mean returns and pessimism by higher mean returns. This difference in performance is highly persistent and economically significant. A long-short contrarian portfolio earns 11% annually over the next five years. Additionally, it is found that the performance of sentiment based portfolio strategies cannot be replicated using information on past returns or past economic growth. Finally, the findings suggest that changes in anticipated risk levels are not a good explanation of the reported return differentials.

A natural interpretation of these findings is that the occasional emergence of conventional views regarding economic prospects generates mispricing for a broad

---

[1] See *Economist* (2009) and *Economist* (2013).

Download English Version:

https://daneshyari.com/en/article/7356106

Download Persian Version:

https://daneshyari.com/article/7356106

Daneshyari.com