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Predictability in financial markets: What do survey expectations tell us?

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There is widespread evidence of excess return predictability in financial markets. For the foreign exchange market a number of studies have documented that the predictability of excess returns is closely related to the predictability of expectational errors of excess returns. In this paper we investigate the link between the predictability of excess returns and expectational errors in a much broader set of financial markets, using data on survey expectations of market participants in the stock market, the foreign exchange market, the bond market and money markets in various countries. The results are striking. First, in markets where there is significant excess return predictability, expectational errors of excess returns are predictable as well, with the same sign and often even with similar magnitude. This is the case for foreign exchange, stock and bond markets. Second, in the only market where excess returns are generally not predictable, the money market, expectational errors are not predictable either. These findings suggest that an explanation for the predictability of excess returns must be closely linked to an explanation for the predictability of expectational errors.

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1. Introduction

There is extensive evidence in financial markets that expected returns are time varying and that excess returns are predictable. This evidence has obvious implications for portfolio allocations. From a theoretical perspective, it is important to understand the source of this predictability. Predictable excess returns run

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against some classic hypotheses made in economics like the expectations theory of the term structure of interest rates or uncovered interest parity between investments in different currencies.

For the foreign exchange market a number of studies have documented a close relationship between the predictability of excess returns and the predictability of expectational errors about excess returns, suggesting that deviations from strong rationality are behind the predictability of excess returns.¹ Since excess return predictability is a broad asset pricing phenomenon, which applies to many different types of financial markets, a natural question is whether the findings for the foreign exchange market apply to other financial markets as well. In other words, is there more generally a close link in financial markets between the predictability of excess returns and the predictability of expectational errors of excess returns? In order to address this question, we use evidence from surveys of market participants in four different financial markets: foreign exchange, stock, bond and money markets.

The results are striking. First, in markets where there is significant excess return predictability, expectational errors of excess returns are predictable as well, with the same sign and often even with similar magnitude. This is the case for foreign exchange, stock and bond markets. Second, in the only market where excess returns are generally not predictable, the money market, expectational errors are not predictable either. The obvious implication from these results is that an explanation for excess return predictability in financial markets is likely to be closely related to an explanation for the predictability of excess returns.

One always needs to be suspicious of survey data because of potential measurement problems. This will be discussed in some detail in the paper. But the pervasiveness of the evidence across countries, time periods, financial markets and market participants makes it hard to attribute all of it to measurement error. The surveys we use all involve actual market participants, either a substantial number of big financial institutions or large numbers of wealthy individual investors. It is important to focus on actual market participants. This avoids well-known biases associated with expectations by financial analysts, especially in the stock market. Moreover, it is market participants who ultimately drive asset prices through their trades.

The methodology is simple. Consider the log excess return q_{t+n} of an investment over n periods, between t and $t+n$, in an asset such as a stock, a bond, or a foreign currency investment. The following regression measures excess return predictability:

$$q_{t+n} = \alpha + \beta x_t + u_{t+n}, \quad (1)$$

where x_t is a variable or a vector of variables observable at time t . As elsewhere in the literature, β is significant in most cases. In standard asset pricing models the expected excess return is a risk premium. Therefore, if there is strong rationality, predictability in Eq. (1) can only be explained by a correlation of x_t with the risk premium.² But alternatively the predictability in Eq. (1) can be explained by deviations from strong rationality. To examine this, survey expectations on excess returns $E_t^s q_{t+n}$ are used to compute the expectational error $q_{t+n} - E_t^s q_{t+n}$.³ Its predictability is measured with the following regression:

$$q_{t+n} - E_t^s q_{t+n} = \gamma + \delta x_t + v_{t+n}. \quad (2)$$

Strong rationality implies that expectational errors are unpredictable by information at time t . But in most cases δ is significant. Moreover, δ tends to be significant precisely when β is significant and the elements of δ are of the same sign and of similar magnitude as the elements of β .

While evidence of predictability of expectational errors violates strong rationality, one needs to be careful not to necessarily interpret this evidence as a violation of more meaningful definitions of rationality. Fama (1991) suggests that “a weaker and economically more sensible version of the efficient market hypothesis says that prices reflect information to the point where the marginal benefits of acting on information do not

¹ Strong rationality is defined as the efficient use of information such that expectational errors are orthogonal to all available information.

² There is another set explanations based on “statistical” problems in estimating Eq. (1). The main problems are small sample bias and the bias caused by the persistence of the x_t variable. However, these problems usually can only explain a part of the evidence. See, for example, Stambaugh (1999), Liu and Maynard (2005) and Campbell and Yogo (2006). Moreover, persistence of x_t will not affect regressions of survey expectational errors on those variables that are discussed below. The reason is that under the null hypothesis expectational errors are white noise. Ferson et al. (2003) have shown that bias due to persistence of the right-hand side variable is only of concern when there is also persistence in the left-hand side variable.

³ We obviously assume that $E_t^s q_{t+n}$ is informative about $E_t q_{t+n}$. If $E_t^s q_{t+n} = E_t q_{t+n} + \varepsilon_{t+n}^s$, where ε_{t+n}^s is a measurement error, we assume that ε_{t+n}^s is not fully negatively correlated with $E_t q_{t+n}$.

exceed the marginal cost". Sims (1998, 2003) has formally argued that agents may rationally only process a limited amount of information because of capacity constraints on processing information. At the same time other explanations of predictability of expectational errors cannot be ruled out, for example based on psychological behavior (see Hirshleifer, 2001 for a survey).

This paper mainly documents the relationship between the predictability of excess returns and expectational errors. We do not attempt to give a definite answer to what accounts for this relationship. It is possible that the relationship is causal from the predictability of expectational errors to the predictability of excess returns. Examples of models where this is the case are Gourinchas and Tornell (2004) for the foreign exchange market and Cecchetti et al. (2000) for the stock market. But it could also be that a third factor causes predictability of both excess returns and expectational errors. A discussion of these issues is taken up in Section 5.

The remainder of the paper is organized as follows. After reviewing some related literature in Section 2, Section 3 describes the survey data sets used for each financial market. An Appendix A provides more details on data sources. Section 4 shows the results on predictability of expectational errors and excess returns from the two regressions above. Section 5 discusses concerns about measurement error and possible explanations for the predictability of expectational errors and the link between predictable expectational errors and excess returns. Section 6 concludes. An unpublished Empirical Appendix, available on our websites, gives additional empirical results.

2. Related literature

It is the evidence from the foreign exchange market that motivates us to investigate the link between predictability of excess returns and expectational errors in other financial markets. The first papers in the foreign exchange literature include Dominguez (1986), Ito (1990), Frankel and Froot (1987) and Froot and Frankel (1989) (see Takagi, 1991, for a review of the early literature). These papers all use surveys of foreign exchange experts of companies operating in the foreign exchange market (both financial and non-financial).⁴ Expectational errors of exchange rate changes are regressed on variables that are in the information set at the time that expectations were formed, in particular the forward discount, past exchange rate changes and past expected exchange rate changes. Despite short samples, these papers resoundingly reject strong rationality. In particular the large negative coefficients of a regression of expectational errors on the forward discount have received a lot of attention. Froot and Frankel (1989) argue that this can explain the entire forward discount puzzle. Subsequent literature for the foreign exchange market, such as Frankel and Chinn (1993), Chinn and Frankel (1994) and Cavaglia et al. (1994) has more currencies and years but confirm the earlier findings. More recently, Chinn and Frankel (2002) use data from 1988 to 1994 for 24 currencies.

For other financial markets little is known about the link between excess return predictability and predictability of expectational errors. For the stock market we are not aware of any evidence on this issue. For the bond market the only paper is Froot (1989). Froot uses survey data from 1969 to 1986 for the United States. Froot regresses expectational errors about future interest rates on the current forward premium (forward interest rate minus current short rate). For assets of all maturities he finds that the coefficient on the forward premium is negative. It is significant for maturities of 12 months and longer. Froot shows that predictable expectational errors help explain the predictability of excess returns on bonds. This is especially the case for long-term bonds of 20- and 30-year maturities.

3. Description of the survey data

Three different surveys are used in this study. The first one is a survey of both exchange rate and interest rate expectations, while the other two are surveys of stock return expectations. We present the main features of these surveys, leaving further details to the Appendix A.

3.1. Exchange rate and interest rate expectations

The survey of exchange rate and interest rate expectations is by Forecasts Unlimited Inc. (the website is FX4casts.com). Currently 45 large financial institutions contribute to the monthly forecast. The survey

⁴ Ito (1990) uses survey data for individual respondents, while the other papers use surveys with only the median or average response reported.

questions are collected over a period of 3 days. Usually the survey is e-mailed (or faxed) on Friday morning (last Friday of the month), with responses collected during Friday and the following Monday and Tuesday. Monthly data are available from August 1986 to July 2005. As explained in the [Appendix A](#), some data are missing. This leaves 219 observations per currency for exchange rates and 165–167 observations for interest rates.

While the survey currently reports forecasts for 31 countries, we focus on the evidence for the main industrialized countries in the survey. This is also the set of countries with a fairly consistent coverage over the last 20 years. Those are 8 countries: U.S., Germany, France, U.K., Japan, Canada, Australia and Switzerland. All exchange rate forecasts are relative to the dollar, so there are 7 currencies. For the foreign exchange market the survey reports the average forecast of the spot exchange rate 3, 6 and 12 months ahead. For interest rates the survey reports the expectations of 3-month Libor, 12-month Libor and 10-year government bond yields 3, 6, and 12 months ahead.

3.2. Stock market expectations

For the stock market two different data sets are used. The first survey is the UBS/Gallup poll. This is a random telephone survey of 1000 investors with at least \$10,000 in financial assets. The data are only for the U.S. stock market. Several questions about return expectations are asked. The one used here is “thinking about the stock market more generally, what overall rate of return do you think the stock market will provide investors during the coming twelve months?”. The poll was conducted twice in 1998 and monthly between February 1999 and April 2003.⁵ This gives a total of 53 observations. The data are collected in the first two weeks of each month.

The second stock market survey contains data for both the United States and Japan. It is available through the International Center for Finance at the Yale School of Management.⁶ For the United States the survey asks about expected percentage change in the Dow Jones Industrial index over the next 1, 3, and 12 months. For Japan the same question is asked for the Nikkei Dow. For the United States there is a separate survey of institutional investors and wealthy individual investors. For institutional investors, the survey starts in 1989 with six-month interval surveys until 1998, after which monthly surveys are conducted. For individual investors one survey was conducted in 1989, one in 1996 and monthly surveys started in 1999.⁷ We have collected the data through October 2004.

4. Empirical results

This section applies the two predictability regressions (1) and (2) to the foreign exchange market, the stock market, the bond market and the money market. These regressions measure the predictability of excess returns and expectational errors using instruments well known from the previous literature. In addition, a third regression documents whether and how risk premia *derived from the survey expectations* are related to these instruments.

Each subsection first describes the precise specification of these regressions and then presents the results. Most of the results presented use monthly data, so that “a period” corresponds to a month. To save space, for the first three markets we only report results for excess returns over a one-year horizon. Results for other horizons lead to essentially the same conclusions and are reported in the unpublished [Empirical Appendix](#).⁸ For the money market we will only report results for excess returns over a 3-month horizon, with again similar results reported for other horizons in the [Empirical Appendix](#).

4.1. Foreign exchange market

4.1.1. Regressions

In the foreign exchange market the excess return on foreign currency investment from t to $t + n$ is

⁵ See [Vissing-Jorgenson \(2003\)](#) for a detailed description and use of this data. The data can be purchased via the Roper Center at the University of Connecticut. UBS/Gallup have discontinued asking the question about the expected stock market return, even though the poll is still conducted monthly with several other questions.

⁶ We would like to thank the International Center for Finance for making these data available to us.

⁷ See [Shiller et al. \(1996\)](#) and <http://icf.som.yale.edu/confidence.index/explanations.html> for more details.

⁸ In addition the [Empirical Appendix](#) provides some basic statistics about survey expectational errors, such as the mean, median, autocorrelation and correlations across countries. The precise data sources are described in the data [Appendix](#) at the end of the paper.

$$q_{t+n} \equiv i_t^* + s_{t+n} - s_t - i_t, \tag{3}$$

where i_t^* is the foreign interest rate on an n -month instrument, i_t is the corresponding domestic interest rate, and s_t the log exchange rate. Regressions for the foreign exchange market always take the U.S. to be the home country, so that i_t is a dollar interest rate and the exchange rate is dollars per foreign currency. Using the interest differential $x_t = i_t - i_t^*$ as predictor, the equation for excess return predictability (1) is

$$s_{t+n} - s_t - (i_t - i_t^*) = \alpha + \beta(i_t - i_t^*) + u_{t+n}. \tag{4}$$

There is an extensive literature on the forward bias puzzle reporting negative and significant estimates of β .⁹ Notice that adding $(i_t - i_t^*)$ back to both sides, yields the standard Fama (1984) regression.

For expectational errors, $q_{t+n} - E_t^s q_{t+n} = s_{t+n} - E_t^s s_{t+n}$, regression (2) is

$$s_{t+n} - E_t^s s_{t+n} = \gamma + \delta(i_t - i_t^*) + v_{t+n}. \tag{5}$$

s_{t+n} is computed as the average exchange rate during the three days that are n months subsequent to the three days over which the survey has taken place. The right-hand side of (5) takes the interest differential prevailing on the day before the survey starts. n -month euro-market interest rates are used. For comparison, regression (4) is run over the same sample. Subtracting Eq. (5) from Eq. (4) gives a third regression that relates directly survey-expected excess returns, or the implied risk premium, to the interest rate differential:

$$E_t^s q_{t+n} = (\alpha - \gamma) + (\beta - \delta)(i_t - i_t^*) + (u_{t+n} - v_{t+n}). \tag{6}$$

Eqs. (4)–(6) are estimated from monthly data over a one-year horizon. The Empirical Appendix also reports results over horizons of 3 months and 6 months. To account for the overlap in the forecast intervals, Newey–West standard errors are reported (lags are chosen to equal the number of monthly observations per period plus one).

4.1.2. Results

Table 1 presents the results. Panel A shows the results for excess return predictability. Except for the U.K., the coefficient β is significant at least at the 5% level, which is consistent with the forward bias puzzle typically found in the literature.¹⁰ The two bottom lines of Panel A give results for the average of countries. To compute these numbers, the regressions for all countries are stacked in a SUR system. This leaves each individual regression's results unchanged but gives us an estimate of the correlation between the standard errors of the β 's across countries.¹¹ The standard error of the average slope then follows from the asymptotic, multivariate normality of the individual slope coefficients. The average estimate for β is -2.4462 and it is significant at the 1% level.

Panel B gives the estimates of Eq. (5). In six out of seven regressions, expectational errors are predictable and δ is significant at least at the 5% level. The only exception is the U.K. On average, the estimate of δ is -2.6424 and its p -value is close to zero. The striking result from Table 1 is that the predictability of expectational errors “matches” the predictability of excess returns. In the only case where excess returns are not predictable (the U.K.) expectational errors are also unpredictable. Moreover, the magnitude of δ is similar to the magnitude of β . This implies that a change in the interest differential has a similar effect on the expectational error as it has on the excess return. Thus, these results show that the predictability of excess returns and the predictability of expectational errors are closely related and that there are deviations from strong rationality.

Consistent with these findings, Panel C of Table 1 shows that the coefficient on the interest rate differential in regression (6) is insignificantly different from zero in five of the seven cases. The average across all currencies is close to zero and insignificant. If the reason for excess return predictability is associated with time-varying risk premia, then the coefficient in Panel C would be the same as the excess return predictability

⁹ Since covered interest parity holds in the markets considered here, $(i_t - i_t^*)$ can be replaced by the forward discount.

¹⁰ This sample is somewhat shorter than recent estimates in the literature because of matching observations with the survey sample. However, results are similar over a longer sample.

¹¹ As discussed above, standard errors are estimated using the Newey–West estimator.

Table 1
Foreign exchange market.

Currencies	β	$\sigma(\beta)$	R^2
Panel A: excess return predictability $q_{t+12} = \alpha + \beta(i_t - i_t^*) + u_{t+12}$			
Australia	-2.4873***	0.6723	0.29
Canada	-1.9729***	0.6611	0.20
France	-2.2524**	1.1029	0.17
Germany	-2.4323**	0.9789	0.22
Japan	-3.8764***	0.7786	0.42
Switzerland	-2.7610***	1.0263	0.23
U.K.	-1.3412	1.1863	0.06
EW avg.	-2.4462***	0.6635	
$p(\beta = 0)$	0.0000		
Currencies	δ	$\sigma(\delta)$	R^2
Panel B: survey error predictability $s_{t+12} - E_t^s s_{t+12} = \gamma + \delta(i_t - i_t^*) + v_{t+12}$			
Australia	-3.3226***	0.6876	0.44
Canada	-2.0242***	0.6063	0.22
France	-2.7630**	1.1299	0.21
Germany	-2.6155***	0.8454	0.22
Japan	-2.9273***	0.8649	0.25
Switzerland	-2.9961***	0.9207	0.24
U.K.	-1.8484	1.2363	0.10
EW avg.	-2.6424***	0.5846	
$p(\delta = 0)$	0.0000		
Currencies	β	$\sigma(\beta)$	R^2
Panel C: survey-expected excess returns $E_t^s q_{t+12} = \alpha + \beta(i_t - i_t^*) + u_t^s$			
Australia	0.8353***	0.1767	0.25
Canada	0.0513	0.2038	0.00
France	0.5105	0.4896	0.03
Germany	0.1832	0.4704	0.00
Japan	-0.9491***	0.3340	0.13
Switzerland	0.2351	0.4935	0.01
U.K.	0.5072	0.4843	0.03
EW avg.	0.1962	0.2729	
$p(\beta = 0)$	0.0000		

Note: $p(\beta = 0)$ and $p(\delta = 0)$ test for joint significance of slopes across equations. Newey–West standard errors with 13 lags. SUR systems for all panels estimated from 207 observations over sample from October 1986 to July 2004. See Section 4.1.1 for construction of data. Twelve months forecast horizon.

coefficient in Panel A. This is clearly not the case. The expected excess return is not systematically related to the interest rate differential.¹²

4.2. Stock market

4.2.1. Regressions

For the stock market, the excess return of stocks over the short-term interest rate is

$$q_{t+n} \equiv r_{t+n} - i_t, \tag{7}$$

where $r_{t+n} = \ln((P_{t+n} + D_{t+n})/P_t)$ is the log return on the stock price index, P_t is the stock price index and D_{t+n} measures dividends paid between t and $t + n$. As before, i_t is the interest rate on an n -month instrument. We will again report results over a 12-month horizon ($n = 12$), with results for 1-month and 3-month horizons reported in the Empirical Appendix. The excess return is regressed on three

¹² This result is consistent with the literature that concludes that explanations based on risk premia fail to explain the forward premium puzzle. For surveys of this literature, see Lewis (1995), Engel (1996), or Sarno (2005).

variables that have been extensively used in the stock market literature on excess return predictability: the short rate i_t , the log dividend-yield $\ln(D_t/P_t)$, and the consumption-wealth ratio cay as proposed by Lettau and Ludvigson (2001). Regarding expectational errors, the two surveys need to be treated somewhat differently since the UBS/Gallup poll gives an expected return, while the ICF/Yale survey gives an expected price change.

For the UBS/Gallup poll, the expectational error $r_{t+12} - E_t^S r_{t+12}$ is regressed on the same predictors, where $E_t^S r_{t+12} = \ln(1 + E_t^S R_{t+12})$ and $E_t^S R_{t+12}$ is the average expectation from the survey. The survey expectations are compared to the average 12-month return on the S&P 500 computed over the precise days of the survey (around 10 working days).¹³ The S&P 500 Composite Dividend-Yield is obtained from DataStream. The one-year Treasury Constant Maturity Rate from FRED measures the interest rate. The average expectational error is regressed on the interest rate and the log dividend-yield measured on the day before the survey is started as well as the most recent quarterly observation of the consumption-wealth ratio before the start of the survey.

For the ICF/Yale data, the method needs to be adapted in three ways. First, as mentioned, the expectations pertain to the percentage stock price change as opposed to the overall return. The log price change is denoted by $\tilde{r}_{t+12} = \ln(P_{t+12}/P_t)$. Second, expectations are recorded for individual respondents. Let $E_t^{S,i} \tilde{r}_{t+12}$ be the log of one plus respondent i 's expected percentage change in the stock price. Therefore $\tilde{r}_{t+12} - E_t^{S,i} \tilde{r}_{t+12}$ is regressed on the predictors available at time t .¹⁴ For each respondent the actual price change in the Dow Jones or Nikkei (from DataStream) during the corresponding forecast period is used to compute $\tilde{r}_{t+12} - E_t^{S,i} \tilde{r}_{t+12}$. The Empirical Appendix reports very similar results when using daily and monthly averages of expectational errors for individual respondents. Third, there are varying overlaps of the forecasting horizons across observations. These overlaps are addressed with Newey–West standard errors where the number of lags included is the average number of observations per year in the sample. Standard errors are very similar when using a lag length equal to the maximum number of observations in a given year.

4.2.2. Results

Table 2 presents evidence using the UBS/Gallup poll, for the sample going from May 1998 to April 2003. Three right-hand side variables are considered: the short-term interest rate, the log dividend-yield, and the consumption-wealth ratio. Panel A shows the results for excess return predictability. Taken individually, only the dividend-yield is significant, but the interest rate becomes significant when considered jointly with the dividend-yield. The consumption-wealth ratio is insignificant. These results differ from those typically obtained over longer samples.¹⁵ Panel B documents that there is predictability of expectational errors when using the dividend-yield ratio alone or combined with the interest rate. Thus, the significant coefficients in excess return predictability correspond exactly to those for survey error predictability.

Panel C shows that the expected excess return derived from survey expectations is related to all the three right-hand side variables. However, the absolute size of coefficients is small compared to those in Panels A and B. While expected excess returns are statistically different from zero, the magnitude of the difference is not large. In that sense the results are again close to those for the foreign exchange market, where on average the expected excess return is close to zero as well. Time-varying risk premia can therefore not explain the predictability of excess returns. Otherwise the coefficients in Panels A and C would have been the same.

Tables 3a–3c present evidence on price changes using the ICF/Yale data. The three panels in each of the Tables 3a–3c correspond to three different surveys: individual and institutional investors for the Dow Jones, and institutional investors for the Nikkei. The sample period for each survey is determined by data availability¹⁶ and the number of observations varies between 1174 and 2348 because of the individual observations. Table 3a shows the results on excess return predictability using the dividend-yield and the interest rate. The dividend-yield is significant for Dow Jones individual investors and for the Nikkei investors. In the latter case, the interest rate is also significant.

Table 3b shows the predictability of survey errors by regressing $\tilde{r}_{t+12} - E_t^{S,i} \tilde{r}_{t+12}$ on the dividend-yield and the interest rate. The results again show that expectational errors are predictable. For the Dow Jones

¹³ Dividend income is included by using the Composite Total Return Index of the S&P 500 computed from DataStream (Thomson Financial).

¹⁴ Results are almost identical when running the regressions in levels rather than in logs.

¹⁵ In regressions of excess return predictability with monthly data over the 1996–2005 sample, we find that the consumption-wealth ratio is strongly significant and the interest rate has a negative coefficient.

¹⁶ The results are not sensitive to the precise sample. The samples used in Tables 3a–3c do not include some responses collected in the very early years. Results are similar when those are included or when a common sample starting in 1999 is considered.

Table 2
U.S. stock market – UBS/Gallup survey.

<i>i</i>	ln(D/P)	Cay <i>p</i>	R ²
<i>Panel A: excess return predictability (survey sample) $q_{t+12} = \alpha + \beta X_t + u_{t+12}$</i>			
–4.1429 (3.2290)			0.14 0.2139
	0.8080*** (0.1421)		0.46 0.0000
		4.7067 (3.5775)	0.14 0.2027
12.0136*** (2.0942)	1.9361*** (0.1372)		0.71 0.0000
11.7387*** (2.3204)	1.9416*** (0.1441)	–0.3918 (2.7524)	0.71 0.0000
<i>Panel B: survey error predictability $r_{t+12} - E_t^s r_{t+12} = \gamma + \delta X_t + v_{t+12}$</i>			
–4.5705 (3.2383)			0.16 0.1722
	0.8506*** (0.1371)		0.50 0.0000
		5.2796 (3.5263)	0.18 0.1481
11.6813*** (2.2884)	1.9475*** (0.1665)		0.72 0.0000
11.9669*** (2.5445)	1.9419*** (0.1664)	0.4070 (2.7294)	0.72 0.0000
<i>Panel C: survey-expected excess returns $E_t^s q_{t+12} = \alpha + \beta X_t + u_t^s$</i>			
0.4276** (0.1721)			0.21 0.0184
	–0.0426** (0.0187)		0.19 0.0301
		–0.5729*** (0.1425)	0.31 0.0002
0.3323 (0.3158)	–0.0114 (0.0356)		0.21 0.0595
–0.2282 (0.3746)	–0.0003 (0.0274)	–0.7988** (0.3405)	0.32 0.0002

Note: Newey–West standard errors reported in brackets (computed with 13 lags). Sample with 53 observations from May 1998 to April 2003. See Section 4.2.1 for construction of data. Twelve months forecast horizon.

individual investors and the Nikkei investors, results are similar to those found in Table 2, where the dividend-yield is strongly significant when taken alone or in combination with the interest rate. The significance of variables is strikingly similar to what is found in Table 3a. First, there is no predictability for the sample corresponding to the Dow Jones institutional investor survey. Second, excess return predictability closely corresponds to the predictability of survey errors for the sample corresponding to the Dow Jones individual investor survey and in Japan for the sample corresponding to the Nikkei investor survey.

Table 3c shows that the expected excess return is predictable by the interest rate and in some cases by the dividend-yield. The ICF/Yale survey expectations appear more responsive to current variables than the UBS/Gallup polls. But in cases where the excess return is predictable, the coefficients in the survey-expected excess return regressions are again close to zero. The only exception is for the Nikkei when regressed on the interest rate.

Although the UBS/Gallup and Yale surveys are for different sets of investors, markets, and horizons, the picture that emerges from the predictability regressions is similar. In most cases there is predictability of expectational errors, mainly by the dividend-yield. This parallels the evidence for excess return predictability over the corresponding sample.

4.3. Bond market

4.3.1. Regression

The bond market equations require a little more explanation since the survey expectations are not of expected returns but expected future interest rates. Most of the literature on excess return predictability in

Table 3a
Stock markets – ICF/Yale survey.

<i>i</i>	ln(<i>D</i> / <i>P</i>)	$\frac{R^2}{p(\hat{\delta} = 0)}$	Obs NW lags
Excess return predictability (survey sample) $q_{t+12} = \alpha + \beta X_t + u_{t+12}$			
<i>Dow Jones (Individuals) Sep/96–Nov/03</i>			
–1.3342		0.02	1174
(2.4496)		0.5864	196
	0.6081***	0.55	1174
	(0.1276)	0.0000	196
2.3716	0.7087***	0.60	1174
(1.7192)	(0.1664)	0.0001	196
<i>Dow Jones (Institutions) Jun/89–Nov/03</i>			
0.3348		0.00	2547
(1.3676)		0.8067	170
	0.0793	0.06	2547
	(0.0663)	0.2325	170
–0.4520	0.0897	0.06	2547
(1.2683)	(0.0613)	0.3340	170
<i>Nikkei (Institutions) Jun/89–Nov/03</i>			
–4.4970***		0.30	1424
(1.1922)		0.0002	95
	0.6713***	0.53	1424
	(0.1153)	0.0000	95
–1.5672	0.5686***	0.55	1424
(1.1011)	(0.1330)	0.0000	95

Note: Newey–West standard errors reported in brackets (lags as indicated above, corresponding to the number of observations per year). See Section 4.2.1 for construction of data. Twelve months forecast horizon.

the bond market is based on zero-coupon bonds. To the extent that the interest rate expectations in the survey pertain to coupon bonds (10-year government bonds), this cannot be replicated here. We therefore use the linearized coupon bond returns of Shiller, Campbell and Schoenholtz (SCS, 1983), also implemented by Froot (1989) and Hardouvelis (1994).

Define a period as one month and consider the return over *n* periods of a coupon bond which has initially a maturity of *m + n* periods. Following SCS, the excess return from *t* to *t + n* is approximately equal to

$$q_{t+n}^{m+n} \equiv r_{t+n}^{m+n} - i_t^n,$$

$$\text{where } r_{t+n}^{m+n} = \frac{D_{m+n} i_t^{m+n} - (D_{m+n} - D_n) i_{t+n}^m}{D_n}.$$

Here i_t^n is the yield-to-maturity at *t* of a coupon bond with remaining maturity of *n* periods (all yields and returns are annualized); $D_n = (1 - \rho^n)/(1 - \rho)$ is the Macaulay duration of a par bond with *n* periods to maturity and coupon rate *c*, where $\rho = 1/(1 + c)$.

The excess return equation is estimated with the yield spread as predictor:

$$q_{t+n}^{m+n} = \alpha + \beta (i_t^{m+n} - i_t^n) + u_{t+n}. \tag{8}$$

The forward discount, another conventional predictor, is proportional to the scaled yield spread.¹⁷

Eq. (8) is estimated for the case where *m* is 10 years, corresponding to the 10-year bonds for which survey expectations are available. We again report results for one-year excess returns (*n* = 12). The Empirical Appendix reports similar results for 3-month and 6-month excess returns. There are no data available on

¹⁷ Let $f_t^{n,m}$ be the forward rate at time *t* for the interest rate from *t + n* to *t + n + m*. Following SCS, the forward rate discount is then equal to

$$f_t^{n,m} - i_t^n = \frac{D_{n+m}}{D_{n+m} - D_n} (i_t^{n+m} - i_t^n). \tag{9}$$

Table 3b
Stock markets – ICF/Yale survey.

i	$\ln(D/P)$	$\frac{R^2}{p(\delta = 0)}$	Obs NW lags
Survey error predictability $\tilde{r}_{t+12} - E_t^S \tilde{r}_{t+12} = \gamma + \delta X_t + v_{t+12}$			
<i>Dow Jones (Individuals) Sep/96–Nov/03</i>			
0.2785		0.00	1174
(2.5923)		0.9145	196
	0.5724***	0.36	1174
	(0.1427)	0.0001	196
4.2042**	0.7507***	0.49	1174
(1.6883)	(0.1696)	0.0001	196
<i>Dow Jones (Institutions) Jun/89–Nov/03</i>			
2.2708*		0.06	2547
(1.3215)		0.0860	170
	0.1164*	0.06	2547
	(0.0693)	0.0933	170
1.5663	0.0803	0.08	2547
(1.1952)	(0.0650)	0.1777	170
<i>Nikkei (Institutions) Jun/89–Nov/03</i>			
–1.6331		0.04	1424
(1.1528)		0.1571	95
	0.4401***	0.21	1424
	(0.1290)	0.0007	95
0.9584	0.5029***	0.22	1424
(1.1944)	(0.1516)	0.0021	95

Note: Newey–West standard errors reported in brackets (lags as indicated above, corresponding to the number of observations per year). See Section 4.2.1 for construction of data. Twelve months forecast horizon.

Table 3c
Stock markets – ICF/Yale survey.

i	$\ln(D/P)$	$\frac{R^2}{p(\beta = 0)}$	Obs NW lags
Survey-expected excess returns $\tilde{E}_t^S q_{t+12} = \alpha + \beta X_t + u_t^S$			
<i>Dow Jones (Individuals) Sep/96–Nov/03</i>			
–1.6127***		0.10	1174
(0.2308)		0.0000	196
	0.0357	0.01	1174
	(0.0523)	0.4956	196
–1.8325***	–0.0420***	0.10	1174
(0.1304)	(0.0115)	0.0000	196
<i>Dow Jones (Institutions) Jun/89–Nov/03</i>			
–1.9360***		0.09	2547
(0.2322)		0.0000	170
	–0.0372	0.01	2547
	(0.0261)	0.1552	170
–2.0183***	0.0094	0.09	2547
(0.3128)	(0.0165)	0.0000	170
<i>Nikkei (Institutions) Jun/89–Nov/03</i>			
–2.8639***		0.24	1424
(0.2204)		0.0000	95
	0.2312***	0.13	1424
	(0.0450)	0.0000	95
–2.5256***	0.0657**	0.25	1424
(0.2347)	(0.0277)	0.0000	95

Note: Newey–West standard errors reported in brackets (lags as indicated above, corresponding to the number of observations per year). See Section 4.2.1 for construction of data. Twelve months forecast horizon.

bonds with maturity $m + n$, but it is reasonable to assume that the term structure is flat over these short intervals over its far end: $i_t^{m+n} \approx i_t^m$ ¹⁸

At time t the only unknown component of the excess return q_{t+n}^m is the future yield i_{t+n}^m . We therefore compute the expected excess return $E_t^s q_{t+n}^m$ using the average survey expectation $E_t^s i_{t+n}^m$ of the yield on government bonds with a remaining 10-year maturity at $t + n$ (m equal to 10 years). We then regress the expectational error on the same yield spread:

$$q_{t+n}^{m+n} - E_t^s q_{t+n}^m = \gamma + \delta \left(i_t^{m+n} - i_t^n \right) + v_{t+n}. \tag{10}$$

In addition to regressions using the yield spread as predictor, multivariate regressions with several yields are also run. This is based on the results of [Cochrane and Piazzesi \(2005\)](#), who show that excess returns are better predicted by a combination of various yields than by a single forward premium. The multivariate regressions use yields of 3 months, 6 months, one year and 10 years instead of the yield spread on the right-hand side of Eqs. (8) and (10).

4.3.2. Results

Tables 4a–4c present the evidence for the bond market. Table 4a presents the results on excess return predictability. When using the term spread as in Eq. (8), there is no significant predictability, with the exception of Switzerland at the 10% level. However, the average coefficient across equations, equal to 1.65, is significant at the 5% level. Moreover, the multivariate regression with yields all show predictability, at the 5% level for the U.K. and at the 1% level for the other countries.¹⁹ The results in Table 4a thus confirm and extend the results of [Cochrane and Piazzesi \(2005\)](#) to several other countries.

Table 4b presents the evidence on the predictability of expectational errors in the bond market. The regressions with multiple yields show significant predictability in all 8 countries. For the spread regression, there are six countries showing predictability and the average coefficient of 2.16 is strongly significant. The magnitude of this coefficient is again similar to that in the excess return regression in Table 4a. Comparing Tables 4a and 4b therefore again shows a strong parallel in forecasting excess returns and forecasting expectational errors.

Table 4c indicates that the survey-expected excess return is in most cases predictable as well. However, the magnitude of this predictability is small. When regressing on the yield spread, the average coefficient is -0.52 , which is an order 4 times smaller than the average regression coefficients in Tables 4a and 4b. This is again consistent with findings for the foreign exchange and stock markets. In all of these markets the expected excess return is much less responsive to current variables than the actual excess return.

4.4. Money market

4.4.1. Regression

In the money market, the surveys deliver similarly structured interest rate expectations, but the underlying instruments do not have coupons. Thus, the approach is somewhat different from the bond market. Consider the excess return on holding $n + m$ -month Libor for n months. Let i_t^n be the annualized Libor interest rate for n months at time t , which corresponds to a zero bond price of:

$$p_t^n = -\frac{n}{12} i_t^n. \tag{11}$$

Similarly to the bond market, define the annualized excess return as

$$q_{t+n}^{m+n} \equiv r_{t+n}^{m+n} - i_t^n, \tag{12}$$

where the return is given by the change in bond prices

¹⁸ [Froot \(1989\)](#) makes a similar assumption.

¹⁹ These results appear robust to the choice of return approximation: as an alternative to the linearization of SCS we compute returns directly from total return indices (including coupon payments) for 10-year government benchmark bonds from DataStream. The results are similar. These indices typically contain the most liquid bond with maturity close to 10 years and are frequently rebalanced as new bonds are issued. Their returns are not perfectly but very closely correlated to the approximate returns computed from the yield changes.

$$r_{t+n}^{m+n} = \frac{12}{n} (p_{t+n}^m - p_t^{m+n}). \quad (13)$$

The excess return is regressed on the corresponding term spread:

$$q_{t+n}^{m+n} = \alpha + \beta (i_t^{m+n} - i_t^n) + u_{t+n}. \quad (14)$$

We then estimate the following regression to evaluate the predictability of expectational errors

$$(q_{t+n}^{m+n} - E_t^s q_{t+n}^{m+n}) = \gamma + \delta (i_t^{m+n} - i_t^n) + v_{t+n}, \quad (15)$$

where the expected excess return is based on the average survey expectation of i_{t+n}^m . In order to run the above regression, data are needed on $n + m$ -month Libor, n -month Libor and survey expectations of i_{t+n}^m . We will report results for the only case for which such data are simultaneously available, which is $n = m = 3$. The regressions then apply to the 3-month excess return on 6-month Libor. The [Empirical Appendix](#) examines regressions with other horizons but with different interest rate spreads as predictors. In all the cases, we consider a second set of regressions, where the single predictor is replaced by a vector of yields, similarly to the bond market regressions.

4.4.2. Results

First consider excess return regressions. [Table 5a](#) shows that there is no predictability in the spread regressions for excess returns in 6 out of 8 countries – only Germany and Switzerland are significant at the 5% level. Regressions with the yield vector find significance at the 5% level in 2 out of 8 cases. Thus, there is limited or no predictability of excess returns in the money market. Turning to expectational error regressions, [Table 5b](#) shows the evidence from estimating Eq. (15). Expectational errors cannot be predicted from the spread at the 5% level in 7 of the 8 countries, while none of the multivariate regressions with the various yields are significant.

Although it is by now repetitive, we can only stress the parallel between the results of the two types of predictability regressions. In the case of the money market, the parallel is that there is little or no predictability either in excess returns or in expectational errors. On the other hand, [Table 5c](#) shows that expected excess returns are significantly affected by the term spread and other interest rates.

5. Discussion

Summing up the last section, we find striking evidence of a link between the predictability of excess returns and of expectational errors. First, in markets where there is significant excess return predictability, expectational errors of excess returns are predictable as well, with the same sign and often even with similar magnitude. This is the case for foreign exchange, stock and bond markets. Second, in the only market where excess returns are generally not predictable, the money market, expectational errors are not predictable either.

The critical reader might have concerns about whether the results can be taken at face value. One could argue that subjective beliefs are hard to measure and that survey evidence could reflect measurement error rather than deviations from strong rationality. While sharing some of this scepticism, we will argue below that measurement error does not invalidate the results.

This begs the important question of what is driving the results. A complete answer is beyond the scope of this empirical paper, but we feel compelled to offer a discussion at the end of this section.

5.1. Measurement error

Measurement error is equal to the difference between the average market expectation of returns and the survey expectation of returns. While there are limitations of survey data, we believe that it goes too far to say that all these results are entirely due to measurement error.²⁰ First, measurement error that is uncorrelated with predictors does not create biased results. Second, we have attempted to minimize biases in the empirical

²⁰ In this context we agree with [Manski \(2004\)](#): “Economists have long been hostile to subjective data. Caution is prudent, but hostility is not warranted.”

Table 4a
10-Year bonds.

Countries	Spread	Libor (3M)	Libor (6M)	Libor (12M)	Bonds (10Y)	R^2 $p(\beta = 0)$
Excess return predictability (survey sample) $q_{t+12}^{132} = \alpha + \beta X_t + u_{t+12}$						
Australia	1.5121 (1.0586)	7.8447 (12.3245)	-10.2138 (22.3352)	-0.4915 (11.8325)	4.4144*** (1.5309)	0.06 0.1580 0.19 0.0006
Canada	1.4901 (0.9119)	3.9681 (6.1721)	-6.2364 (10.4291)	-0.7508 (6.0910)	4.6200** (1.8500)	0.08 0.1066 0.18 0.0000
France	1.5265 (1.3148)	11.5473* (6.6433)	-21.4968 (14.0560)	7.1802 (8.1341)	4.2412** (1.7049)	0.06 0.2506 0.17 0.0383
Germany	1.6873 (1.2286)	20.3362*** (7.7855)	-39.4345*** (9.8149)	17.9282*** (4.6593)	2.1665 (1.3995)	0.11 0.1745 0.22 0.0000
Japan	2.9405 (1.8884)	17.9061*** (4.9320)	-27.1931** (11.8650)	4.7053 (11.0543)	6.2656*** (1.8241)	0.15 0.1240 0.33 0.0000
Switzerland	2.2429*** (0.8552)	6.6367 (6.5703)	-14.0074 (11.4255)	2.2505 (8.0521)	10.1290*** (2.9348)	0.17 0.0101 0.44 0.0000
U.K.	1.2295 (1.0449)	14.0797** (6.2915)	-28.6385** (13.0359)	13.6673 (8.3372)	1.7539 (1.4847)	0.06 0.2443 0.16 0.0012
U.S.	0.5695 (0.8810)	5.8193 (10.9704)	-22.1059 (18.8830)	15.9638* (9.4376)	1.2268 (2.2390)	0.01 0.5217 0.23 0.0010
EW avg.	1.6498** (0.7601)					
Spread: $p(\beta = 0)$						0.0000
Yields: $p(\beta = 0)$						0.0000

Note: The reported p -values correspond to F -tests on the joint significance of slopes across equations. Newey–West standard errors with 13 lags. SUR system for Spread and Yield regressions estimated from 153 observations over sample from September 1987 to July 2004. Spread is the difference in log-yields of Bonds (10Y) and Libor (12M). See Section 4.3.1 for construction of data. Twelve months forecast horizon.

work. It is well known that the expectations of financial analysts can be systematically biased and that a mismatch between the forecast and actual return period can create a bias. We therefore focused on expectations of market participants and we carefully matched the forecast period at the time that the survey is answered to the actual asset return period. Third, even though there are measurement errors in that the survey does not capture all market participants, this should not invalidate the results by much. The surveys do capture large numbers of wealthy investors and financial institutions that actively participate in these markets, suggesting that at least for those respondents the evidence violates strong rationality. Fourth, we find evidence of predictable expectational errors in many financial markets, sample periods and countries.

Finally, previous authors have documented that survey expectations are not just random noise. Froot and Frankel (1989) find that expected depreciation in foreign exchange surveys is highly correlated with the

Table 4b
10-Year bonds.

Countries	Spread	Libor (3M)	Libor (6M)	Libor (12M)	Bonds (10Y)	R^2 $p(\delta = 0)$
Survey error predictability $q_{t+12}^{132} - E_t^s q_{t+12}^{132} = \gamma + \delta X_t + v_{t+12}$						
Australia	1.3363 (1.0044)	6.9603 (10.8385)	-9.9933 (19.2026)	0.9576 (10.1315)	3.0055** (1.4206)	0.05 0.1882 0.11 0.0444
Canada	1.9737** (0.8280)	-2.3027 (6.4304)	0.0798 (10.4363)	-0.1693 (5.5632)	3.1325* (1.6355)	0.12 0.0191 0.17 0.0095
France	2.2944* (1.3724)	15.9189** (7.6597)	-31.1717** (15.6483)	11.9850 (8.6132)	4.7417*** (1.6352)	0.11 0.0988 0.23 0.0278
Germany	2.3000** (1.1241)	23.9462*** (7.0014)	-51.7979*** (8.3578)	26.7230*** (4.9435)	1.9353 (1.6118)	0.14 0.0438 0.30 0.0000
Japan	4.1099*** (1.5453)	19.5079*** (6.4859)	-32.2487** (16.1883)	7.0361 (12.6656)	7.5027*** (1.9052)	0.25 0.0091 0.43 0.0000
Switzerland	2.8284*** (0.7661)	8.4185 (7.3460)	-25.1561** (12.2133)	12.0837 (8.6709)	9.1257*** (2.9786)	0.22 0.0003 0.43 0.0000
U.K.	1.7657** (0.8953)	14.3980** (6.1537)	-29.2440** (12.7765)	13.8754* (8.0943)	1.1994 (1.4071)	0.13 0.0519 0.18 0.0030
U.S.	0.6724 (0.9273)	5.9275 (10.7895)	-25.3290 (18.3315)	19.4278** (9.0217)	0.5589 (2.1434)	0.01 0.4724 0.23 0.0000
EW avg.	2.1601*** (0.6506)					
Spread: $p(\delta = 0)$						0.0000
Yields: $p(\delta = 0)$						0.0000

Note: The reported p -values correspond to F -tests on the joint significance of slopes across equations. Newey–West standard errors with 13 lags. SUR system for Spread and Yield regressions estimated from 153 observations over sample from September 1987 to July 2004. Spread is the difference in log-yields of Bonds (10Y) and Libor (12M). See Section 4.3.1 for construction of data. Twelve months forecast horizon.

forward discount. Vissing-Jorgenson (2003) reports that average market expectations for U.S. stock returns were high when the market was strong at the end of the 1990s and fell sharply when the market went down. While we have shown that the expected excess returns in foreign exchange, stock and bond markets are not very sensitive to current variables, this does not mean that survey expectations are just zero with some noise. On the contrary, small expected excess returns require large and time-varying survey expectations of exchange rates, stock prices and interest rates. Results shown in the Empirical Appendix confirm this. It is shown that expected depreciation is closely related to the interest differential; that expected stock price changes are related to the interest rate and dividend-yield (and cay); and that expected changes in both short and long-term interest rates are closely related to the yield spread for all countries.

Table 4c
10-Year bonds.

Countries	Spread	Libor (3M)	Libor (6M)	Libor (12M)	Bonds (10Y)	R^2 $p(\beta = 0)$
Survey-expected excess returns $E_t^s q_{t+12}^{132} = \alpha + \beta X_t + u_t^s$						
Australia	0.2336 (0.1662)	1.0616 (3.6248)	-0.3757 (6.3967)	-1.5423 (3.2091)	1.5354*** (0.5300)	0.01 0.1644 0.21 0.0015
Canada	-0.5144 (0.3212)	6.3426*** (1.6684)	-6.5133** (3.1862)	-0.4282 (1.8282)	1.4416*** (0.4502)	0.04 0.1134 0.21 0.0000
France	-0.8018*** (0.3007)	-4.0275** (2.0410)	9.3338** (3.8759)	-4.8955** (2.4252)	-0.3263 (0.5229)	0.09 0.0089 0.13 0.0040
Germany	-0.6329* (0.3451)	-3.3122 (2.7529)	12.0391*** (4.5848)	-8.8029*** (2.3143)	0.3423 (0.5162)	0.07 0.0703 0.24 0.0000
Japan	-1.1165* (0.6059)	-1.8164 (4.8657)	5.5649 (7.6737)	-2.6094 (3.8931)	-1.3168** (0.5971)	0.12 0.0689 0.14 0.0037
Switzerland	-0.6765** (0.3034)	-0.9775 (2.2386)	9.9262** (3.8725)	-9.5395*** (2.4238)	1.4221*** (0.5357)	0.09 0.0281 0.31 0.0000
U.K.	-0.5372** (0.2475)	-0.3647 (3.3502)	0.7108 (6.3304)	-0.1889 (3.4101)	0.3785 (0.4067)	0.07 0.0325 0.22 0.0004
U.S.	-0.0905 (0.1769)	0.8173 (2.5993)	2.5658 (4.0159)	-3.9100* (2.1278)	1.0239** (0.4328)	0.00 0.6118 0.09 0.1365
EW avg.	-0.5170** (0.2060)					
Spread: $p(\beta = 0)$						0.0387
Yields: $p(\beta = 0)$						0.0000

Note: The reported p -values correspond to F -tests on the joint significance of slopes across equations. Newey–West standard errors with 13 lags. SUR system for Spread and Yield regressions estimated from 162 observations over sample from September 1987 to April 2005. Spread is the difference in log-yields of Bonds (10Y) and Libor (12M). See Section 4.3.1 for construction of data. Twelve months forecast horizon.

5.2. Predictability of excess returns versus expectational errors

We leave perhaps the most important question for last: what accounts for the close relationship between the predictability of excess returns and expectational errors? The goal of this paper is merely to document this stylized fact. But we briefly comment on two different types of explanations. One set of explanations relies on causality from predictability of expectational errors to predictability of excess returns. Examples of this are Cecchetti et al. (2000) for the stock market and Gourinchas and Tornell (2004) for the foreign exchange market. The causality argument is well known. If the risk premium were a constant rp , and the expected excess return is equal to a risk premium as in most asset pricing models, then $E_t q_{t+1} = rp$. This implies that $q_{t+1} = rp + \varepsilon_{t+1}$, where $\varepsilon_{t+1} = q_{t+1} - E_t q_{t+1}$ is the expectational error. Then the excess return is predictable by any variable that predicts the expectational error and with the same sign and size of the predictability coefficient.

Table 5a
Libor (6M).

Countries	Spread	Libor (3M)	Libor (6M)	Libor (12M)	Bonds (10Y)	R^2 $p(\beta = 0)$
Excess return predictability (survey sample) $q_{t+3}^6 = \alpha + \beta X_t + u_{t+3}$						
Australia	0.2374 (0.7228)					0.00 0.7445
		−0.5945 (1.3906)	1.1385 (2.2089)	−0.6782 (0.9240)	0.2189** (0.0954)	0.07 0.0371
Canada	0.5375 (0.5279)					0.02 0.3131
		−0.7988* (0.4392)	1.1059 (0.8599)	−0.3273 (0.7022)	0.0224 (0.2002)	0.02 0.5034
France	−0.0829 (0.4264)					0.00 0.8470
		0.1872 (0.9594)	0.0246 (1.8130)	−0.3574 (0.9518)	0.2169 (0.1366)	0.03 0.6098
Germany	0.6171** (0.2841)					0.05 0.0324
		−0.5868 (0.7008)	0.5669 (1.2200)	0.0116 (0.5856)	0.0090 (0.0856)	0.05 0.0763
Japan	0.1677 (0.4189)					0.00 0.6913
		−0.5137 (0.4682)	1.0294 (0.7798)	−0.7047* (0.4273)	0.2571*** (0.0788)	0.13 0.0172
Switzerland	0.9637** (0.4092)					0.04 0.0205
		−1.0136* (0.5823)	1.3648 (1.0867)	−0.5256 (0.6201)	0.3089* (0.1780)	0.09 0.0585
U.K.	0.3765 (0.5025)					0.01 0.4575
		−0.2560 (1.0134)	0.1804 (1.6455)	0.0577 (0.7244)	0.0176 (0.0906)	0.01 0.9249
U.S.	−0.0169 (0.4921)					0.00 0.9728
		0.3003 (0.6115)	−0.5969 (0.8901)	0.3716 (0.3900)	−0.0706 (0.1273)	0.03 0.6530
EW avg.	0.3500 (0.2419)					
Spread: $p(\beta = 0)$						0.1733
Yields: $p(\beta = 0)$						0.0000

Note: The reported p -values correspond to F -tests on the joint significance of slopes across equations. Newey–West standard errors with 4 lags. SUR system for Spread and Yield regressions estimated from 163 observations over sample from September 1987 to April 2005. Spread is the difference in log-yields of Libor (6M) and Libor (3M). See Section 4.4.1 for construction of data.

An alternative explanation is that a third factor drives predictability of both excess returns and expectational errors. This factor could be the substantial cost of predicting future asset prices relative to the benefits from doing so. Exchange rates, as well as stock and bond prices, are well known to be very hard to predict. Any predictability of excess returns is therefore largely outshadowed by risk, limiting the expected gain from actively trading on expected excess returns. This may give rise to both predictable expectational errors and predictable excess returns.

First consider the predictability of expectational errors. It may not be worth for most investors to actively trade on the predictability of excess returns if this predictability is outshadowed by risk. Bacchetta and van Wincoop (2008) develop a two-country general equilibrium model for the foreign exchange market in which the welfare gain from full information processing and active trade based on that information are small compared to the fees generally charged for these services. It may therefore not be optimal to be fully informed. Assuming that uncovered interest parity holds (implying a zero expected excess return) may be

Table 5b
Libor (6M).

Countries	Spread	Libor (3M)	Libor (6M)	Libor (12M)	Bonds (10Y)	R^2 $p(\delta = 0)$
Survey error predictability $q_{t+3}^6 - E_t^S q_{t+3}^6 = \gamma + \delta X_t + v_{t+3}$						
Australia	-1.2575* (0.7566)	1.5173 (1.2412)	-1.5874 (2.0122)	-0.0092 (0.9174)	0.1193 (0.1034)	0.08 0.1005 0.10 0.1080
Canada	-0.4598 (0.4716)	0.0441 (0.5112)	0.3774 (0.9265)	-0.4226 (0.6604)	-0.0032 (0.1955)	0.01 0.3340 0.02 0.8803
France	-1.3694*** (0.5001)	1.5355 (1.1407)	-1.5902 (2.1055)	0.0235 (1.0673)	0.0695 (0.1272)	0.18 0.0072 0.19 0.0917
Germany	-0.3427 (0.2404)	0.6851 (0.4662)	-0.9813 (0.8503)	0.3230 (0.4385)	-0.0084 (0.0715)	0.02 0.1586 0.03 0.2745
Japan	-0.4759 (0.4151)	0.2291 (0.4258)	0.1054 (0.6997)	-0.4646 (0.4124)	0.1958*** (0.0754)	0.02 0.2562 0.10 0.1055
Switzerland	-0.4809 (0.4162)	0.9080 (0.5538)	-1.1636 (0.9971)	0.1340 (0.5664)	0.2561 (0.1692)	0.01 0.2525 0.05 0.2174
U.K.	-0.6962 (0.5218)	0.9105 (0.9114)	-1.1029 (1.4043)	0.2310 (0.5836)	-0.0813 (0.0865)	0.03 0.1866 0.05 0.7436
U.S.	-0.5681 (0.4397)	0.6347 (0.4732)	-0.8495 (0.7042)	0.3172 (0.3548)	-0.1326 (0.1033)	0.03 0.2010 0.06 0.3901
EW avg.	-0.7063*** (0.2433)					
Spread: $p(\delta = 0)$						0.0896
Yields: $p(\delta = 0)$						0.0000

Note: The reported p -values correspond to F -tests on the joint significance of slopes across equations. Newey–West standard errors with 4 lags. SUR system for Spread and Yield regressions estimated from 163 observations over sample from September 1987 to April 2005. Spread is the difference in log-yields of Libor (6M) and Libor (3M). See Section 4.4.1 for construction of data.

a good approximation for a foreign exchange investor who is not trading actively. In that case expectational errors are themselves predictable with the same sign as size as excess return predictability.

Next consider the predictability of excess returns. The fact that investors do not trade frequently can lead to excess return predictability. Bacchetta and van Wincoop (2008) show this in the context of a model where agents make infrequent portfolio decisions based on expected excess returns. In that case new information builds gradually into asset prices, which generate excess return predictability. If this view is correct, then predictability of expectational errors do not cause the predictability of excess returns, but they are both the result of the difficulty in predicting future asset prices.²¹

²¹ Also note that in this case, with infrequent portfolio decisions, the expected excess return is no longer equal to a risk premium.

Table 5c
Libor (6M).

Countries	Spread	Libor (3M)	Libor (6M)	Libor (12M)	Bonds (10Y)	R^2 $p(\beta = 0)$
Survey-expected excess returns $E_t^s q_{t+3}^6 = \alpha + \beta X_t + u_t^s$						
Australia	1.4949*** (0.2190)					0.38 0.0000
		-2.1118*** (0.5865)	2.7259*** (1.0185)	-0.6690 (0.4667)	0.0996*** (0.0293)	0.42 0.0000
Canada	0.9973*** (0.2020)					0.22 0.0000
		-0.8429** (0.3490)	0.7285 (0.5354)	0.0953 (0.2252)	0.0256 (0.0460)	0.22 0.0000
France	1.2865*** (0.1106)					0.59 0.0000
		-1.3483*** (0.2718)	1.6148*** (0.4921)	-0.3809 (0.2434)	0.1474*** (0.0470)	0.64 0.0000
Germany	0.9597*** (0.1278)					0.38 0.0000
		-1.2719*** (0.3694)	1.5482** (0.6359)	-0.3114 (0.2903)	0.0174 (0.0328)	0.42 0.0000
Japan	0.6436*** (0.2371)					0.13 0.0077
		-0.7428*** (0.2720)	0.9240** (0.4410)	-0.2401 (0.2306)	0.0613 (0.0386)	0.20 0.0104
Switzerland	1.4446*** (0.1109)					0.50 0.0000
		-1.9216*** (0.1625)	2.5283*** (0.3138)	-0.6596*** (0.1749)	0.0528 (0.0347)	0.54 0.0000
U.K.	1.0728*** (0.1705)					0.28 0.0000
		-1.1666*** (0.3480)	1.2833** (0.6321)	-0.1734 (0.3199)	0.0989** (0.0405)	0.33 0.0000
U.S.	0.5512*** (0.1656)					0.10 0.0012
		-0.3344 (0.3276)	0.2526 (0.5447)	0.0544 (0.2463)	0.0620 (0.0431)	0.14 0.0129
EW avg.	1.0563*** (0.0825)					
Spread: $p(\beta = 0)$						0.0000
Yields: $p(\beta = 0)$						0.0000

Note: The reported p -values correspond to F -tests on the joint significance of slopes across equations. Newey–West standard errors with 4 lags. SUR system for Spread and Yield regressions estimated from 163 observations over sample from September 1987 to April 2005. Spread is the difference in log-yields of Libor (6M) and Libor (3M). See Section 4.4.1 for construction of data.

6. Conclusion

This paper has identified a strong parallel between two types of predictability in financial markets. It is well documented that excess returns are time varying and predictable. But the errors of market participants in forecasting those excess returns are predictable in a similar fashion. This applies to stock, bond and foreign exchange markets across the world.

The main results regarding the predictability of expectational errors can be summarized as follows: (i) expectational errors in the foreign exchange market are predicted by the interest differential for 6 out of the 7 currency pairs considered for the 1986–2004 period; (ii) using the UBS/Gallup survey for stock market returns between 1998 and 2003, expectational errors are predicted by the dividend-yield ratio or by a combination of the dividend-yield and a short-term interest rate; (iii) using the ICF/Yale survey for expected stock price

changes over the period 1985–2003, expectational errors for the Dow Jones are predicted by the dividend-yield, while expectational errors for the Nikkei are predicted by the short-term interest rate; (iv) expectational errors on 10-year bonds are predicted by a combination of yields in our 8 industrialized countries over the 1987–2004 period. There is also predictability by the term spread; (v) there is little predictability of expectation errors for shorter maturities. The tables in the [Empirical Appendix](#) show that most results are robust to varying the horizon of prediction.

What is striking is that the predictability of expectational errors tends to coincide with excess return predictability in each of these markets. This suggests that understanding what determines expectational errors is crucial in explaining excess return predictability. A convincing explanation need not only link time-varying excess returns with expectational errors, but it must apply to all markets as well.

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Appendix A. Data sources

This appendix lists the sources for the market data used in this study, as well as some further information on the survey data.

Foreign exchange rate data

Market data on exchange rates for seven countries (Australia, Canada, France, Germany, Japan, Switzerland and U.K.) against the U.S. dollar are provided by DataStream (“GTIS exchange rate series”). Since Germany and France joined the European Monetary Union in 1999, implied rates for Deutschmark and French Franc are calculated from their official euro conversion rates (1.95583 DEM/EUR, respectively, 6.55957 FFR/EUR) and the euro/dollar exchange rate. The same is done for the survey data.

The interest rate spread is calculated from Euro-market interest rates for the seven countries plus the U.S. which are also provided by DataStream. For Australia DataStream provides a Euro-market interest rate only as of 1997. Instead, an interbank rate is used which is quoted in London and collected by DataStream since 1986. The German and French Euro-market rates are identical to the interest rates quoted for transactions in the euro currency as of January 1999.

Corresponding to the survey’s horizon, the interest rates have a maturity of 3, 6 or 12 months. Since the data are matched with the survey dates as described in Section 4.1, the underlying data set covers daily observations from 15 October 1986 until 28 July 2005.

Stock market data

The stock market data used for the survey error regressions are described in Section 4.2. With the exception of the data on the consumption-wealth ratio (*cay*) and interest rates, they are exclusively obtained from DataStream. The data on *cay* have been downloaded from the website of Martin Lettau (http://pages.stern.nyu.edu/mlettau/data_cay.html). The interest rate is the one-year Treasury Constant Maturity Rate from FRED.

For return predictability regressions (Table 2), monthly observations since March 1966 are obtained from the same data sources: The stock market return is computed from the Composite Total Return Index (i.e., with dividends reinvested) of the S&P 500 from DataStream. As predictors we use the dividend-yield on the same S&P 500 as well as the three-month Treasury Bill rate from FRED and *cay* from Lettau. Since *cay* is only constructed for quarterly observations, our monthly observations on *cay* are set to be equal to its most recent quarterly value.

Bond and money market data

All data on bonds and money markets used for the computations in Sections 4.3 and 4.4 have been obtained from DataStream. Money market rates are Euro-market rates for the eight countries considered (Australia, Canada, France, Germany, Japan, Switzerland, U.K. and U.S.), with a maturity of 3, 6 or 12 months, are the same interest rates used for the foreign exchange regressions. With respect to the availability of survey data, the common sample across all countries and maturities covers the period from September 1987 to July 2005.

Consistent data on 10-year government bonds in the eight countries come from DataStream's government benchmark bond indices. At a given point in time, these indices typically consisted of a single bond, namely the most liquid government bond which has close to 10 year's maturity. The interest rate surveys also provide data on each country's 10-year yield prevailing at the time of the survey. These yields coincide neatly with the yields-to-maturity computed by DataStream for their indices. These yields-to-maturity are used to compute approximate bonds returns as described in Section 4.3. The index data are available on a daily basis, which is required to match the data with the surveys.

For survey error regressions, market data are matched with the surveys in a manner analogous to the foreign exchange survey: since surveys are typically conducted over a three-day window, the survey error is computed as the difference between survey expectations and a three-day average of the realized yield at the end of the survey horizon. To be precise, let a survey be conducted from days $t = 1$ to $t = 3$, the three months realization is then the geometric average of the yields (simple average of the log-yields) prevailing on $t = 91$, $t = 92$ and $t = 93$ (measured in calendar days). The yields used as predictors are not averaged but measured at the earliest date when the survey is conducted, corresponding here to $t = 1$.

The underlying data set for matching market data with surveys covers daily observations from 20 September 1987 until 28 July 2005. For regressions on excess return predictability, data are monthly (end-of-month).

Exchange rate and interest rate survey data

This survey has gone by different names in the past because of changes in ownership. It was initiated by Alan Teck in 1984 under the name "The Currency Forecasters' Digest". In 1990 it was sold to a subsidiary of the Financial Times and renamed the "Financial Times Currency Forecaster" (used for example by Gourinchas and Tornell, 2004). In the following decade it was moved among four different subsidiaries of the Financial Times, each with different personnel. In September 2000 it was bought back by Alan Teck for the company Forecasts Unlimited.

Because of the frequent changes in ownership some of the data are missing. For the exchange rate survey there are missing data for 7 months of the survey. For the interest rate survey there is 3-year gap in the data from November 1997 to November 2000. For most countries and maturities, the survey covers interest rates only as of September 1987. Depending on maturity, there are further missing interest rate survey data for 25–27 months spread throughout the sample.

The number of contributors has not changed much over time, but after December 1993 there was an important change in the type of contributors. Until December 1993 the forecasts came from 30 multinational companies and 18 financial institutions. After that there was a switch to 45 forecasters from financial institutions only. The reason for the change is that forecasts from financial institutions were found to be more reliable.

Stock market survey data

The U.S. data in the ICF/Yale survey are collected by Robert Shiller, while the Japanese data are collected by Yoshiro Tsutsui at Osaka University and Fumiko Kon-Ya of the Japan Securities Research Institute. For Japan the survey is mailed to most of the major financial institutions (165 banks, 46 insurance companies, 113 securities companies and 45 investment trust companies). For U.S. institutional investors about 400 randomly drawn institutions are selected from "Investment Managers" in the "Money Market Directory of Pensions Funds and their Investment Managers". For individual U.S. investors the survey is mailed to a random sample of 400 high income Americans from a list purchased from Survey Sampling Inc. For all three of these surveys the average response rate is about one third. We have the answers by individual respondents as well as the date that they filled out the survey. Even if only one or two surveys were conducted during a particular year,

the responses came in over a period of two or more months. This is not a problem as the date of each individual response is known.

Appendix B. Empirical appendix

Empirical appendix associated with this article can be found, in the online version, at [doi:10.1016/j.jimonfin.2008.09.001](https://doi.org/10.1016/j.jimonfin.2008.09.001).

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