Expectations and trading

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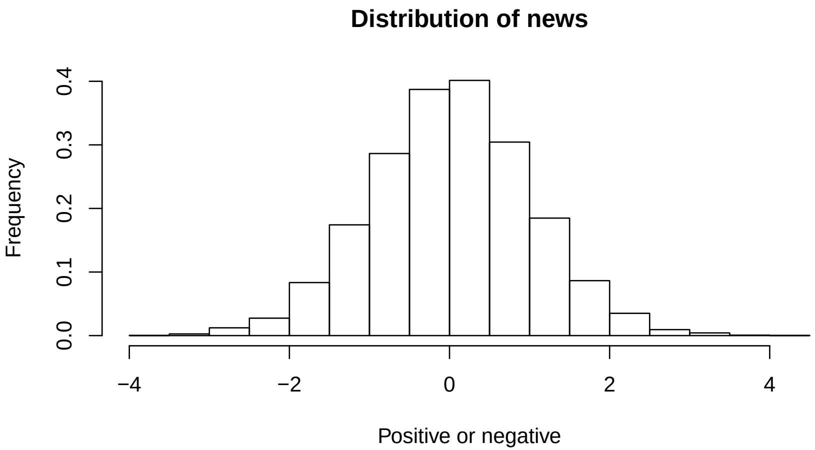
If the market is informationally efficient, the next market move will be determined by the next information that is received.

$$p_{t+1} = p_t + \varepsilon, \qquad \varepsilon \sim N(0, \sigma^2)$$

However, in assessing the market reaction to new information, it is essential to know what is currently discounted.

Centering the distribution



What is discounted?

This is a bigger problem than would be anticipated

Problem

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Radio: "BP shares rose 10% despite the company losing \$10mn in the first half of the year"

Answer

They were expected to lose \$15mn

Assessing expectations

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Assessing expectations

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- The price is some sort of *weighted average* of these expectations
  - Weighted by intensity of belief
  - Weighted by money
- It is not necessarily normally distributed

The distribution of expectations

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- **Positive skew** most people have a consensus belief but there are some extremely positive views
- **Negative skew** most people have a consensus belief that there are some extremely negative views

The distribution of expectations

For example

- **Positive skew** most people have a consensus belief but there are some extremely positive views
- **Negative skew** most people have a consensus belief that there are some extremely negative views
- **Bimodal distribution** there are two nodes to expectation that are some way from each other.

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- What sort of position are held by short-term speculative accounts?
- What sort of positions are held by long-term stable accounts?
- Where are the *take-profits* and *stop-losses*