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The Relation between Confidence Climate and Stock Returns: The Case of Turkey

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Abstract

This study examines the relations between consumer confidence, reel sector confidence and five different stock indices (aggregate, financial, industrial, service and technological) with VAR models. Michigan University Sentiment Index, VIX volatility index and GFK Germany Consumer Climate Index are also associated into the models to investigate international effects.The results suggest that, there is no causality relation from consumer confidence towards stock returns, however, stock returns found to positively affect consumer confidence. On the other hand, two-way causality exists between reel sector confidence index and stock returns, each one effects the other with certain lag of time. Michigan University Consumer Sentiment Index and VIX volatility index have explanatory power on almost all stock indices of Turkey, but GFK Germany Consumer Climate Index has no effect on any stock returns in all models. This may indicate that, globalization takes part in domestic markets, and rather than Germany, USA confidence climate is more felt in Turkey.

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Keywords: Consumer confidence; investor confidence; sentiment and stock returns

1. Introduction

Financial markets, decisions and subjects have always attracted researchers. Prediction of risk, price and returns of financial instruments are mostly studied subjects. Numerous financial theories have been discussed, developed and introduced.

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Conventional financial approach is based on the assumption that individuals act rationally, markets are fully efficient and prices possess random walk behavior. Efficient Market Hypothesis (EMH) introduced by Eugene Fama in the 1960s and reached its height of dominance the 1970s has become important in the last quarter of the 20th century. According the theory, security prices always reflect all available randomly appearing information and it is not possible to beat the market. Higher returns may only result from taking higher risks. Participants are rational and none has power to effect the prices. Transaction costs are negligible and transaction volumes are not serious to affect the operations (Fama, 1970).

Studies carried out over the later years showed that EMH and pricing models based of EMH are unable to explain all price behaviors of stock markets. Some anomalies observed in financial markets, especially in stock markets were evident of deviations from efficiency theory. The studies of behavioral finance to explain the deviations have arisen from the examination of the impacts of human behaviors (Barberis and Thaler, 2003). Suspicions about the efficient market hypothesis have led to a borrow some concepts of other social disciplines such as such as psychology, sociology, neurology, to understand the behavior of securities.

Kahneman and Tversky (1979) developed the Prospect Theory, the foundation of behavioral finance, which claims that people are loss averse, i.e. losses are felt much more, about 2.5 times, intensely than gains. Second, people judge good and bad things in relative to their current situation. And third, as diminishing marginal utility for gains, each successive unit of loss hurts less painfully than the previous one.

In the 1990s, some researchers shed light on developing models of human psychology in financial markets and focus shifted from econometric analyses of time series on prices, dividends and earnings, and behavioral finance emerged (Schiller ,2002). One of the two main elements of behavioral finance is concerned with the market. According to behavioral finance, different from conventional finance, the market is not fully efficient; the investors may not use the unlimited arbitrage possibilities and eliminate irrationality.

Another aspect of behavioral finance is related to investors. According to behavioral finance, investors are not rational, they should be considered as "normal". Investors make decision not only based on risk, return and utility maximization, they make decisions based on satisfaction also which is shaped by cognitive and emotional biases. Some of cognitive biases may be classified as anchoring and adjustment, mental accounting, framing, availability, self-attribution, outcome, recency, conservatism, confirmation, representativeness, illusion of control, hindsight, cognitive dissonance. On the other hand, some of emotional biases are loss aversion, overconfidence, self-control, status quo, endowment, regret aversion, and affinity. Cognitive biases are related to tendency to cling to one's previously held or recently established beliefs irrationally or illogically, and process information either illogically or irrationally. Emotional biases, on the other hand, can cause people to make suboptimal decisions because of feelings (Pompian, 2012).

If consumers and investors make decisions based on psychological motivations and these decisions effect the financial markets, there should be close interaction between human behavior and macroeconomic parameters. That's why governments, central banks and other regulatory and supervisory bodies pay a special attention to manage expectations and perceptions. Consumer and investor sentiments are two important indicators that show expectations and perceptions.

The purpose of this study is to analyze the interaction between consumer and investor sentiments and financial markets, which indicator effects the other, the time and magnitude of the effect. The study may give us also whether consumer and/or investment sentiment can be a leading indicator as we expect consumers to consume more and investors to invest more with increasing confidence, and then macroeconomic indicators and stock prices may be positively affected or vice versa.

This study may be distinguished from its peers first by the included period. The study is conducted with 2004:01-2015:06 data which is the most comprehensive period compared to others. Second, not only consumer confidence,

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