Predictability in Financial Markets: What Do Survey Expectations Tell Us?

Philippe Bacchetta
Study Center Gerzensee
University of Lausanne
FAME & CEPR

and

Elmar Mertens
Study Center Gerzensee
University of Lausanne

and

Eric van Wincoop
University of Virginia
NBER
Hong Kong Institute for Monetary Research

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Summary

There is widespread evidence of excess return predictability in financial markets. Two broad sets of explanations exist in the literature. One set of explanations assumes strong rationality in the Muth sense, which implies that asset prices fully reflect all available public information. In that case excess returns are predictable to the extent that predictors are correlated with risk premia. A second set of explanations is associated with deviations from strong rationality, implying predictable expectational errors. This does not necessarily imply that agents are irrational as it is also consistent with models where agents do not always process all available information if the cost of doing so is larger than the benefit. The goal in this paper is to evaluate the empirical relevance of this second set of explanations by examining evidence from survey data on the predictability of expectational errors and its link to excess return predictability.

Since the evidence of excess return predictability applies to many different financial markets, we use data on survey expectations for a variety of markets: forex, stock, bond and money markets. The surveys we use all involve actual market participants, either a substantial number of big financial institutions or large numbers of wealthy individual investors.

Several other papers have used evidence from survey expectations to evaluate deviations from strong rationality. Those previous papers usually focus on one asset market. The main contribution of our paper is to present a broader set of evidence, for all four financial markets and for more countries and years than previous work. Our hope is that by presenting the evidence for all these markets jointly, a unifying picture arises about the predictability of expectational errors of market participants that in turn can be related to uniform evidence of excess return predictability across all of these markets.

The results are striking. We find extensive evidence of predictability of expectational errors in all four financial markets, when strong rationality implies that expectational errors are unpredictable by publicly available information. Moreover, the direction of the predictability is consistent with evidence of excess return predictability in each of these markets. One always needs to be suspicious of survey data because of potential measurement problems, but the pervasiveness of the evidence across countries, time periods, different financial markets and different market participants makes it hard to attribute it all to measurement error.