Long Term Expectations and Aggregate Fluctuations
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Discussants: Venky Venkateswaran, George-Marios Angeletos

Gianluca Violante opened the discussion, commenting that the paper of Ricardo De la O and Sean Myers shows that cash flow growth expectations explain most movements in the S&P 500 price-dividend and price-earnings ratios. In the De la O and Myers paper, short run expectations have a more important role than long run expectations. Instead, the authors have the opposite result: long run expectations are more important. How can these two different views be reconciled? Is it possible that the definition of long run is different in these two works? Şebnem Kaleli-Özcan followed up with a similar comment. In the international literature, the relationship between exchange rate expectations and UIP deviations is better captured by expectations of one year up to 18 months. Nicola Gennaioli explained that the two views can be reconciled because short term expectations are very volatile and they co-move with earnings and dividends. This is why short-term expectations co-move with the price-dividend ratio. However, while long-term earnings growth expectations predict market returns, short earning growth term expectations do not. Furthermore, long-term earnings growth expectations dampen the predictive power of the price-dividend ratio for returns. Thus, long-term expectations, not short-term ones, are key to understanding market inefficiency. Finally, replying to the discussants, Nicola Gennaioli explained that long-term earnings growth expectations are a valid proxy for non-rational beliefs because they exhibit significant independent variation from market prices. Long-term earnings growth expectations are partly revised by past earnings performance and partly by news about the future. However, recent returns in the stock market cannot instead predict the revision of long-term earnings growth expectations.

Jennifer La’O pointed out that the predictability of forecast errors rules out full information rational expectation models but does not immediately imply irrationality. Indeed, predictability of the forecast errors can also be explained by a rational agents model with incomplete information. For example, if agents learn overtime about a latent variable, it is possible to have predictability of forecast errors. Nicola Gennaioli replied that Jennifer La’O is right. In this paper, they do not try to tease the mechanism of expectation formation, which they do elsewhere, but to show new empirical facts on the connection between measured expectations, the predictability of the error and the macro-financial system. Understanding the scope of learning and irrationality is an interesting and open question for future work.

Ricardo Reis asked for a clarification of how the aggregate long-term growth forecast is constructed, because whether one weights by stock market value, book value, amount of investment, it would make a big difference to how one interprets the results. Furthermore, he suggested that the authors estimate the investment regressions at the firm level instead of at the aggregate level, since authors could match the firm’s earnings forecast with their respective balance sheet. It should be the case that when a firm’s earnings forecasts are optimistic, then that firm invests more. Nicola Gennaioli explained that the long-term growth forecast is constructed as the value-weighted average of the median forecast of each firm. Furthermore, Nicola Gennaioli added that forecast error can be predicted at the firm level, hence without relying on any weighting scheme. Furthermore, the investment regressions were also estimated at the firm level. These results were not shown in the presentation but are in the paper.

Daron Acemoglu pointed out that analysts’ forecasts influence the market through the behavior of investors. However, if incentives of the analysts are changed, for example with an increase in their wage by 10% when they report more positive news, then it could be that investors, and thus the market, react less to analysts’ information. To believe that analysts’ forecasts are informative of market behavior, it must be
assumed that investors’ behavior is independent of analysts’ incentives. To what extent can analysts’ forecast be a good proxy for market behavior? Nicola Gennaioli pointed out that there is no obvious reason to believe that the incentives of analysts should be unstable, due to incentives, in a way that induces them to be excessively optimistic in good times and pessimistic in bad times. Most importantly, this feature of expectations emerges when one looks at data from market participants that may have very different incentives from analysts. In other work with his co-authors, they show that a CFO’s growth expectations of their own company were in line with analysts’ expectations. Furthermore, a CFOs’ expectation predicted firm investment better than market variables, such as the Tobin’s Q. Hence, expectations data, including those of analysts, seem good proxies for beliefs about the future growth of firms.

Martin Eichenbaum commented that the co-movement of news shocks and the business cycle cannot be explained by the real business cycle model. However, nominal rigidities and credit market frictions can explain this co-movement. Nicola Gennaioli agreed with this point and added that financial market frictions are an important complement to excessively volatile expectations because the empirical results indeed show that financing investment when expectations are optimistic is relatively easier, potentially leading to a subsequent bust in investment when excess optimism is corrected.