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Headline: Emotions and Subjective Crash Beliefs

Article Link: https://www.nber.org/papers/w32589

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Publication	National Bureau of Economic Research
Publication Date	June 25, 2024

Tweet: .@RobertJShiller and @WGoetzmann find that subjective assessments consistently overestimate the risk of stock market collapse, and that emotional response to non-fundamental shocks explains at least some of the variation.

Summary: Using more than two decades of Shiller's Stock Market Confidence Survey we decompose crash beliefs into subjective and fundamental components based upon option prices, [which] reflect the time-varying beliefs and preferences of the marginal investor in these markets [who] take[s] into account fundamental factors and on average, rationally assess[es] crash probabilities. The subjective crash probability measure is highly volatile, typically right-skew, and nearly always positive. To better understand the subjective component in crash risk forecasts, we apply a large language model (LLM) to [survey response] narratives, to construct high-frequency measures of sentiment/emotion. The model is fine-tuned using rich data on human-derived emotion annotations to narratives. We find that investor sentiment is correlated with the subjective crash probability component and find strong evidence that it is related to non-fundamental variation. [Finally] we find that exposure and attention to news of rare, extreme events: i.e. nearby earthquakes, large lottery winnings, and excess COVID deaths is significantly associated with a higher or lower rare crash probability, depending on emotional valence.

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