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Earnings news, expected earnings, and aggregate stock returns ☆

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ABSTRACT

In contrast to firm-level relations, researchers have found that aggregate earnings changes and aggregate stock returns are negatively related. In this paper, we construct new measures of aggregate earnings news based on revisions in analyst forecasts. The findings suggest aggregate earnings news is positively related to contemporaneous stock returns. The results also show that aggregate stock returns are positively related to unexpected aggregate forecast errors, and negatively associated with expected aggregate earnings growth. Taken together, these findings suggest the negative relation between aggregate earnings changes and aggregate contemporaneous stock returns results from the expected component of aggregate earnings, rather than aggregate earnings surprises.

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1. Introduction

Ever since Ball and Brown (1968), researchers have repeatedly demonstrated that positive firm-level earnings changes result in increased stock prices and positive returns. This association is commonly viewed as a price reaction to cash flow news, whereas changes in earnings represent an earnings surprise that leads to changes in expected cash flows. In addition to providing information about firm-level cash flows, earnings can inform investors about overall economic activity. Specifically, aggregate earnings changes likely represent changes in industrial production, GDP growth, and the ability of the economy as a whole to generate cash flows. However, in contrast to firm-level studies, recent work documents the opposite relation between aggregate earnings changes and aggregate (market) returns (e.g., Kothari, Lewellen, and Warner, 2006; Sadka, 2007; Hirshleifer, Hou, and Teoh, 2009). These studies document that aggregate earnings changes are negatively related to contemporaneous aggregate stock returns.

If positive aggregate earnings changes do not reflect lower cash flows expectations, then this negative relation must be driven by fluctuations in discount rates. In this context, this literature stream provides two potential explanations for the negative empirical relation. The first hypothesis in the literature, which we call the return news hypothesis, suggests aggregate earnings changes proxy for an aggregate earnings surprise, and represent earnings news.[1] This hypothesis suggests investors adjust their required rate of return in response to the earnings surprise. Specifically, investors increase (decrease) the rate of return they demand on their investments when they receive positive (negative) earnings news. This may occur because positive (aggregate) earnings news implies that the riskiness of the projects pursued (in the economy) is higher than expected, which increases required discount rates. Higher future (required) discount rates result in lower prices, which in turn result in lower stock returns in the current period (e.g., Kothari, Lewellen, and Warner, 2006; Kang, Liu, and Qi, 2010). This results in a negative contemporaneous relation between aggregate earnings and aggregate returns.

The second hypothesis in the literature, which we call the expected earnings hypothesis, suggests that aggregate earnings changes are more predictable than firm-level changes, and thus are not an ideal proxy for aggregate earnings surprises. In other words, changes in aggregate earnings contain less earnings news than firm-level earnings changes. Consistently, our empirical evidence shows that aggregate earnings are more predictable than firm-level earnings. Moreover, this hypothesis suggests that the negative association between earnings and returns is due to a negative association between expected earnings and expected returns (e.g., Chen, 1991; Sadka, 2007; Ball, Sadka, and Sadka, 2009; Sadka and Sadka, 2009; He and Hu, 2014). This implies that investors demand lower discount rates when they expect higher earnings and cash flows.[2] If aggregate earnings are largely predictable, then returns are lower during periods of higher aggregate earnings growth because investors demand lower returns for their investments when they expect to be wealthier. The expected earnings hypothesis is consistent with consumption-based asset pricing, where investors become less risk averse, and demand lower returns for their investments, when their wealth is higher.

Consistent with the literature, the primary tests in this paper employ an indirect test to examine these hypotheses. Since it is difficult to measure expected returns directly, we cannot examine the components that give rise to the negative relation between aggregate earnings and returns directly. Therefore, we employ an indirect test to shed light on this issue. We further our understanding of the relation between expected earnings and expected returns by examining the relation between earnings news and stock returns. Our results can be analyzed in conjunction with prior findings regarding

[1] Kothari, Lewellen, and Warner (2006) use two additional measures of aggregate earnings surprises that are based on earnings changes. An AR(1) model, and an error term of earnings changes on past earnings changes and past returns. They find a negative contemporaneous relation between returns and these measures as well.

[2] Several researchers attempt to distinguish between these hypotheses by examining the relation between earnings, accruals, and the discount rate (Hirshleifer, Hou, and Teoh, 2009; Kang, Liu, and Qi, 2010; Guo and Jiang, 2011). However, without a good proxy for expected earnings and earnings news, it is difficult to interpret the association between earnings and future returns. Furthermore, these researchers struggle to distinguish between these hypotheses, because they fail to find a relation between changes in aggregate earnings and aggregate future returns.

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