

# Where there is amplification, there are sunspots\*

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## Abstract

We provide a complete analysis of sunspot equilibria in a canonical dynamic economy with financing constraints. Under financial frictions, risk considerations affect the asset ownership distribution. Supposing, in addition, the ownership distribution matters for asset prices, self-fulfilling fluctuations emerge: if agents suddenly become fearful about asset volatility, ensuing fire sales shift allocative efficiency, creating an asset-price decline that justifies the fear. A supplementary complete-market representative-agent example with nominal rigidities illuminates the mechanism. Sunspot equilibria can help resolve several puzzling patterns, permitting arbitrary amounts of volatility, a decoupling of crisis fluctuations from fundamentals, and faster crisis recovery.

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It has by now become commonplace, especially after the 2008 global financial crisis, for macroeconomic models to prominently feature banks, limited participation, imperfect risk-sharing, and other such “financial frictions.” Incorporating these features allows macroeconomists to speak meaningfully about financial crises and desirable policy responses. The universal feature of these models is *amplification*: small exogenous shocks to fundamentals can create large endogenous movements in economic observables. Despite the dramatic growth in this literature, there remains a sizeable disconnect between the predictions of such models and actual crisis data. Among other things, the literature has had difficulty reproducing the observed severity and suddenness of economic downturns and asset-price dislocations. One might say that the degree of amplification in the models has been insufficient.<sup>1</sup>

We embrace *sunspots* as a potential resolution. Throughout our paper, sunspots refer to non-fundamental fluctuations that only occur because agents expect them. This paper makes three main contributions. First, we show that standard financial friction models are already subject to a wide variety of sunspot fluctuations, with no further assumptions. In this sense, the very same financial frictions activating amplification also provide scope for sunspots. Second, we demonstrate how sunspot equilibria alleviate some of the empirical shortcomings for this class of models. Third, we provide a supplementary complete-market representative-agent model which exhibits sunspot fluctuations, to clarify the culprits of multiplicity.

**Model and mechanism.** We study a simple stripped-down model with financial frictions, similar to [Kiyotaki and Moore \(1997\)](#), [Brunnermeier and Sannikov \(2014\)](#), and many others.<sup>2</sup> There are two types of agents (“experts” and “households”) with identical preferences but different levels of productivity when managing capital. Heterogeneous productivity means the identity of capital holders matters for aggregate output. But in-

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<sup>1</sup>For example, [Gertler and Kiyotaki \(2015\)](#) and [Gertler et al. \(2020\)](#) attempt to integrate bank runs into a conventional financial accelerator model, in order to capture additional amplification and non-linearity (in particular, the suddenness with which financial systems collapse). As a more fundamental critique, financial accelerator models have a difficult time inducing the financial intermediary leverage and risk concentration needed to generate large amounts of amplification. This can be seen in [Di Tella \(2017\)](#), in which the retirement rate of bankers/experts needs to be calibrated to 115% per year, or in [Khorrami \(2018\)](#), in which the implied entry costs needed to match crisis dynamics of asset prices are on the order of 90% of wealth. [Krishnamurthy and Li \(2020\)](#) and [Maxted \(2020\)](#) build a sentiment process on top of a relatively standard financial accelerator model, in order to help address some of these issues, in particular the onset of crises even in absence of fundamental shocks. The similarity to this paper is that their “behavioral sentiment” is replaced by a rational notion of sentiments.

<sup>2</sup>We work in continuous time, contributing to a burgeoning financial frictions literature. See also [He and Krishnamurthy \(2012, 2013, 2019\)](#), [Moreira and Savov \(2017\)](#), [Klimenko et al. \(2017\)](#), and [Caballero and Simsek \(2020c\)](#). For a survey, see [Brunnermeier and Sannikov \(2016\)](#).

complete markets prevent agents from sharing risks associated to their capital holdings, so optimal capital holdings depend to some degree on these risks. There are no other features: no borrowing/collateral constraints, no default externalities, and no irrational beliefs. And yet, this basic model can feature a tremendous amount of multiplicity that has been overlooked in the literature.

The following story clarifies the mechanism. Suppose there is a sudden rise in *fear*, purely as a sunspot phenomenon (i.e., no change in preferences or technology). Fear manifests as higher perceived asset-price volatility, which results in a *fire sale*: first-best capital users (experts) sell to less-efficient users (households). The reason is that, with financial frictions, both risk-sharing and productive-efficiency considerations matter for the capital distribution, and elevated risk propels risk-sharing considerations to the forefront. Because productive efficiency falls, asset prices fall as well. Thus, the new allocation features a less efficient capital allocation, lower asset prices, and higher volatility.

This allocation will only be an equilibrium if it does not lead to explosive paths. While this may seem technical, it is a real concern here: with higher volatility in the new equilibrium, any subsequent fear shocks would have a larger direct impact, further raise volatility, and so on, ad infinitum. Rational forward-looking agents would rule this out at the beginning and decide to suppress their fear.

In this class of models, explosions are easily prevented because of an indeterminacy in the dynamic equilibrium. The key observation is that optimal capital holdings are a function of the *risk premium*. Consequently, only the risk premium is pinned down by equilibrium; risky expected returns and riskless rates are not separately determined. This indeterminacy in risky expected returns, hence in expected capital gains, provides a tool with which sunspot equilibria can be engineered.

As long as agents expect asset prices to “bounce back” from “extreme states,” i.e., when they get too low or too high, short-run fear can be consistent with non-explosive long-run equilibrium. Nothing rules out such bounce-back beliefs in this class of models. In our continuous-time setup, bounce-back beliefs are simply boundary conditions at the extreme states. Such boundary restrictions are both analytically-convenient and mild; many types of dynamics are possible away from extreme states.

In summary, a sunspot rise in fear creates a self-fulfilled decline in asset prices, through coordinated fire sales. Conversely, sunspot bravery (decline in fear) raises asset prices, through coordinated purchases. Due to this mechanism of self-fulfilment, any amount of price volatility is justifiable in equilibrium!

**Overview of results.** While explaining our mechanism above, we abstracted from the

wealth distribution between experts and households. Typically in the financial frictions literature, this wealth distribution is the key state variable modulating the dynamics. The first results of our paper (Section 2) demonstrate how restricting attention to these type of equilibria – equilibria which are Markovian in the wealth distribution – precludes essentially all interesting sunspot dynamics.

Our main results pertain to a richer class of self-fulfilling equilibria (Section 3). Mathematically, we dispense with the assumption that equilibria must be Markovian in the wealth distribution, which can be understood as removing an ad-hoc restriction on agents’ beliefs. This generalization considerably complicates the analysis but also engenders several new insights.

First, arbitrarily large capital price volatility can be justified. Second, sunspot-driven crises feature far larger volatility spikes, and thus more closely resemble real-world financial crises, than fundamentals-based recessions. This finding emerges because high-volatility states are characterized by a decoupling of the economy from real shocks. Third, recoveries from fundamentals-based recessions are too slow in our class of economies; recoveries from sunspot-driven crises can be faster.

We conclude with a supplementary model to clarify the culprits of multiplicity (Section 4). We study a complete-markets representative-agent economy, which surprisingly can exhibit sunspot volatility due to nominal rigidities and the zero-lower bound. This example features an aggregate demand externality at the zero-lower bound, which operates through a connection between asset prices and output. By contrast, our baseline model features an aggregate supply externality, whereby expert fire sales reduce allocative efficiency – this is also an asset price-output link. Our aim is to analogize the price-output links of these models, to show how financial frictions are not critical *per se*, beyond their role in establishing this link.

**Related literature.** The theoretical focus on financial frictions and sunspots is not new to this paper. Several studies show how multiplicity emerges through the interaction between asset valuations and borrowing constraints.<sup>3</sup> Relative to these papers, we study different financial frictions (equity-issuance constraints), offer a complete characterization of sunspot fluctuations, and dispense with features that are auxiliary to our main point.

Bank runs, financial panics, and sudden stops are related to, but distinct from, our

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<sup>3</sup>For instance, bubbles can relax firms’ credit constraints, allowing greater investment and thus justifying the existence of the bubble (Farhi and Tirole, 2012; Miao and Wang, 2018; Liu and Wang, 2014). Self-fulfilling credit dynamics can also arise with *unsecured* lending as opposed to collateralized (Gu et al., 2013; Azariadis et al., 2016).

self-fulfilled fluctuations.<sup>4</sup> Whereas bank runs and its cousins are liability-side phenomena, our self-fulfilled fire sales are pure asset-side phenomena. When selling assets, investors deleverage, which clarifies our mechanism as a “funding demand” decline rather than the “funding supply” decline that characterizes a run. It is not that investors cannot obtain financing, just that they do not want to.

Given our results hold even without borrowing constraints or runs, we illustrate that a much broader class of financial crisis models are subject to sunspots. We also do not rely on the more traditional multiplicity-inducing assumptions, such as overlapping generations, non-convexities or externalities in technology,<sup>5</sup> asymmetry of information,<sup>6</sup> or multiple assets.<sup>7</sup>

Our equilibrium construction also differs from the literature in a more technical sense. Sunspot equilibria are often constructed by essentially randomizing over a multiplicity of deterministic transition paths to a stable steady state. By contrast, the deterministic version of our model features an unstable steady state; critically, the introduction of volatility flips the stability properties of equilibrium.<sup>8</sup>

Methodologically, we prove our existence results with tools from the “stochastic stability” literature (the stochastic differential equation analog of Lyapunov stability for ODE systems). As one might expect from deterministic models, the existence of sunspot equilibria is tied directly to stability properties. Stochastic stability tools are ideally suited for this type of issue.

## 1 Model

**Information Structure.** Time  $t \geq 0$  is continuous. There are two types of uncertainty in the economy, modeled as two independent Brownian motions  $Z := (Z^{(1)}, Z^{(2)})$ . All random processes will be adapted to  $Z$ .<sup>9</sup> As will be clear below, the first shock  $Z^{(1)}$

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<sup>4</sup>In a setup close to ours, [Mendo \(2020\)](#) studies self-fulfilled panics that induce collapse of the financial sector, an extreme example of the fluctuations we analyze. [Gertler and Kiyotaki \(2015\)](#) and [Gertler et al. \(2020\)](#) study bank runs in a similar class of models.

<sup>5</sup>For example, see [Azariadis and Drazen \(1990\)](#) for multiplicity under threshold investment behavior. See [Farmer and Benhabib \(1994\)](#) for a multiplicity under increasing returns to scale.

<sup>6</sup>In a macro context, [Piketty \(1997\)](#) and [Azariadis and Smith \(1998\)](#) for self-fulfilling dynamics in the presence of screened/rationed credit. In a finance context, [Benhabib and Wang \(2015\)](#) and [Benhabib et al. \(2016, 2019\)](#) generate sunspot fluctuations in dispersed information models.

<sup>7</sup>[Hugonnier \(2012\)](#), [Gârleanu and Panageas \(2020\)](#), and [Khorrami and Zentefis \(2020\)](#) all build “redistributive” sunspots that shift valuations among multiple positive-net-supply assets.

<sup>8</sup>[Peck and Shell \(1991\)](#), [Gottardi and Kajii \(1999\)](#), and [Hens \(2000\)](#) also obtain sunspot equilibria in models which have a unique fundamental equilibrium, though for different reasons than us.

<sup>9</sup>In the background, the Brownian motion  $Z$  exists on a filtered probability space  $(\Omega, \mathcal{F}, (\mathcal{F}_t)_{t \geq 0}, \mathbb{P})$ , assumed to be equipped with all the “usual conditions.” All equalities and inequalities involving random

represents a *fundamental shock* in the sense that it directly impacts production possibilities, whereas the second shock  $Z^{(2)}$  is a *sunspot shock* that is extrinsic to any economic primitives but nevertheless may impact endogenous objects.

**Technology, Markets.** There are two goods, a non-durable good (the numéraire, “consumption”) and a durable good (“capital”) that produces the consumption good. The aggregate supply of capital grows exogenously as

$$dK_t = K_t[gdt + \sigma dZ_t^{(1)}],$$

where  $g$  and  $\sigma$  are exogenous constants. The capital-quality shock  $\sigma dZ^{(1)}$  is a standard way to introduce fundamental randomness in technology. Individual capital holdings evolve identically.

There are two types of agents, experts and households, who differ in their production technologies. Experts produce  $a_e$  units of the consumption good per unit of capital, whereas households’ productivity is  $a_h \in (0, a_e)$ .

Capital is freely tradable, with its relative price denoted by  $q_t$ , determined in equilibrium. Conjecture the following form for capital price dynamics:

$$dq_t = q_t[\mu_{q,t}dt + \sigma_{q,t} \cdot dZ_t]. \quad (1)$$

There are two potential avenues for random fluctuations. The standard term  $\sigma_q \cdot \begin{pmatrix} 1 \\ 0 \end{pmatrix}$  represents amplification (or dampening) of fundamental shocks, as in [Brunnermeier and Sannikov \(2014\)](#) and others. By contrast,  $\sigma_q \cdot \begin{pmatrix} 0 \\ 1 \end{pmatrix}$  measures sunspot volatility that only exists because agents believe in it.

Financial markets consist solely of an instantaneously-maturing, risk-free bond that pays interest rate  $r_t$  is in zero net supply. The key financial friction: agents cannot issue equity when managing capital. It is inconsequential that the constraint be this extreme. Partial equity issuance, as long as there is some limit, will generate identical results on sunspot volatility.<sup>10</sup>

**Preferences and Optimization.** Given the stated assumptions, we can write the dynamic

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variables are understood to hold almost-everywhere and/or almost-surely.

<sup>10</sup>In particular, a partial equity-issuance constraint simply scales the mapping between expert wealth and asset prices. As is well-known, the equilibrium of economies in the class we consider will live in the region where the equity constraint is always-binding. Equity-issuance restrictions, sometimes called “skin-in-the-game” constraints, often arise as the optimal contract in a moral hazard problem, though this micro-foundation is not important for our purposes here.

budget constraint of an agent of type  $j$  (expert or household) as

$$dn_{j,t} = \left[ (n_{j,t} - q_t k_{j,t}) r_t - c_{j,t} + a_j k_{j,t} \right] dt + d(q_t k_{j,t}), \quad (2)$$

where  $n_j$  is the agent's net worth,  $c_j$  is consumption, and  $k_j$  is capital holdings. The term  $d(qk)$  represents the capital and price appreciation that accrues while holding capital.

Experts and households have time-separable logarithmic utility, with discount rates  $\rho_e$  and  $\rho_h \leq \rho_e$ , respectively. All agents have rational expectations and solve

$$\sup_{c_j \geq 0, k_j \geq 0, n_j \geq 0} \mathbb{E} \left[ \int_0^\infty e^{-\rho_j t} \log(c_{j,t}) dt \right] \quad (3)$$

subject to (2). The constraint  $n_{j,t} \geq 0$  is the standard solvency constraint. Everything in this optimization problem is homogeneous in  $(c, k, n)$ , so we can think of the expert and household as representative agents within their class.

Finally, to guarantee a stationary wealth distribution, we also allow an overlapping generation structure: agents perish idiosyncratically at rate  $\delta$ ; perishing agents are replaced by newborns, who inherit an equal share of perishing wealth; a fraction  $\nu \in [0, 1]$  of newborns are exogenously designated experts, and  $1 - \nu$  are households; there are no annuity markets to trade death risk. As the death rate  $\delta$  affects an agent's lifetime utility, the subjective discount rates  $\rho_e, \rho_h$  are assumed inclusive of  $\delta$ . To acknowledge the fact that OLG creates intertemporal transfers across agent types, which do not affect alive agents' individual net worth evolution, let  $N_e$  and  $N_h$  denote aggregate expert and household net worth. The dynamic evolutions of  $N_e$  and  $N_h$  will mirror (2), with additional terms capturing OLG-related transfers.<sup>11</sup> We reiterate that OLG is unnecessary for our sunspot results and only serves to obtain stationarity in case we set  $\rho_e = \rho_h$ .

**Equilibrium.** The definition of competitive equilibrium is standard: (i) taking prices as given, and given an exogenous time-0 allocation of capital, experts and households solve (3) subject to (2); (ii) markets for consumption and capital clear at all dates, i.e.,

$$c_{e,t} + c_{h,t} = a_e k_{e,t} + a_h k_{h,t} \quad (4)$$

$$k_{e,t} + k_{h,t} = K_t. \quad (5)$$

The market for riskless bonds clears automatically by Walras' Law.

To benchmark this environment, note that frictionless equity-issuance allows perfect

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<sup>11</sup>In particular,  $dN_e = N_e(dn_e/n_e) - \delta N_e dt + \delta \nu(N_e + N_h)dt$ , and  $dN_h = N_h(dn_h/n_h) - \delta N_h dt + \delta(1 - \nu)(N_e + N_h)dt$ .

risk-sharing and fully-efficient production ( $k_h = 0$ ). In this frictionless world, there can be no sunspot volatility nor amplification ( $\sigma_q = 0$ ). As is well known, limited equity-issuance begets imperfect risk-sharing and inefficient production, which opens the door for amplification; our contribution is to show sunspot volatility can also emerge.

**Characterization of Equilibrium.** We present a useful equilibrium characterization that aids all future analysis. Given log utility and the scale-invariance of agents' budget sets, individual optimization problems are readily solvable. Optimal consumption satisfies the standard formula  $c_j = \rho_j n_j$ . Optimal capital holding by experts and households implies

$$\frac{a_e}{q} + g + \mu_q - r = \frac{qk_e}{n_e} |\sigma_R|^2 \quad (6)$$

$$\frac{a_h}{q} + g + \mu_q - r \leq \frac{qk_h}{n_h} |\sigma_R|^2 \quad (\text{with equality if } k_h > 0), \quad (7)$$

where

$$\sigma_{R,t} := \sigma \begin{pmatrix} 1 \\ 0 \end{pmatrix} + \sigma_{q,t} \quad (8)$$

denotes the shock exposure of capital returns.

Next, we aggregate. Due to financial frictions and productivity heterogeneity, both the distribution of wealth and capital holdings will matter in equilibrium. However, because all experts (and households) make the same scaled consumption  $c_j/n_j$  and portfolio choices  $k_j/n_j$ , the wealth and capital distributions may be summarized by experts' wealth share  $\eta := N_e/(N_e + N_h) = N_e/qK$  and experts' capital share  $\kappa := k_e/K$ . Substituting optimal consumption into goods market clearing (4), and using the definitions of  $\eta$  and  $\kappa$ , yields an *asset price-output* relation

$$q\bar{\rho} = \kappa a_e + (1 - \kappa) a_h, \quad (\text{PO})$$

where  $\bar{\rho}(\eta) := \eta \rho_e + (1 - \eta) \rho_h$  is the wealth-weighted average discount rate. As capital is allocated more efficiently (higher  $\kappa$ ), its value rises (higher  $q$ ).

Differencing the optimal portfolio conditions (6)-(7), we obtain the *risk balance* condition

$$0 = \min \left[ 1 - \kappa, \frac{a_e - a_h}{q} - \frac{\kappa - \eta}{\eta(1 - \eta)} |\sigma_R|^2 \right]. \quad (\text{RB})$$



Either experts manage the entire capital stock ( $\kappa = 1$ ) or the excess return experts obtain over households,  $(a_e - a_h)/q$ , represents fair compensation for differential risk exposure,  $\frac{\kappa - \eta}{\eta(1 - \eta)}|\sigma_R|^2$ . On the other hand, summing agents' portfolio optimality conditions (weighted by  $\kappa$  and  $1 - \kappa$ ) yields an equation for the riskless rate:

$$r = \frac{\kappa a_e + (1 - \kappa)a_h}{q} + g + \mu_q - \left( \frac{\kappa^2}{\eta} + \frac{(1 - \kappa)^2}{1 - \eta} \right) |\sigma_R|^2. \quad (9)$$

Finally, by time-differentiating the definition of experts' wealth share  $\eta = N_e / (N_e + N_h)$ , and using agents' net worth dynamics (2) along with contributions from OLG, wealth share dynamics are given by

$$d\eta_t = \mu_{\eta,t} dt + \sigma_{\eta,t} \cdot dZ_t, \quad \text{given } \eta_0, \quad (10)$$

where

$$\mu_\eta = \eta(1 - \eta)(\rho_h - \rho_e) + (\kappa - 2\eta\kappa + \eta^2) \frac{\kappa - \eta}{\eta(1 - \eta)} |\sigma_R|^2 + \delta(\nu - \eta) \quad (11)$$

$$\sigma_\eta = (\kappa - \eta)\sigma_R. \quad (12)$$

The preceding equations are the only ones imposed by equilibrium. We thus simplify our search for equilibria by looking for processes that satisfy them.

**Definition 1.** Given  $\eta_0 \in (0, 1)$ , an *equilibrium* consists of processes  $(\eta_t, q_t, \kappa_t, r_t)_{t \geq 0}$  such that equations (PO), (RB), (9), and (11)-(12) hold for all  $t \geq 0$ .

**Remark 1** (Indeterminacy preview). *Our multiplicity results are foreshadowed by the fact that Definition 1 provides “too few” equilibrium conditions, in the following sense. Definition 1 calls for entire time-paths of  $\eta$  and  $q$ . Given the evolution equations (1) and (10), this translates to time-paths for the SDE coefficients  $(\sigma_\eta, \mu_\eta)$  and  $(\sigma_q, \mu_q)$ , as well as initial value  $q_0$  (since  $\eta_0$  is given). Thus, equilibrium requires the 7 endogenous objects  $(\sigma_\eta, \mu_\eta, \sigma_q, \mu_q, q_0, \kappa, r)$ . However, only 5 restrictions are imposed: equations (PO), (RB), (9), and (11)-(12). In Section 2, we restrict attention to Markov equilibria in  $\eta$ , so the sixth and seventh equilibrium restrictions will be provided by Itô's formula, essentially eliminating any interesting sunspot dynamics.<sup>12</sup> In the general case of Section 3, we have two degrees of freedom that allow non-trivial sunspot dynamics.*

<sup>12</sup>Indeed, if  $q$  is solely a function of  $\eta$ , Itô's formula provides us with two additional restrictions:  $q\sigma_q = \sigma_\eta q'$  and  $q\mu_q = \mu_\eta q' + \frac{1}{2}|\sigma_\eta|^2 q''$ . In other words, we have 7 unknown endogenous objects and 7 equilibrium restrictions. Usually, we combine the drift restriction with the other equilibrium conditions to obtain a differential equation that determines the unknown function  $q(\eta)$ .

**Remark 2** (Transversality and No-Ponzi). *By additionally imposing a “No-Ponzi condition” on individual agents, we require the conditions<sup>13</sup>*

$$\lim_{T \rightarrow \infty} e^{-\rho_e T} \frac{\kappa_T}{\eta_T} = 0 \quad \text{and} \quad \lim_{T \rightarrow \infty} e^{-\rho_h T} \frac{1 - \kappa_T}{1 - \eta_T} = 0. \quad (13)$$

*In all of our equilibria, we will show that  $(\eta_t)_{t \geq 0}$  possesses a stationary distribution on  $(0, 1)$ , with no mass at the boundaries, so condition (13) will always be satisfied.*

Finally, we categorize our equilibria into two types: fundamental and sunspot.

**Definition 2.** An equilibrium in which  $\sigma_q \cdot \begin{pmatrix} 0 \\ 1 \end{pmatrix} \equiv 0$  is called a *Fundamental Equilibrium* (FE). If  $\sigma_q \cdot \begin{pmatrix} 0 \\ 1 \end{pmatrix}$  is not identically zero, we have a *Brownian Sunspot Equilibrium* (BSE).

## 2 A Class of Uninteresting Markov Equilibria

Because of financial frictions and productivity heterogeneity, the expert wealth share  $\eta$  serves as a state variable in this model. Universally, papers studying this class of models restrict attention to Markov equilibria, in which  $\eta$  is the *only* state variable.<sup>14</sup> This section illustrates how these equilibria are too restrictive for our purposes. We first present a sunspot equilibrium which is Markov in  $\eta$  (Section 2.1), and then we argue this equilibrium is inherently uninteresting (Sections 2.2-2.3). Alternatively, readers can skip directly to Section 3 with no difficulty.

### 2.1 Markov BSE in $\eta$ : Existence and Properties

We study a Markov equilibrium with state variable  $\eta$ . Suppose additionally that  $\sigma = 0$ , so that fundamental shocks  $Z^{(1)}$  play no role. Without any intrinsic uncertainty, there always exists a deterministic Fundamental Equilibrium (FE).

**Lemma 1** (Fundamental Equilibrium). *If  $\sigma = 0$ , there exists an equilibrium in which experts manage all capital,  $\kappa = 1$ , and the price of capital  $q_t = a_e / \bar{p}(\eta_t)$  evolves deterministically.*

<sup>13</sup>The proof is as follows. Let  $(M_{j,t})_{t \geq 0}$  denote the state-price density process for type- $j$  agents,  $j \in \{e, h\}$ . Optimality implies  $M_{j,t} = e^{-\rho_j t} / c_{j,t} = e^{-\rho_j t} / (\rho_j n_{j,t})$  (note also that the individual transversality condition  $\lim_{T \rightarrow \infty} \mathbb{E}_t[M_{j,T} n_{j,T}] = 0$  is automatically satisfied). Thus,  $\lim_{T \rightarrow \infty} M_{j,T} n_{j,T} = 0$ . Letting  $b_{j,t} := q_t k_{j,t} - n_{j,t}$  be the riskless bond position, the No-Ponzi condition states  $\lim_{T \rightarrow \infty} M_{j,T} b_{j,T} \leq 0$ , and the inequality “ $\leq$ ” is replaced by an equality “ $=$ ” under optimality. Combining these results, we have the requirement  $\lim_{T \rightarrow \infty} M_{j,T} q_T k_{j,T} = 0$ , which becomes (13) after substituting  $M_{j,t}$ ,  $q_t k_{e,t} / n_{e,t} = \kappa_t / \eta_t$ , and  $q_t k_{h,t} / n_{h,t} = (1 - \kappa_t) / (1 - \eta_t)$ .

<sup>14</sup>The fact that this is possible means that  $\eta$  fully summarizes all fundamental data for this class of economies. In other words, our fundamental equilibria will generically be functions of  $\eta$  and only  $\eta$ .

But there is also another equilibrium, a Brownian Sunspot Equilibrium (BSE), which has volatility. In a Markov BSE, the capital price will depend only on  $\eta$ , i.e.,  $q_t = q(\eta_t)$  for some function  $q$ . By Itô's formula, we then have  $\sigma_q = \frac{q'}{q}\sigma_\eta$ . On the other hand, equations (8) and (12) with  $\sigma = 0$  imply  $\sigma_\eta = (\kappa - \eta)\sigma_q$ . Solving this two-way feedback between  $\sigma_q$  and  $\sigma_\eta$ ,

$$\left[1 - (\kappa - \eta)\frac{q'}{q}\right]\sigma_q = 0. \quad (14)$$

Therefore, there are two possibilities: either (i)  $\sigma_q = 0$ , which corresponds to the FE of Lemma 1; or (ii)  $1 = (\kappa - \eta)\frac{q'}{q}$ , in which case  $\sigma_q$  can be non-zero. We pursue the latter.

Substituting  $\kappa < 1$  from price-output relation (PO), we obtain a first-order ODE for  $q$ :

$$q' = \frac{(a_e - a_h)q}{q\bar{\rho} - \eta a_e - (1 - \eta)a_h}, \quad \text{if } \kappa < 1. \quad (15)$$

Consider boundary condition  $\kappa(0) = 0$ , which translates via (PO) to  $q(0) = a_h/\rho_h$ . The appendix justifies this choice of boundary condition, which says that experts fully de-lever as their wealth shrinks.<sup>15</sup> Then, ODE (15) is solved on the endogenous region  $(0, \eta^*)$  where households manage some capital, i.e.,  $\eta^* := \inf\{\eta : \kappa(\eta) = 1\}$ .<sup>16</sup> Given a solution for  $(q, \kappa)$ , the risk balance equation (RB) yields capital price variance as

$$\sigma_q^2 = \frac{\eta(1 - \eta)}{\kappa - \eta} \frac{a_e - a_h}{q}, \quad \text{if } \kappa < 1. \quad (16)$$

Since  $\sigma_q \neq 0$  in equation (16), a BSE exists as long as a solution exists to the ODE (15).

**Proposition 1** (Markov BSE). *If  $\sigma = 0$ , there exists a Markov BSE in  $\eta$  with  $\kappa(0) = 0$ , in which  $\sigma_q(\eta) \neq 0$  on  $(0, \eta^*)$  and  $\sigma_q(\eta) = 0$  on  $(\eta^*, 1)$ .*

<sup>15</sup>We use the boundary condition  $\kappa(0) = 0$  in accordance with the literature. In Appendix E.1, we show that this is not necessary in principle. There are actually a continuum of BSEs indexed by  $\kappa_0 = \kappa(0) \in [0, 1]$ , which one can think of as agents' "disaster belief", i.e., what happens in the worst-case scenario.

Nevertheless, there are good reasons to select  $\kappa_0 = 0$ . First, as we show in Appendix E.2, if managing capital involves any amount of idiosyncratic risk, even if vanishingly-small, any equilibrium must feature  $\kappa \rightarrow 0$  as  $\eta \rightarrow 0$ . Second, Appendix E.3 shows how adding any amount of limited commitment frictions, even if vanishingly-small, automatically restricts equilibrium to feature  $\kappa \rightarrow 0$  as  $\eta \rightarrow 0$ .

Despite this discussion, several numerical examples in the paper use  $\kappa_0$  slightly above zero, to aid numerical stability. This approximation is not problematic, given we show in Proposition E.1 that equilibria are continuous in  $\kappa_0$ , even at  $\kappa_0 = 0$ .

<sup>16</sup>When  $\rho_h = \rho_e$ , there is a closed form solution for capital price

$$q(\eta) = \frac{1}{\rho} \left[ (a_e - a_h)\eta + a_h + \sqrt{((a_e - a_h)\eta + a_h)^2 - a_h^2} \right], \quad \text{for } \eta < \eta^* = \frac{1}{2} \frac{a_e - a_h}{a_e}.$$

For exposition purposes, we refer to this equilibrium as *the* BSE, or sometimes the Markov BSE. Figure 1 displays a numerical example with the capital price  $q$  and volatility  $\sigma_q$  as functions of the expert wealth share. Notice that the equilibrium is stationary, in the sense that  $(\eta_t)_{t \geq 0}$  possesses a stationary distribution (the right panel of Figure 1 plots the stationary CDF of  $\eta$ ).<sup>17</sup> The appendix extends these results to sunspot jumps and non-log utility.<sup>18</sup>

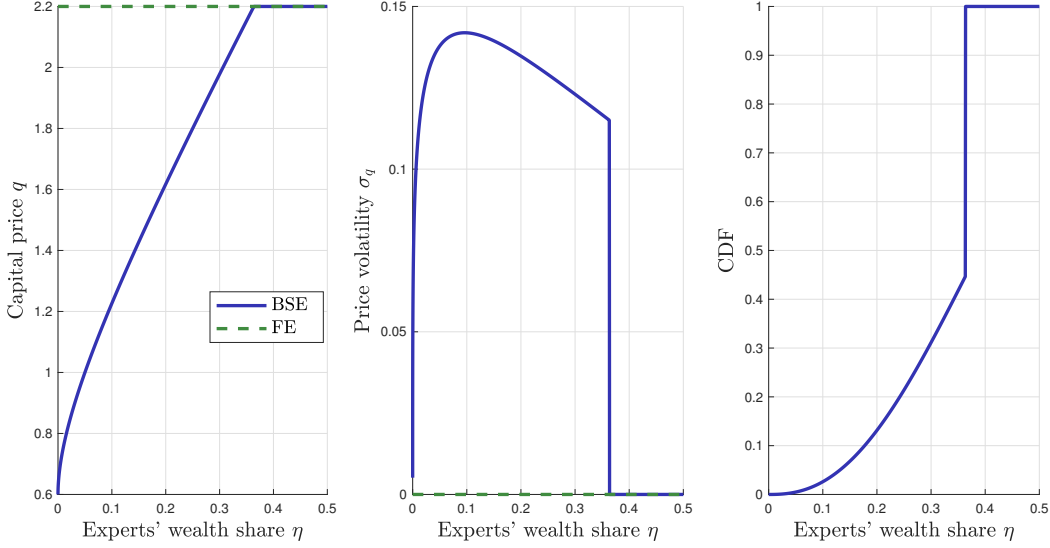


Figure 1: Capital price  $q$ , volatility  $\sigma_q$ , and stationary CDF of  $\eta$ . Parameters:  $\rho_e = \rho_h = 0.05$ ,  $a_e = 0.11$ ,  $a_h = 0.03$ . OLG parameters (for the CDF):  $\nu = 0.1$  and  $\delta = 0.04$ .

The intuition communicated by the BSE equations above is as follows. If agents believe the sunspot shock can affect asset prices, then the actual arrival of such a shock triggers trading of capital between experts and households. Since experts are more productive than households, capital transfers have real effects and move asset prices. But it does not end there: asset-price fluctuations feed back into the wealth distribution, which initiates another round of capital transfers, and so on. Ultimately, the question is whether there exists an initial belief about asset prices that can be self-justified by this process, and this is tantamount to solving the ODE (15).

<sup>17</sup>One can show that this economy possesses a stationary distribution on  $(0, \eta^*]$  under mild parameter restrictions. For example, if experts are more impatient than households ( $\rho_e > \rho_h$ ), or the economy has an OLG structure with sufficiently few experts ( $\delta > 0$  and  $\nu < \eta^*$ ), then sunspot volatility survives in the long run. Note that  $\eta_t = \eta^*$  about 55% of the time in the numerical example of Figure 1, i.e., there is a mass point at  $\eta^*$ .

<sup>18</sup>Appendix E.4 shows how to solve equilibrium with Poisson jump sunspots instead of Brownian sunspots. Appendix E.5 shows how BSEs can be obtained with more general CRRA preferences.

## 2.2 Markov BSE is inconsistent with fundamental shocks

The previous section shows how a Markovian sunspot equilibrium can arise without fundamental shocks ( $\sigma = 0$ ). But with fundamental shocks ( $\sigma \neq 0$ ), we obtain the stark result that capital prices must be completely insensitive to the sunspot shock  $Z^{(2)}$ . In this sense, the Markov BSE is not robust to the inclusion of fundamental uncertainty.

To see this, solve for the shock loadings  $\sigma_\eta$  and  $\sigma_q$ . Following the same analysis leading to equation (14), we obtain an equation for  $\sigma_q$ :

$$\left[1 - (\kappa - \eta) \frac{q'}{q}\right] \sigma_q = \begin{pmatrix} 1 \\ 0 \end{pmatrix} (\kappa - \eta) \sigma \frac{q'}{q}. \quad (17)$$

Equation (17) is really two equations stacked. Given  $\sigma \neq 0$ , the first equation can only hold if  $(\kappa - \eta) \frac{q'}{q} \neq 1$ . This is inconsistent with the second equation, unless  $\sigma_q \cdot \begin{pmatrix} 0 \\ 1 \end{pmatrix} = 0$ .

**Lemma 2.** *If  $\sigma \neq 0$ , any Markov equilibrium in  $\eta$  must be insensitive to sunspot shocks.*

## 2.3 Markov BSE is approximately a fundamental equilibrium

Lemma 2 shows that, in the presence of fundamental shocks, a Markovian equilibrium in  $\eta$  must be a Fundamental Equilibrium (FE). These FE are studied extensively in the literature, with the defining feature that fundamental shocks are amplified by endogenous wealth dynamics (Brunnermeier and Sannikov, 2014).

To briefly recap these FE (for more details, see Appendix F), rearrange equation (17) to obtain

$$\sigma_q = \frac{(\kappa - \eta) q' / q}{1 - (\kappa - \eta) q' / q} \sigma. \quad (18)$$

Equation (18) is often interpreted as *amplification*, because  $\frac{(\kappa - \eta) q' / q}{1 - (\kappa - \eta) q' / q}$  takes the form of a convergent geometric series. In words, a negative fundamental shock reduces experts' wealth share  $\eta$  directly through  $(\kappa - \eta) \sigma$ , which reduces asset prices through  $q' / q$ . This explains the numerator of (18). But the reduction in asset prices has an indirect effect: a one percent drop in capital prices reduces experts' wealth share by  $(\kappa - \eta)$ , which feeds back into a  $(\kappa - \eta) q' / q$  percent further reduction capital prices, which then triggers the loop again. The second-round impact is  $[(\kappa - \eta) q' / q]^2$ , and so on. This infinite series is convergent if  $(\kappa - \eta) q' / q < 1$ , such that incremental amplification is reduced in each successive round of the feedback loop.

In the BSE with  $\sigma = 0$ , recall that  $(\kappa - \eta)q'/q = 1$  (equation (14)). The BSE has no dampening in successive rounds of the feedback loop, leading to infinite amplification!

Despite this contrast, it turns out that the Markov BSE is “close” to these FE. As  $\sigma$  shrinks, amplification rises because falling exogenous volatility incentivizes expert leverage, which buoys endogenous volatility. As  $\sigma$  vanishes, amplification rises explosively and equilibria become sunspot-like.<sup>19</sup>

**Lemma 3.** *Suppose a Markov equilibrium in  $\eta$  exists for each  $\sigma > 0$  small enough, with  $\kappa(0) = 0$ . As  $\sigma \rightarrow 0$ , the equilibrium converges to the Markov BSE.*

Thus, even if fundamentals are truly deterministic, our Markov BSE “looks similar” to the FEs that have been studied in the literature. This approximate observational equivalence implies the Markov BSE cannot possibly generate the type of novel dynamics promised in the introduction.

### 3 Sunspots with richer dynamics

Section 2 says that Markov equilibria in experts’ wealth share  $\eta$  are either (a) pure FE (Lemma 2); or (b) look very much like pure FE (Lemma 3).

To address this critique, we endeavor here to analyze a richer class of sunspot equilibria that are not Markov in  $\eta$ . First, we establish some sufficient theoretical conditions for sunspot equilibria of this class (Section 3.1). Then, we provide some more concrete constructions, and highlight novel substantive insights (Section 3.2).

#### 3.1 Generalized BSEs

We are interested in BSEs which are not Markovian in the state variable  $\eta$ . Because the capital price  $q$  is the critical endogenous object (one may think of  $q$  as the “co-state” variable), non-Markov equilibria share the defining characteristic that a variety of different asset prices can prevail for a given wealth distribution. Essentially all such non-Markov equilibria will be BSEs, so we proceed with the following definition.<sup>20</sup>

<sup>19</sup>Brunnermeier and Sannikov (2014) provide a related limiting result, arguing that asset-price volatility does not vanish as  $\sigma \rightarrow 0$ , also known as the “volatility paradox.” Related results can be found in Manuelli and Peck (1992) and Bacchetta et al. (2012), in which sunspot equilibria could be seen as limits of fundamental equilibria when fundamental uncertainty vanishes.

<sup>20</sup>A BSE is one in which shock  $Z^{(2)}$  matters (Definition 2). Recall that when  $\sigma \neq 0$ , no such equilibrium exists if  $q$  is a single-valued function of  $\eta$  (Lemma 2). Thus, BSEs with  $\sigma \neq 0$  are a subset of the equilibria in Definition 3. We extend this notion to  $\sigma = 0$  to distinguish from the Markov BSE of Section 2.

**Definition 3.** A *Generalized Brownian Sunspot Equilibrium* (GBSE) is an equilibrium with multiple solutions for  $q_0$ , for a positive-measure subset of values  $\eta_0 \in (0, 1)$ .

**Remark 3** (Stability and multiplicity: connection to literature). *One benefit of defining GBSEs this way is to connect our results with those of deterministic dynamic economies. For example, recall the neoclassical growth model, in which capital and consumption are the state and co-state variables, respectively, and only one value of initial consumption is consistent with a non-explosive equilibrium. By contrast, OLG versions of the growth model can feature a stable steady state, to which many alternative values of initial consumption would converge (Azariadis, 1981; Cass and Shell, 1983). This literature generates stochastic sunspot equilibria by basically randomizing over the multiplicity of transition paths. Per this discussion, stability is the critical property enabling sunspots in deterministic dynamical systems.*

GBSEs of our model will also feature a type of stability, whereby many values of the co-state  $q_0$  can all be consistent with non-explosive behavior. But the analogy to deterministic models breaks down in an important sense: Appendix E.2 shows that the deterministic steady state of our class of models is only saddle-path stable, so we cannot obtain volatility by randomizing over a multiplicity of deterministic transition paths. For the same reason, we cannot hard-wire arbitrary amounts of volatility for any combination  $(\eta, q)$ . Rather, as will soon be clear, our model uniquely determines return volatility  $|\sigma_R|$  for each  $(\eta, q)$ , which is reminiscent of the endogenously-determined sentiment distribution in Benhabib et al. (2015).

We make some mild parameter restrictions and then present the main results.

**Assumption 1.** *Parameters satisfy (i)  $0 < \frac{a_h}{\rho_h} < \frac{a_e}{\rho_e} < +\infty$ ; (ii)  $\sigma^2 < \rho_e(1 - a_h/a_e)$ ; and (iii) either  $0 < \delta v < \delta$ , or  $\sigma^2 < \rho_e - \rho_h$ .*

Assumption 1 part (i), only for convenience, makes the very modest assumption that the capital price is higher if experts control 100% of wealth than if households control 100% of wealth. Part (ii), meant to make the problem interesting, ensures experts sometimes hold all capital (i.e.,  $\kappa = 1$ ) and sometimes do not ( $\kappa < 1$ ). Part (iii) guarantees experts do not asymptotically hold all wealth.

**Theorem 1** (Existence of GBSEs). *Let Assumption 1 hold. Then, there exists a GBSE in which  $(\eta_t, q_t)_{t \geq 0}$  remains in  $\mathcal{D} := \{(\eta, q) : 0 < \eta < 1 \text{ and } \eta a_e + (1 - \eta)a_h < q\bar{\rho}(\eta) \leq a_e\}$  almost-surely and possesses a non-degenerate stationary distribution.*

---

On the other hand, Definition 3 permits equilibria with  $\binom{0}{1} \cdot \sigma_q = 0$  (i.e., Fundamental Equilibria), but one can examine the proof of Theorem 1 to see that such Fundamental Equilibria are a zero-measure subset of possible equilibria satisfying Definition 3. In other words, almost all Fundamental Equilibria are Markovian in the wealth share  $\eta$ .



Theorem 1 is proved in Appendix A with an explicit GBSE construction. To understand its properties and the challenges in the construction, we first explain the static mechanism that allows sunspot volatility and then the dynamic mechanism that prevents sunspot volatility from becoming explosive.

**Static indeterminacy mechanism.** Given a wealth distribution  $\eta$  and a level of return volatility  $|\sigma_R|$ , the capital market is equilibrated at each time via the risk-balance condition (RB) and the price-output relation (PO), restated here for convenience:

$$0 = \min \left[ 1 - \kappa, \frac{a_e - a_h}{q} - \frac{\kappa - \eta}{\eta(1 - \eta)} |\sigma_R|^2 \right] \quad (\text{RB})$$

$$q\bar{\rho} = \kappa a_e + (1 - \kappa)a_h. \quad (\text{PO})$$

The left panel of Figure 2 shows how the intersection of these two curves determines the capital allocation  $\kappa$  and the capital price  $q$ . The downward-sloping risk-balance (RB) can be thought of as experts' relative capital demand: for a fixed level of wealth  $\eta$  and return volatility  $|\sigma_R|$ , experts will only hold more capital if it is cheaper, thereby offering a higher expected return. The upward-sloping price-output (PO) is a capital supply curve: experts' capital provision raises allocative efficiency, creating higher aggregate capital valuation.

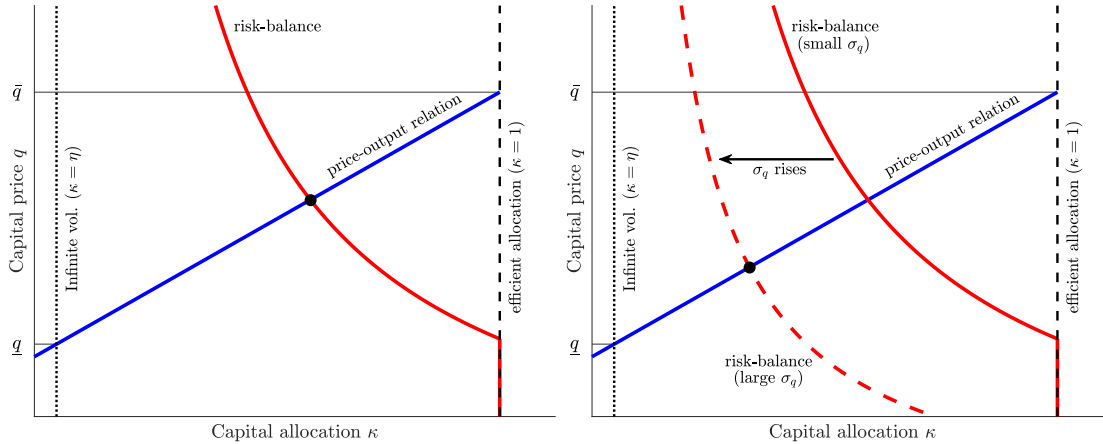


Figure 2: Static sunspot mechanism. Both panels plot the risk-balance condition (RB) and price-output relation (PO) for a fixed level of  $\eta$  ( $= 0.2$ ). The horizontal lines labeled  $\bar{q}$  and  $q$  refer to maximal and minimal possible values of the capital price, respectively, corresponding to an efficient capital allocation ( $\kappa = 1$ ) and an infinite-volatility allocation ( $\kappa = \eta$ ). *Left panel:* equilibrium with  $|\sigma_R| = 0.13$ . *Right panel:* equilibrium after a shift from  $|\sigma_R| = 0.13$  to  $|\sigma_R| = 0.20$ . Other parameters:  $\rho_e = \rho_h = 0.05$ ,  $a_e = 0.11$ ,  $a_h = 0.03$ , and  $\sigma = 0.10$ .

But whereas  $\eta$  is a state variable that can be rightly treated as fixed in this static sense, return volatility  $|\sigma_R|$  is not. The right panel of Figure 2 shows what changes if there is



a sudden rise in *fear*, manifested as higher perceived volatility  $|\sigma_R|$ . Experts, being risk-averse, are less willing to hold capital when volatility is high. This is illustrated as a leftward shift in the risk-balance curve from the solid to the dashed line. The new allocation, after this “fire sale,” features a less efficient capital allocation, lower asset prices, and higher volatility.

So far, nothing rules out this arbitrary rise in fear, and  $|\sigma_R|$  appears indeterminate. The indeterminacy in  $|\sigma_R|$  translates into an indeterminacy in  $q$ , which can be seen by combining (RB) and (PO) to obtain the negative price-variance association:

$$|\sigma_R|^2 = \frac{\eta(1-\eta)(a_e - a_h)^2}{q\bar{\rho}(\eta) - \eta a_e - (1-\eta)a_h} \frac{1}{q}, \quad \text{when } \kappa < 1. \quad (19)$$

Therefore, static restrictions are consistent with many solutions for  $q_0$ , given any  $\eta_0$ , as required for a GBSE. Each  $q_0$  corresponds to a different  $\sigma_R$ , by (19).

But this will only be an equilibrium if it does not lead to explosive paths. This is a real concern here: with higher volatility in the new candidate equilibrium, any subsequent fear shocks would have a larger direct impact, further raise volatility, and so on, ad infinitum. Formally, as  $\kappa \rightarrow \eta$ , we have  $|\sigma_R| \rightarrow +\infty$ . Intuitively, volatility must be explosive because agents with heterogeneous productivities but identical preferences will take identical portfolio positions only if risk is so enormous that it swamps other considerations.

With unbounded volatility, there is an imminent violation of the equilibrium conditions. For example,  $\kappa$  would fall below  $\eta$ , and (RB) could not hold. Rational forward-looking agents would rule this out at the beginning, decide to suppress their fear, and there would be no indeterminacy. Thus, the static indeterminacy mechanism is incomplete without some force that also prevents this type of explosion.

**Dynamic stability mechanism.** If a GBSE supports multiple values of  $q_0$ , some force must be keeping the dynamical system  $(\eta_t, q_t)_{t \geq 0}$  stable and preventing explosions. That force is the drift  $\mu_q$ , which is indeterminate and can be judiciously chosen.

The key observation is that optimal capital holdings are a function of the *risk premium*. This is clearly visible in the optimal portfolio FOCs (6)-(7), where only the spread  $\mu_q - r$  appears. Consequently, only the spread  $\mu_q - r$  is pinned down in equilibrium, as equation (9) shows;  $\mu_q$  and  $r$  are not separately determined.

Making a judicious choice for  $\mu_q$  is straightforward. Because  $(\eta_t, q_t)_{t \geq 0}$  evolves in a diffusive fashion, stability criteria conveniently boil down to boundary behavior of the dynamical system. Thus, by imposing certain boundary conditions on  $\mu_q$ , we prevent ex-

plosive volatility and ensure a stochastically stable system. For example, we can impose that  $\mu_q \rightarrow +\infty$  if  $q$  falls too low, and  $\mu_q \rightarrow -\infty$  if  $q$  rises too high.

If agents understand such a stabilizing force arises in these “extreme states,” an entire fear-driven sequence of asset price drops can be justified. Intuitively, agents understand that future capital price dynamics will keep things stationary and prevent explosive behavior, so current prices  $q_0$  can take essentially arbitrary values. This is the sense in which “anything goes.”

**Corollary 1** (Anything goes). *Given initial wealth share  $\eta_0 \in (0, 1)$ , let  $\mathcal{Q}(\eta_0)$  denote the set of possible GBSE values of  $q_0$ , and let  $\mathcal{V}(\eta_0)$  denote the associated set of possible GBSE values of return variance  $|\sigma_R(\eta_0, q_0)|^2$ . Then,*

$$\mathcal{Q}(\eta) = \begin{cases} \left( \frac{\eta a_e + (1-\eta)a_h}{\bar{\rho}(\eta)}, \frac{a_e}{\bar{\rho}(\eta)} \right), & \text{if } \eta < \eta^* := \frac{\rho_h}{\rho_e} \left( \frac{1-a_h/a_e}{\sigma^2} \rho_e - 1 + \frac{\rho_h}{\rho_e} \right)^{-1}; \\ \left[ \frac{\eta a_e + (1-\eta)a_h}{\bar{\rho}(\eta)}, \frac{a_e}{\bar{\rho}(\eta)} \right], & \text{if } \eta \geq \eta^*, \end{cases}$$

and

$$\mathcal{V}(\eta) = \left( \min \left[ \eta \bar{\rho}(\eta) \frac{a_e - a_h}{a_e}, \sigma^2 (\bar{\rho}(\eta) / \rho_e)^2 \right], +\infty \right).$$

In particular, if fundamental volatility  $\sigma = 0$ , then return variance spans any value between 0 and  $+\infty$ , regardless of the wealth distribution  $\eta$ . Finally, a GBSE can be constructed such that, in the stationary distribution, positive probability is placed on all elements of  $\mathcal{Q}(\eta)$  and  $\mathcal{V}(\eta)$ .

Figure 3 plots the admissible set of  $\eta$  and  $q$ , along with return volatility  $|\sigma_R|$  (indicated by shading) at each point in the space. For reference, we also place the Markov BSE (which has  $\sigma = 0$ ) and a Markov Fundamental Equilibrium (with  $\sigma = 0.1$ ). These equilibria attain only 10-20% volatility, a tiny amount of what a GBSE can do.

**Other indeterminacy in GBSEs.** Besides the vast amount of multiplicity in  $q_0$ , GBSEs also allow: (1) arbitrary decoupling of volatility from fundamentals; and (2) almost any degree of persistence or mean-reversion in asset prices.

GBSEs do not pin down the fraction of volatility stemming from the fundamental and sunspot shocks,  $Z^{(1)}$  and  $Z^{(2)}$ , respectively. The reason: when trading, agents only care about total return variance, not its source. Mathematically, the price-variance association (19) is a single equation relating  $q$  and  $|\sigma_R|$ , but  $\sigma_R$  itself has two components that can make indeterminate contributions to equilibrium.<sup>21</sup> Consequently, asset prices and

<sup>21</sup>This was somewhat obfuscated earlier in Remark 1 when we mentioned that there were 7 endogenous objects and 5 equilibrium restrictions. In fact, accounting for the fact that  $\sigma_q$  and  $\sigma_\eta$  are  $2 \times 1$  vectors, there are 9 endogenous objects, but only 6 equilibrium restrictions. Economically, the equation that captures “agents only care about total return variance” is (RB), which only provides 1 restriction on  $\sigma_R$ .

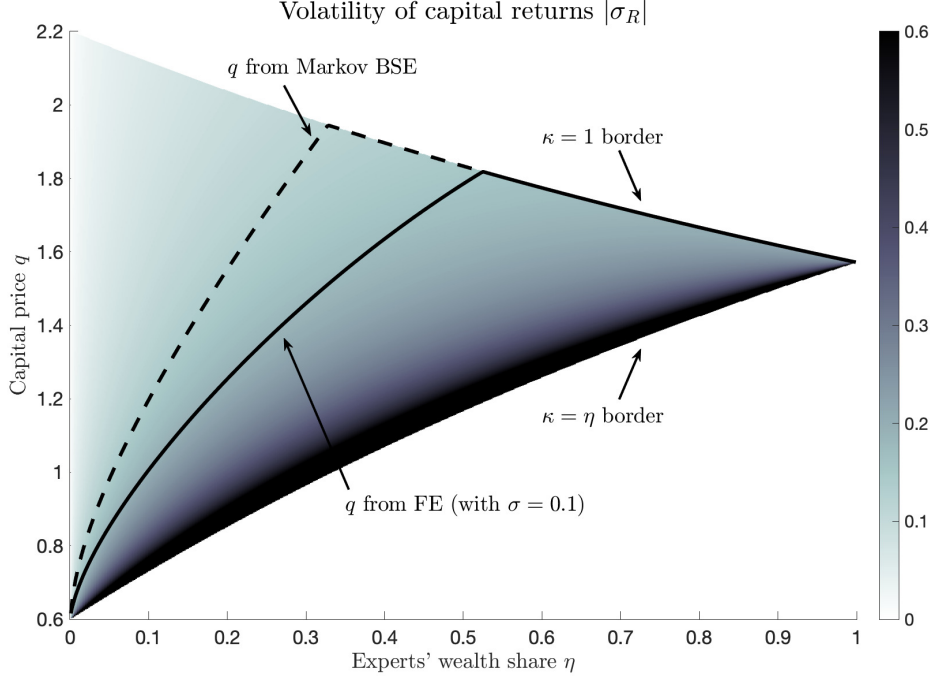


Figure 3: Colormap of capital return volatility  $|\sigma_R|$  as a function of  $(\eta, q)$ , within the region  $\mathcal{D} := \{(\eta, q) : 0 < \eta < 1 \text{ and } \eta a_e + (1 - \eta)a_h < q\bar{p}(\eta) \leq a_e\}$ . Volatility is truncated for aesthetic purposes (because  $|\sigma_R| \rightarrow \infty$  as  $\kappa \rightarrow \eta$ ). For reference, also included are the Markov BSE with the same parameters, and the Fundamental Equilibrium (FE) with  $\sigma = 0.1$ . Parameters:  $\rho_e = 0.07$ ,  $\rho_h = 0.05$ ,  $a_e = 0.11$ ,  $a_h = 0.03$ .

economic activity can be either closely linked to fundamentals, or completely decoupled from them, and this decoupling can be time-varying in arbitrary ways. Nevertheless, the next section presents perhaps the most natural example of a GBSE, in which volatility and fundamentals decouple as total volatility rises.

Finally, as suggested earlier, the proof of Theorem 1 only imposes certain boundary conditions on  $\mu_q$ , which allows almost arbitrary behavior in the interior of the state space. For example, asset prices could almost always behave like a random walk (corresponding to  $\mu_q \approx 0$  in the interior), with just enough mean-reversion in extreme states to keep things stationary. Alternatively, fluctuations could be much more transitory in nature, or anything in between. In the next section, we harness this indeterminacy to address recovery speeds.

### 3.2 Concrete examples and substantive results

We have just demonstrated that sunspot equilibria, which are endemic to this class of models, in principle can support rich dynamics. Now, we solve some concrete examples to illustrate several substantive results along these lines.

In contrast to the previous subsection's non-Markovian setting (where  $q$  acted as the co-state variable), here we implement our sunspot equilibria with an explicit state variable. Although the equilibria we present here are essentially special cases of the GBSEs in Section 3.1, being more explicit about the sunspot state variable is useful for several reasons. First, the Markov equilibrium construction will be pedagogically more familiar to the literature on sunspots. Second, adding a sunspot state variable brings some clarity, as the sunspot state dynamics can be modeled as locally uncorrelated with fundamental shocks. Third, this setting happens to facilitate building sunspot equilibria in which experts fully de-lever as their wealth shrinks, i.e.,  $\kappa \rightarrow 0$  as  $\eta \rightarrow 0$ , for which there are natural justifications.

Let  $s$  be a pure sunspot that is irrelevant to economic fundamentals and loads on only the second shock (recall  $Z^{(1)}$  affects capital and  $Z^{(2)}$  does not):<sup>22</sup>

$$ds_t = \mu_{s,t}dt + \sigma_{s,t} \begin{pmatrix} 0 \\ 1 \end{pmatrix} \cdot dZ_t, \quad s_t \in \mathcal{S}. \quad (20)$$

The time-varying drift and diffusion of  $s$  capture cleanly the non-iid nature of sunspot shocks. By contrast, Section 2 did not include additional state variables governing sunspot dynamics, effectively restricting sunspot shocks to be iid. This is one way to view the core distinction between the BSEs of Section 2 from the GBSEs of this section.

**Definition 4.** A Markov GBSE in state variables  $(\eta, s) \in \mathcal{D} := (0, 1) \times \mathcal{S}$  consists of functions  $(q, \kappa, r, \sigma_\eta, \mu_\eta, \sigma_s, \mu_s) : \mathcal{D} \mapsto \mathbb{R}$ , each  $C^2$  almost-everywhere, such that the process  $(\eta_t, q(\eta_t, s_t), \kappa(\eta_t, s_t), r(\eta_t, s_t))_{t \geq 0}$  is a GBSE of Definition 3.

**Remark 4** (Endogenous sunspot dynamics). *Note that the statement of Definition 4 allows  $(\sigma_s, \mu_s)$  to be endogenous, in the sense that they could depend on the wealth distribution  $\eta$ . Our examples in this section purposefully entertain this endogeneity, partly because we think of this as the more interesting and realistic situation. Why? As shown in Section 3.1, dynamics depend explicitly on  $q$  in a GBSE. Thus, it is completely sensible for agents in our GBSEs to use asset prices directly in forecasting; in particular, sunspot dynamics  $(\sigma_s, \mu_s)$  – which are nothing but belief dynamics – themselves should condition on  $q$ . But  $q$  will depend on both  $s$  and  $\eta$ , implying sunspot dynamics  $(\sigma_s, \mu_s)$  depend on  $\eta$  too, through  $q$ . That said, we verify in Appendix C.4 that similar types of sunspot equilibria can be constructed with exogenously-specified sunspot dynamics, i.e.,  $(\sigma_s, \mu_s)$  are only functions of  $s$ , not  $\eta$ .*

<sup>22</sup>This is only for clarity. We have solved examples with sunspots correlated to fundamentals, i.e., with  $ds_t = \mu_{s,t}dt + \sigma_{s,t}^{(1)}dZ_t^{(1)} + \sigma_{s,t}^{(2)}dZ_t^{(2)}$ . An additional feature that emerges relative to what we show here is that  $\sigma_s^{(1)}$  can work to reduce asset price volatility at times, unlike  $\sigma_s^{(2)}$ . See Appendix C.3 for details.

The equilibrium conditions are derived similarly to previous sections. By applying Itô's formula to  $q(\eta, s)$ , we obtain the capital price volatility  $\sigma_q$  in terms of  $\sigma_\eta$ . From equation (12), we also have  $\sigma_\eta$  in terms of  $\sigma_q$ . Solving this two-way feedback, we obtain

$$\sigma_q = \frac{\begin{pmatrix} 1 \\ 0 \end{pmatrix}(\kappa - \eta)\sigma\partial_\eta \log q + \begin{pmatrix} 0 \\ 1 \end{pmatrix}\sigma_s\partial_s \log q}{1 - (\kappa - \eta)\partial_\eta \log q}. \quad (21)$$

Using (21) in (RB), we obtain the following equation linking capital prices, the capital distribution, and sunspot volatility:

$$0 = \min \left[ 1 - \kappa, \frac{a_e - a_h}{q} - \frac{\kappa - \eta}{\eta(1 - \eta)} \left( \frac{\sigma^2 + (\sigma_s\partial_s \log q)^2}{(1 - (\kappa - \eta)\partial_\eta \log q)^2} \right) \right]. \quad (22)$$

Our strategy to find a Markov GBSE is to guess a capital price function  $q(\eta, s)$  and then use equation (22) to “back out” the sunspot volatility  $\sigma_s$  that justifies it. We purposefully perform this construction such that sunspots only increase volatility, to highlight their potential for resolving puzzles.

More specifically, suppose a fundamental equilibrium, where sunspots do not matter, exists with equilibrium capital price  $q^0$ . We will think of  $q^0$  as the “best-case” capital price, because despite featuring amplification,  $q^0$  inherits no sunspot volatility. Conversely, think of the capital price  $q^1$  associated to an infinite-volatility equilibrium as the “worst-case” capital price (substitute  $|\sigma_R| \rightarrow \infty$  into (19) to find  $q^1 := \frac{\eta a_e + (1 - \eta)a_h}{\bar{\rho}}$ ).

Our strategy is essentially to treat the sunspot variable  $s$  as a device to shift continuously between the best-case  $q^0$  and the worst-case  $q^1$ . Mathematically, we conjecture a capital price that is approximately a weighted average of  $q^0$  and  $q^1$ , with weights  $s$  and  $1 - s$ .<sup>23</sup> The novelty of our approach here is to then use equation (22) to solve for sunspot volatility  $\sigma_s$ , which will generically depend on experts' wealth share  $\eta$ . In the proposition below, we verify that such a construction is indeed an equilibrium.

**Proposition 2.** *Let Assumption 1 above hold, and assume a fundamental equilibrium exists for each  $\sigma$  small enough. Then, for all  $\sigma > 0$  small enough, there exists a Markov GBSE. This equilibrium is stationary in the sense that the paths  $(\eta_t, s_t)_{t \geq 0}$  induced by  $(\sigma_\eta, \mu_\eta, \sigma_s, \mu_s)$  remain in  $\mathcal{D}$  almost-surely and possess a non-degenerate stationary distribution. Finally, this equilibrium features full deleveraging, in the sense that  $\kappa(0, s) = 0$  for all  $s$ .*

<sup>23</sup>In this particular equilibrium, capital prices can never literally achieve the “worst-case” capital price  $q^1$ , for two technical reasons, both of which ensure that sunspot volatility stays  $\sigma_s$  bounded: (i) to ensure  $\kappa(0, s) = 0$ , we need  $q(\eta, s)$  to behave like the fundamental solution  $q^0(\eta)$  for  $\eta$  close enough to zero, and all  $s$ ; (ii) we need  $q(\eta, s) > q^1(\eta)$ , so that  $\kappa(\eta, s) > \eta$  for all  $(\eta, s)$ . Thus, in the proof of Proposition 2, we actually construct  $q^1$  as a close approximation to the worst-case price, such that (i) and (ii) are satisfied.

Proposition 2, unlike the GBSEs of Section 3.1, is built to satisfy the full-deleveraging condition  $\kappa(0, s) = 0$ . Thus, a large class of GBSEs are robust to refinements that beget full deleveraging, e.g., a small amount of idiosyncratic capital risk (Appendix E.2) or a small amount of commitment frictions (Appendix E.3).

**Numerical example and substantive properties.** We construct a numerical example closely following Proposition 2. In our example, the sunspot variable  $s$  lives in  $\mathcal{S} = (0, 1)$ , and spans between the fundamental equilibrium (as  $s \rightarrow 0$ ) and the worst-case equilibrium (as  $s \rightarrow 1$ ). The left panel of Figure 4 shows the capital price function in this construction. Positive sunspot shocks reduce the capital price, independently of experts' wealth share  $\eta$ .

The middle panel of Figure 4 displays capital return volatility, which can be substantially greater than in the fundamental equilibrium. As discussed above, such large volatility is necessary as a self-fulfilling mechanism to justify low capital prices. Implied by capital return volatility is an underlying sunspot shock size  $\sigma_s$ , which is displayed in the right panel of Figure 4. Sunspot dynamics become more volatile both as experts become poor ( $\eta$  shrinks) and as the economy approaches the worst-case equilibrium ( $s$  rises). The strong dependence of  $\sigma_s$  on  $\eta$  is the notion of endogenous beliefs that can occur in a GBSE.

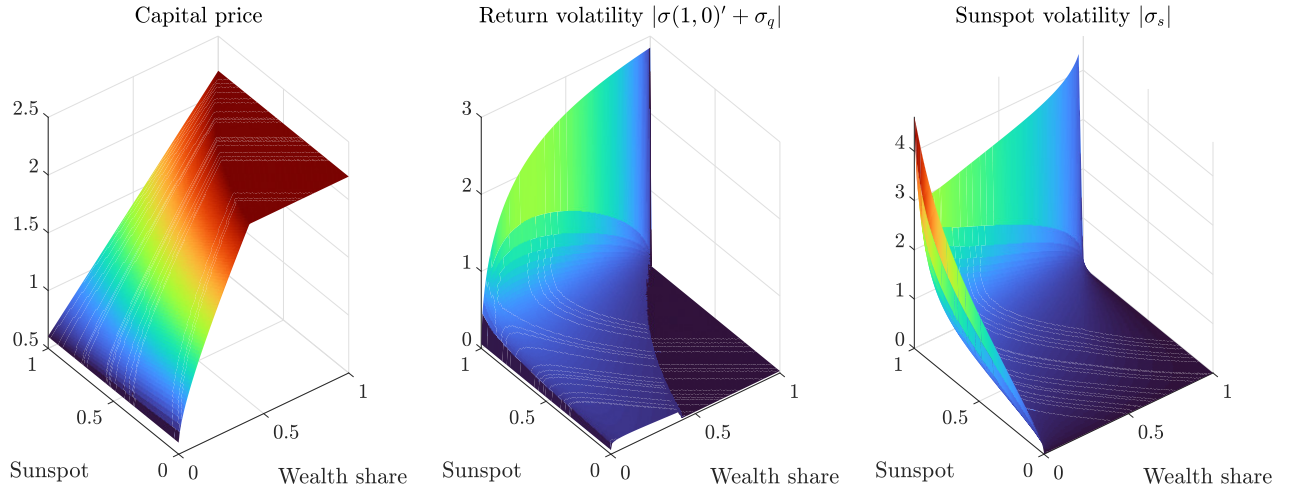


Figure 4: Capital price  $q$ , volatility of capital returns  $|(1, 0)' \sigma + \sigma_q|$ , and sunspot shock volatility  $\sigma_s$ . Parameters:  $\rho_e = \rho_h = 0.05$ ,  $a_e = 0.11$ ,  $a_h = 0.03$ ,  $\sigma = 0.025$ .

The magnitude of the difference between the sunspot and fundamental equilibrium is quantified in Figure 5. We plot unconditional cumulative distribution functions for asset prices (left panel) and return volatility (right panel) in both equilibria. We also plot the CDF for  $\begin{pmatrix} 1 \\ 0 \end{pmatrix} \cdot \sigma_q$ , which highlights the contribution to total volatility coming



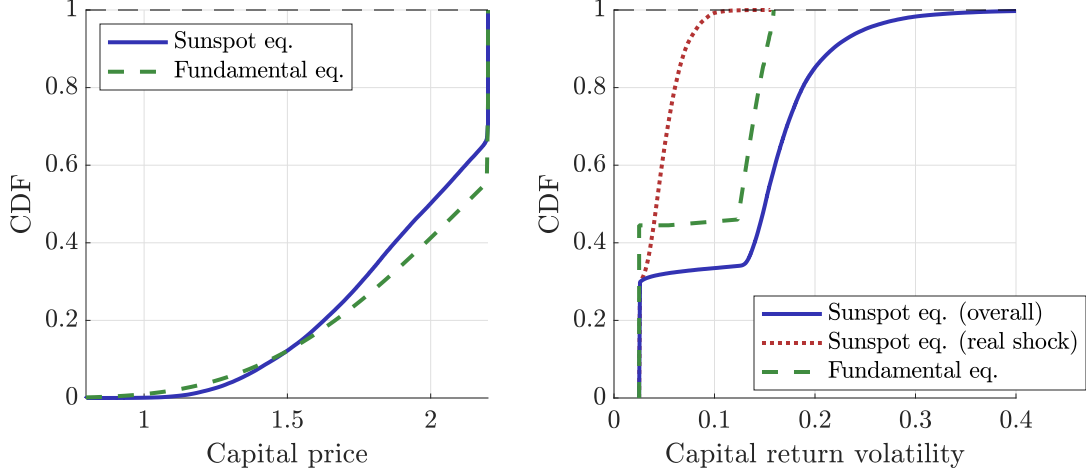


Figure 5: Unconditional CDFs of capital prices and capital return volatility. Parameters:  $\rho_e = \rho_h = 0.05$ ,  $a_e = 0.11$ ,  $a_h = 0.03$ ,  $\sigma = 0.025$ . OLG parameters:  $\nu = 0.1$  and  $\delta = 0.04$ . In this example, we set the sunspot drift  $\mu_s = 0.05 + s^{-1.5} - (s_{\max} - s)^{-1.5}$ , where  $s_{\max} = 0.95$ . This choice ensures  $s_t \in (0, s_{\max})$  with probability 1.

from the fundamental shock  $Z^{(1)}$ . Sensitivity to fundamental shocks  $Z^{(1)}$  is reduced in the sunspot equilibrium, with the difference more than made up by sunspot shocks  $Z^{(2)}$ . In the next two results, we formalize and extend these notions, i.e., that sunspot equilibria can feature much higher volatility (Proposition 3) which is decoupled from fundamentals (Proposition 4).

**Proposition 3** (Arbitrary volatility). *Given any target variance  $\Sigma^* > 0$  and any parameters satisfying the assumptions of Proposition 2, there exists a Markov GBSE with stationary average return variance exceeding the target, i.e.,  $\mathbb{E}[|\sigma(\frac{1}{0}) + \sigma_{q,t}|^2] > \Sigma^*$ .*

**Proposition 4** (Volatility decoupling). *The class of Markov GBSEs from Proposition 2 has the following monotonicity properties on  $\{(\eta, s) : \kappa < 1, \eta > \epsilon, \text{ some } \epsilon \geq 0\}$ :*

- (i) *amplified fundamental volatility  $|(\frac{1}{0}) \cdot \sigma_q|$  is decreasing in  $s$ ;*
- (ii) *sunspot price volatility  $|(\frac{0}{1}) \cdot \sigma_q|$  is increasing in  $s$ ;*
- (iii) *total return volatility  $|(\frac{1}{0})\sigma + \sigma_q|$  is increasing in  $s$ .*

The macroeconomics literature has faced difficulties generating high-enough amplification to replicate financial crises; Proposition 3 provides some resolution to that puzzle. The literature has also struggled to identify a “smoking gun” (e.g., TFP shocks, capital efficiency shocks) for financial crises and dramatic price swings; Proposition 4, which shows how asset prices decouple from fundamental shocks at some times but not others, provides helpful insights into this issue.

In the proof of Proposition 3, we employ an important degree of freedom in Markov GBSEs: besides stability requirements, nothing pins down  $\mu_s$  at all. Thus, one can design  $\mu_s$  to keep  $s_t$  forever in the vicinity of the infinite-volatility equilibrium.<sup>24</sup>

The flexibility in  $\mu_s$  can also help address another puzzle: empirically, recoveries from financial crises are much faster than predictions from models based on bank balance sheets. To see the problem and how sunspots can help, Figure 6 compares impulse responses to large balance-sheet shock (i.e., decline in  $\eta$ ) versus a sunspot (i.e., increase in  $s$ ). The solid lines show the extremely slow speed of recovery from a “balance-sheet recession,” with half-lives on the order of 10 years. By contrast, the dashed lines show accelerated recoveries from a “self-fulfilled crisis” driven by high  $s$ , with complete recovery in 5 years. Sunspot recovery speeds are closer to empirical evidence.<sup>25</sup>

Moreover, the volatility IRFs in Figure 6 can be read as term structures of uncertainty. The steep downward-slope of the sunspot IRF suggests a plethora of short-term uncertainty, relative to the more modest slope of the balance-sheet IRF. Sunspot-driven recessions are thus more consistent with evidence that uncertainty term structures display strong negative slopes in times of recession (Gormsen, 2020).

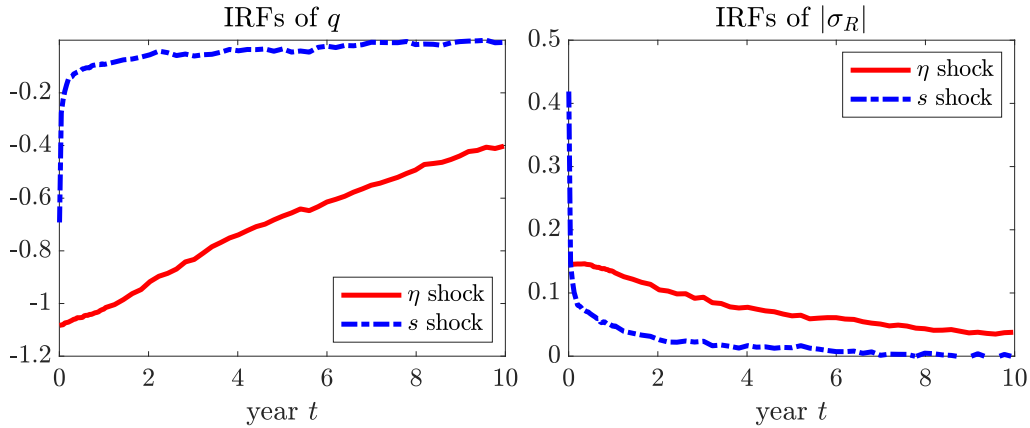


Figure 6: Impulse response functions (IRFs) of capital price  $q$  and return volatility  $|\sigma_R|$ , in response to two shocks. The IRFs labeled “ $\eta$  shock” are responses to a decrease in  $\eta$  from  $\eta_{0-} = 0.5$  to  $\eta_0 = 0.1$ , holding  $s_0$  fixed at 0.1. The IRFs labeled “ $s$  shock” are responses to an increase in  $s$  from  $s_{0-} = 0.1$  to  $s_0 = 0.9$ , holding  $\eta_0$  fixed at 0.5. Note that  $\eta_0$  would respond to an “ $s$  shock,” since  $\sigma_\eta$  has a non-zero second element, but we keep it fixed here. IRFs are computed as averages across 500 simulations at daily frequency. Parameters:  $\rho_e = \rho_h = 0.05$ ,  $a_e = 0.11$ ,  $a_h = 0.03$ ,  $\sigma = 0.025$ . OLG parameters:  $\nu = 0.1$  and  $\delta = 0.04$ . In this example, we set the sunspot drift  $\mu_s = 0.05 + s^{-1.5} - (s_{\max} - s)^{-1.5}$ , where  $s_{\max} = 0.95$ . This choice ensures  $s_t \in (0, s_{\max})$  with probability 1.

<sup>24</sup>For example, if we set  $\mu_s = -(s_{\max} - s)^{-(1+\beta)} + (s - s_{\min})^{-(1+\beta)}$  for any  $\beta > 0$ , the stationary distribution of  $s_t$  will live in  $(s_{\min}, s_{\max})$ . This exact claim is demonstrated in the proof of Proposition 2.

<sup>25</sup>For a rough idea of what the data says about crisis recoveries, see Jordà et al. (2013) and Reinhart and Rogoff (2014) for output, and see Muir (2017) and Krishnamurthy and Muir (2020) for credit spreads and stock prices. Across these many measures, and using broad-based international panels, crisis recovery times tend to range from 4-6 years on average.



**Remark 5** (What is a sunspot?). *What is the variable  $s$  in reality? Mathematically, a sunspot can be anything agents coordinate on. But perhaps it is natural to think of agents coordinating on variables that actually have real effects. We entertain this situation in Appendix C.4, where fundamental volatility  $\sigma$  is modeled as a function of  $s$ . There, we illustrate two main results:*

- (a) *Depending on coordination on  $s$ , equilibrium can either behave more “intuitively” or less. Intuition usually says that prices move inversely to fundamental volatility, but coordination can easily reverse this relationship.*
- (b) *As the contribution of  $s$  to fundamental volatility becomes small, equilibrium can converge to one where  $s$  still matters, i.e., a sunspot equilibrium. Thus, sunspot equilibria are limits of fundamental equilibria, with a vanishingly-small real contribution of  $s$ .*

## 4 Multiplicity without financial frictions?

In this section, we elaborate on the true prerequisites for sunspot volatility. The framework of Sections 1-3 requires both (i) a link between asset prices and the real economy and (ii) financial frictions. Without a price-output link, capital ownership cannot affect asset prices (e.g., if  $a_e = a_h = a$ , then  $q = a/\bar{p}$  independently of  $\kappa$ ).<sup>26</sup> Without financial frictions, risk-sharing is decoupled from capital ownership, and the price-output link becomes trivial (e.g., if experts could issue unlimited equity, they would always manage the entire capital stock,  $\kappa = 1$ ). The fact that the wealth distribution is an endogenous state variable is itself playing no role in supporting multiplicity.<sup>27</sup>

In this section, we clarify this point even further by example. We present a complete-markets economy with nominal rigidities that supports self-fulfilling fluctuations. These fluctuations differ from the typical self-fulfilling inflation volatility that can occur in New Keynesian models at the zero-lower bound (Benhabib et al., 2001); here, firms will have

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<sup>26</sup>This is despite the fact that our model, like Bacchetta et al. (2012), always possesses a negative relationship between asset prices and volatility – see equation (19). Nevertheless, general equilibrium imposes a strong discipline: from (PO), asset prices are given by  $a_e/\bar{p}$  in the cases  $a_h = -\infty$  or  $a_e = a_h$ . This discipline occurs through the endogenous adjustments by the interest rate. One can only conclude that “self-fulfilling risk panics” of Bacchetta et al. (2012) must be relying on auxiliary features (either OLG or an uncleared bond market).

<sup>27</sup>One sharp way to see this is to consider an endowment economy with heterogeneous preferences or beliefs. Such economies connect the wealth distribution to asset prices, but they generically feature a unique equilibrium (Chan and Kogan, 2002; Bhamra and Uppal, 2014; Borovička, 2020). Even tacking on financial frictions like short-selling and equity-issuance constraints, we are skeptical of sunspot volatility in such a world: if all agents’ unconstrained optimal portfolios are positive, then the constraints are effectively non-binding. Markets would be effectively complete and externality-free, ruling out sunspots. It is possible that extreme pessimists would face binding short-sales constraints, but even papers with this feature find unique equilibrium (Scheinkman and Xiong, 2003).

completely-sticky prices, so inflation will be zero. This economy features a price-output link, but has no financial friction (and the wealth distribution plays no role). We closely follow [Caballero and Simsek \(2020c\)](#), which the reader can consult for more details, but the results on multiplicity are new.

**Economic environment.** Because of complete markets, it is without loss of generality to assume all agents have the same productivity  $a$ .

However, because of nominal rigidities, firms may not always operate at capacity. In particular, let  $\chi \leq 1$  denote firms' capital utilization, which will be determined in equilibrium. Aggregate output is  $\chi K$ , where the aggregate capital stock  $K$  grows deterministically at rate  $g$ . Assume (i) all firms have completely-sticky prices; and (ii) the nominal interest rate is set by monetary policy to implement  $\chi = 1$  whenever possible, subject to a zero-lower bound. Assumptions (i) and (ii) imply a zero-lower bound on the real rate, and they imply full utilization whenever the real rate is positive:

$$0 = \min[1 - \chi, r]. \quad (23)$$

[Caballero and Simsek \(2020c\)](#) discuss a few auxiliary assumptions (lump sum profit taxes and linear capital subsidies) designed to simplify the analysis, which we also implicitly adopt, to ensure the market portfolio dividend equals aggregate output  $\chi K$ .

To prepare for sunspot equilibria, introduce an extrinsic one-dimensional Brownian motion  $Z$  that could affect asset prices. In particular, conjecture the capital price  $q$  evolves as

$$dq_t = q_t[\mu_{q,t}dt + \sigma_{q,t}dZ_t].$$

Finally, all agents have logarithmic utility with discount rate  $\rho$ .

**Equilibrium.** Agents consume a fraction  $\rho$  of their wealth, so goods market clearing can be written as a price-output relation, similar to [\(PO\)](#):

$$\rho q = \chi a. \quad (24)$$

Portfolio choices are unconstrained, and imply the following Euler equation:

$$r = \frac{\chi a}{q} + g + \mu_q - \sigma_q^2. \quad (25)$$

Using [\(24\)](#), the first term on the right-hand-side of [\(25\)](#) equals  $\rho$ . Equilibrium involves solutions for processes  $(q, \chi, r)$  that solve [\(23\)](#)-[\(25\)](#).

There is always an equilibrium with full utilization,  $\chi = 1$ .<sup>28</sup> Using  $\chi = 1$  in equation (24), we obtain  $q = a/\rho$ , so  $\mu_q = \sigma_q = 0$  must hold in this equilibrium. By equation (25), the interest rate is given by  $r = \rho + g > 0$ , which satisfies (23).

**Lemma 4.** *The complete-markets model with nominal rigidities always supports an efficient equilibrium with full utilization at all times,  $\chi_t = 1$ , and zero volatility.*

The efficient equilibrium is “unstable” in the traditional sense. Indeed, suppose  $\sigma_q = 0$  so that all dynamics are deterministic, and consider an allocation with  $\chi < 1$ . By (23), under-utilization implies a binding ZLB. Using  $r = 0$  and  $\sigma_q = 0$  in (25) implies that  $\mu_q = -(\rho + g)$ , so  $q$  must be converging to zero asymptotically. This instability means, in a deterministic equilibrium,  $q_t$  can never take any value other than its efficient steady-state value  $a/\rho$ .

Nevertheless, an inefficient volatile equilibrium can emerge. Suppose again  $\chi < 1$  but do not impose  $\sigma_q = 0$ . Using  $r = 0$  in (25), we obtain  $\mu_q = -(\rho + g) + \sigma_q^2$ . Equilibrium places no further restrictions, except that  $(\sigma_q, \mu_q)$  must keep  $q_t \in (0, a/\rho]$ . This is a relatively modest requirement, because the presence of volatility  $\sigma_q$  now adds a risk premium to the price drift, which buoys price  $q$  and restores “stability.” As  $\sigma_q$  is indeterminate, there are many ways to do this. Appendix D proves the following theorem, and Figure 7 below displays a numerical example.

**Theorem 2.** *Let  $h : \mathbb{R} \mapsto \mathbb{R}_+$  be any Lipschitz continuous function that is strictly positive on  $(0, a/\rho)$  and satisfies  $h(0) > \rho + g$ . The complete-markets model with nominal rigidities always supports an inefficient and volatile equilibrium, in which  $\sigma_{q,t}^2 = h(q_t)$  and  $\mu_{q,t} = -\rho - g + h(q_t)$  whenever  $q_t < a/\rho$ . Furthermore, the inefficient equilibrium can be permanent, transitory, or anything in between, i.e., the stationary probability of inefficiency can be any  $\pi \in [0, 1]$ .*

(i) *If  $h(a/\rho) = 0$ , then inefficiency is permanent:  $\pi = 1$ .*

(ii) *If  $h(a/\rho) > 0$ , inefficiency eventually subsides but can re-emerge:  $\pi < 1$ .*

The reader may find it surprising that multiplicity is possible in a representative-agent environment. To understand the logistics, suppose agents are suddenly *fearful*, and they conjecture  $\sigma_q > 0$ . Is this justified? Fear leads to precautionary savings, putting downward pressure on the interest rate. Without a ZLB,  $r$  would fall enough to clear

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<sup>28</sup>If aggregate capital  $K$  had additional exogenous fundamental volatility  $\sigma > 0$ , then the full-utilization equilibrium disappears if  $\sigma$  is large enough, which is the point of Caballero and Simsek (2020c). See also Caballero and Farhi (2018) for a related observation (due to safe asset shortage, which additionally requires a financial friction). Our point, by contrast, is that an inefficient equilibrium exists even when an efficient one does too. This point is most easily expressed under  $\sigma = 0$ .

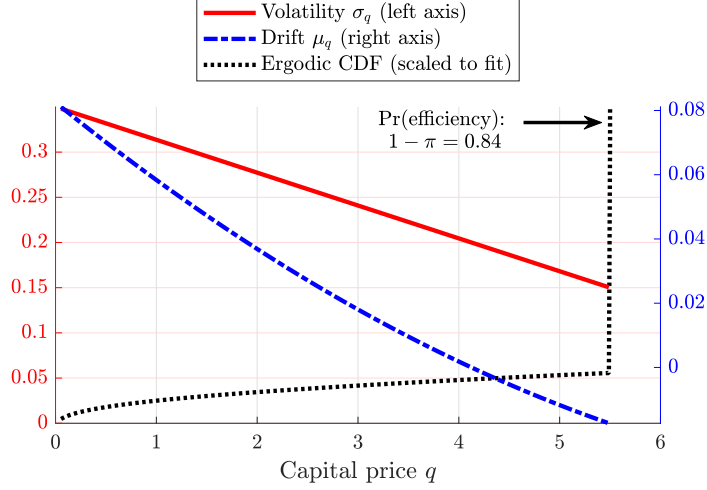


Figure 7: Equilibrium with nominal rigidities. We set volatility  $\sigma_q(q) = (1 - \rho q/a)\sqrt{\rho + g} + 0.15$  when  $q < a/\rho$ , which meets conditions of Theorem 2. To compute the stationary CDF, we specify the dynamics of an auxiliary diffusion  $x$  on domain  $(0, 1.1a/\rho)$ , and put  $q = \min[x, a/\rho]$ . When  $x < a/\rho$ , dynamics of  $x$  and  $q$  match, by definition. When  $x > a/\rho$  (i.e.,  $q = a/\rho$ ), dynamics of  $x$  can be set arbitrarily, and they control how long  $q$  stays at  $a/\rho$ . The resulting stationary CDF features a mass point of size  $1 - \pi = 0.84$  at  $q = a/\rho$  (i.e., inefficiency occurs 16% of the time). Parameters:  $a = 0.11$ ,  $\rho = 0.02$ ,  $g = 0.02$ .

bond markets, and agents consume and save as before. Goods markets would be unaffected, utilization  $\chi$  and price  $q$  would remain fixed, and agents' fear would be unsubstantiated. Forward-looking agents can think through this entire hypothetical sequence of events, and they will reject the feeling of fear as irrational.

By contrast, suppose fear and its associated precautionary savings pushes  $r$  to the ZLB. Markets only clear if a counteracting force reduces savings, which is why wealth must fall. Due to wealth effects, current consumption also falls, and firms meet their lower demand by operating at less than full capacity in production ( $\chi < 1$ ). Although this process is inefficient, nothing makes this sequence of hypothetical events irrational. Agents' fear will be justified, so long as it does not lead to explosive long-run behavior. Mathematically, non-explosiveness boils down to the requirement that  $q_t$  never attain zero, which is precisely what Theorem 2 ensures.

This economy showcases an aggregate demand externality. Because production is demand-determined at the ZLB, a fear-triggered consumption downturn reduces current and future output, hence total wealth, hence other agents' consumption. Conversely, our baseline model features an aggregate supply externality: when fire-selling capital, experts do not account for their impact on production efficiency. And yet this distinction between demand and supply externalities is immaterial to the existence of sunspot equilibria. Commonalities between these frameworks suggest the necessary ingredient is a link between asset prices and the real economy, which can be achieved via financial

frictions or via nominal rigidities.<sup>29</sup>

While this economy is stylized, the insights are general: we can add fundamental risk, other state variables, heterogeneous agents (e.g., some hand-to-mouth), and partial price flexibility, and the results will remain qualitatively unchanged.<sup>30</sup>

## 5 Conclusion

We have shown that macroeconomic models with financial frictions may inherently permit sunspot volatility. In fact, financial frictions are not necessary, as long as a connection exists between asset prices and the efficiency of the real economy – such a link might arise under nominal rigidities, even with complete markets. The types of models we study are extremely common in macroeconomics, so this phenomenon cannot be ignored.

On the bright side, our paper demonstrates how a fully-rational notion of “sentiments” can be a powerful input into macro-finance dynamics. Unbounded amplification, sharp volatility spikes, and transitory financial crises are among the many interesting possibilities raised by our framework.

On the hazier side, our results suggest a modicum of caution. Many researchers employ numerical techniques to solve and analyze DSGE models that are built upon the core assumptions in our paper – these procedures implicitly select an equilibrium, without any explicit justification. A deeper analysis of refinements, perhaps leveraging global-games approaches or adaptive learning, still remains to be done.

What about policy?<sup>31</sup> Caveated by the need for further study on refinements, we can offer some initial thoughts. Some traditional policies become less effective in sunspot equilibria. For example, deposit insurance has less bite because run-like behavior can occur solely due to fire-sale coordination, i.e., on the asset side rather than the liability side. Sunspot equilibria also decouple financial crises from bank balance sheets and wealth, which defangs capital requirements, bailouts, and the like. Given the two frameworks we study carefully rely on fire sales and the zero-lower bound, quantitative easing

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<sup>29</sup>A related interpretation, offered by [Benhabib et al. \(2020\)](#) in extending the model of [Bacchetta et al. \(2012\)](#), is that asset prices should have a direct impact on the stochastic discount factor, which is exactly what happens with a price-output link. Certain OLG specifications, financial frictions, and as we show here, nominal rigidities all connect asset prices to the SDF.

<sup>30</sup>See [Caballero and Simsek \(2020a,b,c\)](#) for some of these extensions. They show that the mechanics of the price-output relation, which is the key here, are unchanged.

<sup>31</sup>Many studies in the recent literature on macro dynamics with financing frictions have moved toward policy analysis. See [Phelan \(2016\)](#), [Dávila and Korinek \(2018\)](#), [Drechsler et al. \(2018\)](#), [Di Tella \(2019\)](#), [Silva \(2017\)](#), [Elenev et al. \(2021\)](#), [Begenau \(2020\)](#), [Begenau and Landvoigt \(2021\)](#), and [Klimenko et al. \(2016\)](#).

(e.g., asset purchases) and unconventional monetary policy could be interesting to analyze, perhaps even as an equilibrium refinements.

## A Proof of Theorem 1

*Step 0: Reduce the system.* We will start by eliminating  $(r, \kappa, \sigma_\eta, \mu_\eta)$  from the system of endogenous objects, given  $(\eta, q, \sigma_q, \mu_q)$ . First, price-output relation (PO) determines  $\kappa$  as a function of  $(\eta, q)$  and nothing else, given by

$$\kappa(\eta, q) := \frac{q\bar{\rho}(\eta) - a_h}{a_e - a_h}. \quad (\text{A.1})$$

Second, substituting this result for  $\kappa$ , equation (9) fully determines  $r$ , given knowledge of  $(\eta, q, \sigma_q, \mu_q)$ . Third, equations (11)-(12), after plugging in the result for  $\kappa$ , fully determine  $(\sigma_\eta, \mu_\eta)$ , given knowledge of  $(\eta, q, \sigma_q)$ . Thus, given  $(\eta, q)$ , it suffices to determine  $(\sigma_q, \mu_q)$  from the remaining equilibrium conditions, i.e., namely (RB).

*Step 1: Define perturbed domain.* To facilitate analysis, it will be more convenient to analyze a slightly modified system instead of  $(\eta, q)$ , and on a slightly perturbed domain.

First, define the following auxiliary functions. Fix  $\epsilon \in (0, \frac{a_e - a_h}{\rho_h})$ . Let  $\beta(\cdot)$  be a strictly increasing, continuously differentiable function such that  $\beta(1) = -\beta(0) = \epsilon$ , and  $\beta(\eta_\beta^*) = 0$ , where  $\eta_\beta^* \in (\eta^*, 1)$  and

$$\eta^* := \frac{\rho_h}{\rho_e} \left( \frac{1 - a_h/a_e}{\sigma^2} \rho_e - 1 + \frac{\rho_h}{\rho_e} \right)^{-1}. \quad (\text{A.2})$$

Note that  $\eta^* < 1$  by Assumption 1, part (ii). Let  $\alpha(\cdot)$  be an increasing, continuously differentiable function such that  $\alpha(0) = 0$ ,  $\alpha'(0) \in (0, \infty)$ , and  $\alpha(1) = \epsilon/2$ .

Next, define the following functions,

$$\begin{aligned} q^H(\eta) &:= a_e / \bar{\rho}(\eta) \\ q^L(\eta) &:= \bar{a}(\eta) / \bar{\rho}(\eta), \end{aligned}$$

where  $\bar{a}(\eta) := \eta\rho_e + (1 - \eta)\rho_h$ . Using (A.1), one notices that  $q^H$  corresponds to the capital price when  $\kappa = 1$ , whereas  $q^L$  corresponds to the capital price when  $\kappa = \eta$ . Put

$$\begin{aligned} q_\beta^H(\eta) &:= q^H(\eta) + \beta(\eta) \\ q_\alpha^L(\eta) &:= q^L(\eta) + \alpha(\eta). \end{aligned}$$

Using these functions, define the perturbed domain (which is an open set)

$$\mathcal{X} := \left\{ (\eta, x) : \eta \in (0, 1) \quad \text{and} \quad q_\alpha^L(\eta) < x < q_\beta^H(\eta) \right\}.$$

Note that, boundaries aside,  $\mathcal{X}$  will coincide with  $\mathcal{D}$  as  $\epsilon \rightarrow 0$ . For reference, the perturbed domain  $\mathcal{X}$  is displayed in Figure A.1.

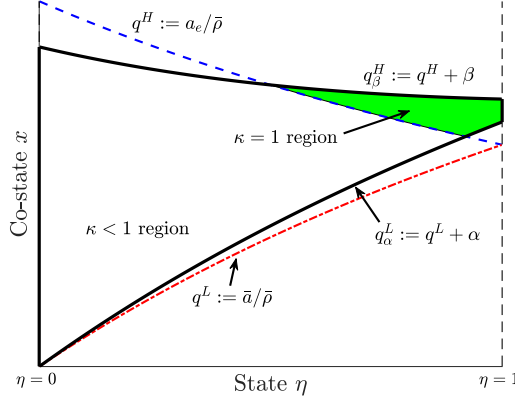


Figure A.1: The perturbed domain  $\mathcal{X}$  is shown as the region surrounded by solid black lines. The original domain  $\mathcal{D}$  is the region defined by the dashed lines. The perturbation functions  $\alpha$  and  $\beta$  are chosen to be linear functions, with  $\epsilon = 0.2$ . Parameters:  $\rho_e = 0.07$ ,  $\rho_h = 0.05$ ,  $a_e = 0.11$ ,  $a_h = 0.03$ ,  $\sigma = 0.1$ .

We will define a stochastic process  $x_t$  such that the capital price  $q$  coincides with  $x$  when it lies below  $q^H$ , i.e.,

$$q_t = \min \left[ x_t, q^H(\eta_t) \right]. \quad (\text{A.3})$$

By (A.3), we may analyze the dynamical system  $(\eta_t, x_t)_{t \geq 0}$  rather than  $(\eta_t, q_t)_{t \geq 0}$ . Furthermore, to prove the claim that  $(\eta_t, q_t)_{t \geq 0}$  remains in  $\mathcal{D}$  almost-surely, it suffices to prove  $(\eta_t, x_t)_{t \geq 0}$  remains in  $\mathcal{X}$  almost-surely (Step 4 below).

*Step 2: Construct  $\sigma_q$  so that (RB) is satisfied.* First consider  $\{x < q^H(\eta)\}$  so that  $q = x$ . Note that this case corresponds to  $\kappa < 1$ . Let  $\gamma(\eta, x) : \mathcal{X} \mapsto (0, 1)$  be any  $C^2$  function. Put

$$\sigma_q = \begin{bmatrix} \sqrt{\gamma \frac{\eta(1-\eta)}{\kappa-\eta} \frac{a_e - a_h}{q}} - \sigma \\ \sqrt{(1-\gamma) \frac{\eta(1-\eta)}{\kappa-\eta} \frac{a_e - a_h}{q}} \end{bmatrix}, \quad \text{if } x < q^H(\eta). \quad (\text{A.4})$$

Substituting (A.4), one can verify that the second term of condition (RB) is zero. Importantly, the definitions of  $q_\alpha^L$  and  $q_\beta^H$  imply that  $\sigma_q$  is bounded on  $\mathcal{X} \cap \{x < q^H(\eta)\}$ . Indeed, because of  $\alpha'(0) > 0$ , the slowest possible rate that  $\kappa \rightarrow 0$  as  $\eta \rightarrow 0$  is lower-bounded away from 1, i.e.,  $\liminf_{\eta \rightarrow 0, (\eta, x) \in \mathcal{X}} \kappa/\eta > 1$ . And because  $\alpha(1) > 0$ , we have  $\kappa = 1$  for all  $\eta$  near enough to 1; thus  $\eta$  is bounded away from 1 on  $\{x < q^H(\eta)\}$ .

Next consider  $\{x \geq q^H(\eta)\}$  so that  $q = q^H(\eta)$ . Note that this case corresponds to



$\kappa = 1$ . Since  $q$  is an explicit function of  $\eta$ , we use Itô's formula to compute  $(\frac{1}{0}) \cdot \sigma_q = -\sigma_\eta \bar{\rho}' / \bar{\rho}$ , which after substituting equation (12) for  $\sigma_\eta$  delivers

$$\sigma_q = \begin{cases} -\frac{(1-\eta)(\rho_e - \rho_h)/\bar{\rho}}{1 + (1-\eta)(\rho_e - \rho_h)/\bar{\rho}} \sigma & \text{if } x \geq q^H(\eta). \\ 0 & \end{cases} \quad (\text{A.5})$$

Note that (A.5) will be consistent with (RB) as long as  $(\eta_t, x_t)_{t \geq 0}$  remains in  $\mathcal{X}$  almost-surely, which will be verified in Step 4.<sup>32</sup>

Note finally that  $\sigma_q$  defined in (A.4)-(A.5) is solely a function of  $(\eta, x)$ , so sometimes we will write  $\sigma_q(\eta, x)$ . Similarly, with  $\sigma_q$  in hand, we now have  $\mu_\eta$  and  $\sigma_\eta$  as functions of  $(\eta, x)$  alone.

*Step 3: Construct  $\mu_q$ .* Similar to  $\sigma_q$ , separately consider  $\{x < q^H(\eta)\}$  and  $\{x \geq q^H(\eta)\}$ . On  $\{x \geq q^H(\eta)\}$ , since  $q = q^H(\eta)$  is an explicit function of  $\eta$ , we set  $\mu_q$  via Itô's formula. On  $\{x < q^H(\eta)\}$ , we have no equilibrium considerations restricting  $\mu_q$ . Thus, we will put  $\mu_q = m_q$ , where  $m_q$  is a function in class  $\mathcal{M}$ , defined as follows. A function  $m : \mathcal{X} \mapsto \mathbb{R}$  is a member of  $\mathcal{M}$  if  $m$  is  $C^2$  and possesses the following boundary conditions:

$$\inf_{\eta \in (0,1)} \lim_{x \searrow q_\alpha^L(\eta)} (x - q_\alpha^L(\eta)) m(\eta, x) = +\infty \quad (\text{A.6})$$

$$\sup_{\eta \in (0,1)} \lim_{x \nearrow q_\beta^H(\eta)} (q_\beta^H(\eta) - x) m(\eta, x) = -\infty \quad (\text{A.7})$$

$$\text{for any } x \in (q_\alpha^L(0), q_\beta^H(0)), \quad \lim_{\eta \searrow 0} |m(\eta, x)| < +\infty \quad (\text{A.8})$$

$$\text{for any } x \in (q_\alpha^L(1), q_\beta^H(1)), \quad \lim_{\eta \nearrow 1} |m(\eta, x)| < +\infty. \quad (\text{A.9})$$

Collecting these results

$$\mu_q(\eta, x) = \begin{cases} m_q(\eta, x), & \text{if } x < q^H(\eta); \\ \frac{\rho_e - \rho_h}{\bar{\rho}(\eta)^2} [-\bar{\rho}(\eta) \mu_\eta(\eta, x) + |\sigma_\eta(\eta, x)|^2], & \text{if } x \geq q^H(\eta). \end{cases} \quad (\text{A.10})$$

*Step 4: Verify stationarity.* We demonstrate the time-paths  $(\eta_t, x_t)_{t \geq 0}$  remain in  $\mathcal{X}$  almost-surely and admit a stationary distribution.

<sup>32</sup>Plugging  $q = a_e / \bar{\rho}$  into the second term of equation (RB), we require  $|\sigma_R|^2 \leq \eta \bar{\rho}(\eta)(1 - a_h/a_e)$ . Substituting (A.5), we obtain  $|\sigma_R|^2 = \sigma^2(\bar{\rho}/\rho_e)^2$ . Combining these, we require.  $\eta \geq \eta^*$  when  $x \geq q^H(\eta)$ , where  $\eta^*$  is defined in (A.2). Therefore, for all  $\eta < \eta^*$ , we insist  $x < q^H(\eta)$ . As long as  $(\eta, x) \in \mathcal{X}$ , this will hold, because  $q_\beta^H(\eta) < q^H(\eta)$  for all  $\eta < \eta^*$ , and  $x < q_\beta^H(\eta)$  for all  $\eta$ .



The dynamics of  $x_t$  are specified as follows. Denote its diffusion and drift coefficients by  $(x\sigma_x, x\mu_x)$ , where  $\sigma_x$  and  $\mu_x$  are functions of  $(\eta, x)$  to be specified shortly. By (A.3), when  $q_\alpha^L(\eta) < x < q^H(\eta)$ , we must put  $\sigma_x = \sigma_q$  and  $\mu_x = \mu_q$ . Outside of this region, we put  $\sigma_x$  and  $\mu_x$  to preserve stationarity.

To this end, let  $\tilde{\sigma}_x : \mathcal{X} \mapsto \mathbb{R}_+$  be any positive and bounded  $C^2$  function.<sup>33</sup> Put

$$\sigma_x(\eta, x) = \begin{cases} \sigma_q(\eta, x), & \text{if } x < q^H(\eta); \\ \tilde{\sigma}_x(\eta, x), & \text{if } x \geq q^H(\eta). \end{cases}$$

Note that  $\sigma_x$  is bounded (recall  $\sigma_q$  is bounded on  $\{x < q^H(\eta)\}$ , and  $\tilde{\sigma}_x$  is assumed bounded).

Similarly, for the drift, let  $m_x : \mathcal{X} \mapsto \mathbb{R}$  be any function in class  $\mathcal{M}$  defined above (note:  $m_x$  need not coincide with  $m_q$  above). Put

$$\mu_x(\eta, x) = \begin{cases} \mu_q(\eta, x), & \text{if } x < q^H(\eta); \\ m_x(\eta, x), & \text{if } x \geq q^H(\eta). \end{cases}$$

Thus,  $\mu_x$  satisfies boundary conditions (A.6)-(A.9) on all boundaries of  $\mathcal{X}$ .

Corresponding to the SDEs induced by  $(\sigma_\eta, \sigma_x, \mu_\eta, \mu_x)$ , define the infinitesimal generator  $\mathcal{L}$ , where for any  $C^2$  function  $f$ ,

$$\mathcal{L}f = \mu_\eta \partial_\eta f + (x\mu_x) \partial_x f + \frac{1}{2} |\sigma_\eta|^2 \partial_{\eta\eta} f + \frac{1}{2} |x\sigma_x|^2 \partial_{xx} f + x\sigma_x \cdot \sigma_\eta \partial_{\eta x} f.$$

Let  $\{\mathcal{X}_n\}_{n \geq 1}$  be an increasing sequence of open sets, whose closures are contained in  $\mathcal{X}$ , such that  $\cup_{n \geq 1} \mathcal{X}_n = \mathcal{X}$ . Note that  $(\sigma_\eta, \sigma_x, \mu_\eta, \mu_x)$  are bounded on  $\mathcal{X}_n$  for each  $n$ . Consequently, despite the (potential) discontinuity in  $(\sigma_\eta, \sigma_x, \mu_\eta, \mu_x)$  at the one-dimensional subset  $\{x = q^H(\eta)\}$ , there exists a unique weak solution  $(\tilde{\eta}_t^n, \tilde{x}_t^n)_{0 \leq t \leq \tau_n}$ , up to first exit time  $\tau_n := \inf\{t : (\eta_t, x_t) \notin \mathcal{X}_n\}$ , to the SDEs defined by the infinitesimal generator  $\mathcal{L}$ . See Krylov (1969, 2004) for weak existence and uniqueness in the presence of drift and diffusion discontinuities.

Letting  $\tau := \lim_{n \rightarrow \infty} \tau_n$ , we thus define  $(\eta_t, x_t)_{0 \leq t \leq \tau}$  by piecing together  $(\tilde{\eta}_t^n, \tilde{x}_t^n)_{0 \leq t \leq \tau_n}$  for successive  $n$ . In other words,  $(\eta_t, x_t) = (\tilde{\eta}_t^n, \tilde{x}_t^n)$  for  $0 \leq t \leq \tau_n$ , each  $n$ . Our goal is to show (a)  $\tau = +\infty$  a.s.; and (b) the resulting stochastic process  $(\eta_t, x_t)_{t \geq 0}$  possesses a non-degenerate stationary distribution on  $\mathcal{X}$ . These will be proved if we can obtain a

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<sup>33</sup>Note that  $\tilde{\sigma}_x$  need not vanish at the boundary of  $\mathcal{X}$ , but if it does some of the boundary conditions on  $m_x$ , to follow, can be relaxed.

function  $v$  satisfying the assumptions (i)-(iii) of Lemma A.1 below.

Define the positive function  $v$  by

$$v(\eta, x) := \frac{1}{\eta^{1/2}} + \frac{1}{1-\eta} + \frac{1}{x - q_\alpha^L(\eta)} + \frac{1}{q_{\beta,\lambda}^H(\eta) - x}.$$

Note that  $v$  diverges to  $+\infty$  at the boundaries of  $\mathcal{X}$ , so assumption (i) of Lemma A.1 is proved. Next, if assumption (iii) of Lemma A.1 holds (which we will prove below), then there exists  $N$  such that  $\mathcal{L}v < 0$  on  $\mathcal{X} \setminus \mathcal{X}_n$  for all  $n > N$ . Furthermore, for each given  $n$ ,  $\mathcal{L}v$  is bounded on  $\mathcal{X}_n$ . Consequently, we can find a constant  $c$  large enough such that  $\mathcal{L}v \leq cv$  on all of  $\mathcal{X}$ , which verifies part (ii) of Lemma A.1.

It remains to prove assumption (iii) of Lemma A.1, namely that  $\mathcal{L}v \rightarrow -\infty$  as  $(\eta, x) \rightarrow \partial\mathcal{X}$ . We will examine the boundaries of  $\mathcal{X}$  one-by-one. In the following, we use the notation  $g(x) = o(f(x))$  if  $g(x)/f(x) \rightarrow 0$  as  $x \rightarrow 0$ , and the notation  $g(x) = O(f(x))$  if  $g(x)/f(x) \rightarrow C$  as  $x \rightarrow 0$ , where  $C$  is a finite constant.

As  $\eta \rightarrow 0$  (and  $x$  bounded away from  $q_\alpha^L(0)$  and  $q_\beta^H(0)$ , such that  $\kappa$  is bounded away from 0 and 1, the latter due to the definition of  $q_\beta^H$ ), we have

$$\begin{aligned} \mu_\eta &= \delta v + \frac{a_e - a_h}{x} \kappa + \eta[\rho_h - \rho_e - \delta] + o(\eta) \quad \text{and} \quad |\sigma_\eta|^2 = \eta(\kappa - \eta) \frac{a_e - a_h}{x} + o(\eta) \\ \mu_x &= O(1) \quad \text{and} \quad |\sigma_x|^2 = O(1). \end{aligned}$$

We used condition (A.8) to obtain  $\mu_x$  bounded. Thus,

$$\mathcal{L}v = -\frac{1}{2\eta^{3/2}}[\delta v + \frac{1}{4} \frac{a_e - a_h}{x} \kappa] + o(\eta^{-3/2}) \rightarrow -\infty,$$

irrespective of  $\delta v > 0$  or  $\delta v = 0$ .

As  $\eta \rightarrow 1$  (and  $x$  bounded away from  $q_\alpha^L(1)$  and  $q_\beta^H(1)$ ; note that  $\kappa = 1$  at this boundary), we have

$$\begin{aligned} \mu_\eta &= -\delta(1 - v) - (\rho_e - \rho_h)(1 - \eta) + o(1 - \eta) \quad \text{and} \quad |\sigma_\eta|^2 = (1 - \eta)^2 \sigma^2 \\ \mu_x &= O(1) \quad \text{and} \quad |\sigma_x|^2 = O(1). \end{aligned}$$

We used condition (A.9) to obtain  $\mu_x$  bounded. Thus,

$$\mathcal{L}v = -(1 - \eta)^{-2} \delta(1 - v) - (1 - \eta)^{-1} [\rho_e - \rho_h - \sigma^2] + o((1 - \eta)^{-1}) \rightarrow -\infty,$$

irrespective of  $\delta(1 - v)$ , due to Assumption 1 part (iii).

We separately calculate the limit  $x \rightarrow q_\alpha^L(\eta)$  (with  $\eta$  bounded away from 0) in the two cases  $\{x < q^H(\eta)\}$  and  $\{x \geq q^H(\eta)\}$ , since  $\kappa < 1$  in the first case, and  $\kappa = 1$  in the second case. Still, we find that in both cases,

$$\begin{aligned} \mu_\eta &= O(1) \quad \text{and} \quad |\sigma_\eta|^2 = O(1) \\ \mu_x &= o((x - q_\alpha^L)^{-1}) \quad \text{and} \quad |\sigma_x|^2 = O(1). \end{aligned}$$

We used condition (A.6) to obtain the order of  $\mu_x$ . Thus,

$$\mathcal{L}v = -(x - q_\alpha^L)^{-2}x\mu_x + O((x - q_\alpha^L)^{-3}) \rightarrow -\infty.$$

Similarly, we separately calculate the limit  $x \rightarrow q_\beta^H(\eta)$  (with  $\eta$  bounded away from 0) in the two cases  $\{x < q^H(\eta)\}$  and  $\{x \geq q^H(\eta)\}$ . Again, we find that in both cases,

$$\begin{aligned} \mu_\eta &= O(1) \quad \text{and} \quad |\sigma_\eta|^2 = O(1) \\ \mu_x &= (-1) \times o((q_\beta^H - x)^{-1}) \quad \text{and} \quad |\sigma_x|^2 = O(1). \end{aligned}$$

We used condition (A.7) to obtain the order of  $\mu_x$ . Thus,

$$\mathcal{L}v = (q_\beta^H - x)^{-2}x\mu_x + O((q_\beta^H - x)^{-3}) \rightarrow -\infty.$$

Finally, all the corners of  $\mathcal{X}$  can be analyzed in a straightforward way by combining the cases above, with the exception of  $(\eta, x) = (0, q_\alpha^L(0)) = (0, a_h/\rho_h)$ . Approaching this corner, we must take a particular path of  $x \rightarrow a_h/\rho_h$  as  $\eta \rightarrow 0$ . Denote this path by  $\hat{x}(\eta)$  and denote the asymptotic slope by  $\hat{x}'(0) \in (\frac{d}{d\eta}q_\alpha^L(0), +\infty)$ , where  $\frac{d}{d\eta}q_\alpha^L(0) = [\frac{a_e}{a_h} - \frac{\rho_e}{\rho_h}] \frac{a_h}{\rho_h} + \alpha'(0) > 0$ , by Assumption 1, part (i), and the fact that  $\alpha'(0) > 0$ . Denote the associated path of  $\kappa$  by  $\hat{\kappa}(\eta)$  and the corresponding asymptotic slope by  $\hat{\kappa}'(0) = \frac{1}{a_e - a_h}[\hat{x}'(0)\rho_h + (\rho_e - \rho_h)a_h/\rho_h]$ . Substituting in, we find  $\hat{\kappa}'(0) \in (1 + \frac{\alpha'(0)}{a_e - a_h}, +\infty)$ . When computing  $\mathcal{L}v$ , we will take the supremum over all possible paths, meaning over  $\hat{x}'(0)$  and  $\hat{\kappa}'(0)$ . Using similar calculations from the initial  $\eta \rightarrow 0$  case, but using these paths, we obtain

$$\begin{aligned} \mu_\eta &= \delta v + \eta[\frac{a_e - a_h}{\hat{x}}\hat{\kappa}' + \rho_h - \rho_e - \delta] + o(\eta) \quad \text{and} \quad |\sigma_\eta|^2 = \eta^2[\hat{\kappa}' - 1]\frac{a_e - a_h}{\hat{x}} + o(\eta) \\ \mu_x &= o((\hat{x} - q_\alpha^L)^{-1}) \quad \text{and} \quad |\sigma_x|^2 = O(1) \\ \text{and} \quad \sigma_x \cdot \sigma_\eta &= \eta[\frac{a_e - a_h}{\hat{x}} - \sigma(\gamma(\hat{\kappa}' - 1)\frac{a_e - a_h}{\hat{x}})^{1/2}] + o(\eta). \end{aligned}$$

Since  $\hat{x} \geq O(\eta)$  and  $\hat{\kappa} \geq O(\eta)$  (in the sense that both could be  $+\infty$ ), we may treat

terms like  $(\hat{x} - q_\alpha^L)^{-1}$  as smaller than  $\eta^{-1}$ . This identifies the dominant terms as those associated to  $\mu_\eta$ ,  $|\sigma_\eta|^2$ , and  $\mu_x$ . Thus,

$$\begin{aligned} \mathcal{L}v &= -\frac{1}{2\eta^{3/2}}\delta v + \frac{1}{2\eta^{1/2}}[\rho_e - \rho_h + \delta - \frac{a_e - a_h}{\hat{x}} - \frac{a_e - a_h}{\hat{x}}(\hat{\kappa}' - 1)/4] + o(\eta^{-3/2}) \\ &\quad - (\hat{x} - q_\alpha^L)^{-2}x\mu_x + O((\hat{x} - q_\alpha^L)^{-3}) \rightarrow -\infty, \end{aligned}$$

irrespective of  $\delta v$ , because  $\rho_e - \rho_h - \frac{a_e - a_h}{a_h/\rho_h} = \rho_h[\rho_e/\rho_h - a_e/a_h] < 0$  by Assumption 1, part (i), and because  $\inf\{\hat{\kappa}'(0)\} > 1$ .

This completes the verification that  $\mathcal{L}v \rightarrow -\infty$  as  $(\eta, x) \rightarrow \partial\mathcal{X}$ , which proves stationarity by Lemma A.1 below. This completes the proof.  $\square$

## A.1 Stochastic stability: a useful lemma

To prove the stationarity claims of Theorem 1 and Proposition 2, we need the following lemma, which is a slight generalization of Theorems 3.5 and 3.7 of Khasminskii (2011), in the sense that weaker conditions are imposed on the coefficients  $\alpha$  and  $\beta$ . Indeed, any coefficients  $(\alpha, \beta)$  are permissible as long as they admit existence of a weak solution to the SDE system. See also Remark 3.5 and Corollary 3.1 in Khasminskii (2011) which allow the arguments in  $\mathbb{R}^l$  to generalize to any open domain  $\mathcal{D}$ .

**Lemma A.1.** *Suppose  $(X_t)_{0 \leq t \leq \tau}$  is a weak solution to the SDE  $dX_t = \beta(X_t)dt + \alpha(X_t)dZ_t$  in an open connected domain  $\mathcal{D} \subset \mathbb{R}^l$ , where  $Z$  is a  $d$ -dimensional Brownian motion and  $\tau := \inf\{t : X_t \notin \mathcal{D}\}$  is the first exit time from  $\mathcal{D}$ . Define the infinitesimal generator  $\mathcal{L}$  by (for any  $C^2$  function  $f$ )*

$$\mathcal{L}f = \sum_{i=1}^n \beta_i \frac{\partial f}{\partial x_i} + \frac{1}{2} \sum_{i,j=1}^n (\alpha_i \cdot \alpha_j) \frac{\partial^2 f}{\partial x_i \partial x_j}.$$

*Suppose there is a non-negative  $C^2$  function  $v : \mathcal{D} \mapsto \mathbb{R}_+$  such that (i)  $\liminf_{x \rightarrow \partial\mathcal{D}} v(x) = +\infty$ ; (ii)  $\mathcal{L}v \leq cv$  for some constant  $c \geq 0$ ; and (iii)  $\limsup_{x \rightarrow \partial\mathcal{D}} \mathcal{L}v(x) = -\infty$ . Then,*

(a)  $\tau = +\infty$  almost-surely;

(b) the distribution of  $X_0$  can be chosen such that  $(X_t)_{t \geq 0}$  is stationary.

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# Online Appendix:

## Where there is amplification, there are sunspots

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### B Proofs for Section 2

PROOF OF LEMMA 1. Suppose  $\kappa = 1$ ,  $q = a_e/\bar{\rho}$ , and  $\sigma_q = 0$ . Set  $\mu_\eta$  and  $\sigma_\eta$  by (11)-(12), and set  $r$  by (9). By inspection, both (PO) and (RB) are satisfied. Furthermore, the Itô condition  $\sigma_q = \frac{q'}{q}\sigma_\eta$  is trivially satisfied. Thus, Definition 1 is satisfied.  $\square$

PROOF OF PROPOSITION 1. Consequence of Proposition E.1 (take  $\kappa_0 \rightarrow 0$ ).  $\square$

PROOF OF LEMMA 2. In the text leading up to the statement of the lemma.  $\square$

PROOF OF LEMMA 3. Note that the other equations characterizing equilibrium, beyond (18), are (PO) and (RB), the latter repeated here for convenience:

$$0 = \min \left[ 1 - \kappa, \frac{a_e - a_h}{q} - \frac{\kappa - \eta}{\eta(1 - \eta)}(\sigma + \sigma_q)^2 \right]. \quad (\text{B.1})$$

Denote the equilibrium solution for  $\sigma > 0$  by  $(q^{(\sigma)}, \kappa^{(\sigma)})$ . Define  $q^{(0)} := \lim_{\sigma \rightarrow 0} q^{(\sigma)}$  and  $\kappa^{(0)} := \lim_{\sigma \rightarrow 0} \kappa^{(\sigma)}$ . Combine equations (18) and (B.1) and rearrange terms to get

$$\left( 1 - (\kappa^{(\sigma)} - \eta) \frac{(q^{(\sigma)})'}{q^{(\sigma)}} \right)^2 = \frac{(\kappa^{(\sigma)} - \eta)q^{(\sigma)}}{\eta(1 - \eta)(a_e - a_h)}\sigma, \quad \text{if } \kappa^{(\sigma)} < 1. \quad (\text{B.2})$$

Note that this implies  $\kappa^{(\sigma)} > \eta$ . Furthermore, continuity of  $\kappa^{(\sigma)}(\eta)$  and  $\kappa_0 = \kappa^{(\sigma)}(0+) < 1$  imply  $\kappa^{(\sigma)}(\eta) < 1$  for all  $\eta$  close enough to 0. Using these facts, and writing (B.2) instead as an integral equation, we obtain

$$\frac{q^{(\sigma)}(\eta_2)}{q^{(\sigma)}(\eta_1)} = \exp \left\{ \int_{\eta_1}^{\eta_2} \frac{1}{\kappa^{(\sigma)}(x) - x} \left[ 1 \pm \sqrt{\frac{(\kappa^{(\sigma)}(x) - x)q^{(\sigma)}(x)}{x(1 - x)(a_e - a_h)}}\sigma \right] dx \right\}, \quad 0 < \eta_1 < \eta_2,$$

where  $\eta_2$  is chosen small enough. Because the right-hand-side is continuous in both  $q^{(\sigma)}$  and  $\kappa^{(\sigma)}$ , and both are bounded, taking the limit as  $\sigma \rightarrow 0$  implies

$$\frac{q^{(0)}(\eta_2)}{q^{(0)}(\eta_1)} = \exp \left\{ \int_{\eta_1}^{\eta_2} \frac{1}{\kappa^{(0)}(x) - x} dx \right\}.$$

Differentiate this equation with respect to  $\eta_2$  to obtain

$$\frac{d}{d\eta} \log q^{(0)} = \frac{1}{\kappa^{(0)} - \eta},$$

for all  $\eta$  small enough. Rearranging this equation delivers the ODE characterizing the BSE, i.e., selecting the solution  $(\kappa - \eta)q'/q = 1$  in equation (14). Since  $\kappa^{(\sigma)}(0+) = \kappa_0$  is fixed for all  $\sigma > 0$ , we also have the desired boundary condition  $\kappa^{(0)}(0+) = \kappa_0$ , for any  $\kappa_0 \in [0, 1)$ . Finally, all the other equations of the Markov BSE can be verified by simply taking limits as  $\sigma \rightarrow 0$ .  $\square$

## C Other proofs and analysis for Section 3

### C.1 Proof of Corollary 1

Start from the construction of GBSE in Theorem 1, and note that we can make  $\epsilon$  arbitrarily small such that the boundaries  $q_\alpha^L \rightarrow \bar{a}/\bar{\rho}$  and  $q_\beta^H \rightarrow a_e/\bar{\rho}$ . In addition, the limit can be taken such that  $\eta_\beta^* \rightarrow \eta^*$ , its minimal possible level. Hence, a GBSE can be constructed such that the set of prices  $q$  matches  $\mathcal{Q}(\eta)$  arbitrarily closely. The result on return variance comes from using (A.4) when  $\kappa < 1$  (i.e., when  $\eta < \eta^*$ ) and using (A.5) when  $\kappa = 1$  (i.e., when  $\eta \geq \eta^*$  and  $q$  is at its upper bound). Using the definition of  $\eta^*$  provides the form of  $\mathcal{V}$  with the minimum as the lower bound.

To show that a GBSE can be constructed such that positive probability is placed on all elements of  $\mathcal{Q}$  and  $\mathcal{V}$ , we simply note that a construction exists such that  $\sigma_q \neq 0$  on the entirety of  $\text{int}(\mathcal{D})$ .  $\square$

### C.2 Proofs for Section 3.2

PROOF OF PROPOSITION 2. We proceed by construction. Without loss of generality, let  $\mathcal{S} = (0, 1)$  so that the domain of the state variables is  $\mathcal{D} = (0, 1) \times (0, 1)$ . Recall that  $\bar{\rho} := \eta\rho_e + (1 - \eta)\rho_h$ . By analogy, let  $\bar{a} := \eta a_e + (1 - \eta)a_h$ .

*Step 1: Fundamental equilibrium.* Let  $(\hat{q}^0, \hat{\kappa}^0)$  be the solution to the fundamental equilibrium (which exists by assumption), and let  $\eta^0 := \inf\{\eta : \hat{q}^0 \geq a_e/\bar{\rho}\} = \inf\{\eta : \hat{\kappa}^0 \geq 1\}$ . By part (v) of Lemma F.1, there exists  $\bar{\sigma}_A > 0$  such that, if  $\sigma < \bar{\sigma}_A$ , then  $\eta^0 < 1$ . By part (iv) of Lemma F.1, there exists  $\bar{\sigma}_B > 0$  such that, if  $\sigma < \bar{\sigma}_B$ , then  $(\hat{q}^0)' > \frac{a_e - a_h}{\bar{\rho}}$  for  $\eta \in (0, \eta^0)$ . Only to assist with step 9 below, we also denote  $\bar{\sigma}_C = \sqrt{\rho_e - \rho_h} \mathbf{1}_{\delta=0} + (+\infty) \mathbf{1}_{\delta>0}$ . Assume  $\sigma < \min(\bar{\sigma}_A, \bar{\sigma}_B, \bar{\sigma}_C)$ . In particular, this implies  $\frac{d}{d\eta}[\hat{q}^0 - \bar{a}/\bar{\rho}] > 0$  for  $\eta \in (0, \eta^0)$ .

*Step 2: Two basis functions.* We design two “extremal” functions that will assist our construction. First, let  $\varphi$  be a  $C^2$  function with the properties  $\varphi(\eta^0) = 0$  and  $\varphi' > (\bar{a}/\bar{\rho})' - (a_e/\bar{\rho})' = \frac{a_e - a_h}{\bar{\rho}}[1 - (1 - \eta)\frac{\rho_e - \rho_h}{\bar{\rho}}]$  for all  $\eta$ . Define

$$q^0(\eta) := \begin{cases} \hat{q}^0(\eta), & \text{if } \eta < \eta^0; \\ \hat{q}^0(\eta) + \varphi(\eta), & \text{if } \eta \geq \eta^0. \end{cases} \quad (\text{C.1})$$

Note that  $q^0$  is  $C^\infty$  except at  $\eta = \eta^0$ , due to part (vi) of Lemma F.1.

To construct the other basis function, fix some  $\epsilon \in (0, \eta^0)$ , let  $\tilde{\epsilon} \in (\epsilon, \eta^0)$ , and define a  $C^\infty$  (but necessarily non-analytic) function  $\beta : (0, 1) \mapsto \mathbb{R}_+$  with the following properties

$$\begin{aligned} \beta(\epsilon) &= q^0(\epsilon) - \bar{a}(\epsilon)/\bar{\rho}(\epsilon) \\ \beta^{(k)}(\epsilon) &= \frac{d^k}{d\eta^k}[q^0 - \bar{a}(\eta)/\bar{\rho}(\eta)]|_{\eta=\epsilon} \quad \text{for each derivative of order } k \geq 1 \\ \beta'(\eta) &< \frac{d}{d\eta}[q^0 - \bar{a}(\eta)/\bar{\rho}(\eta)] \quad \text{for all } \eta > \epsilon \\ \beta(\eta) &= 0 \quad \text{for all } \eta > \tilde{\epsilon}. \end{aligned}$$

A particular consequence of  $\sigma < \bar{\sigma}_B$  in step 1 is  $\frac{d}{d\eta}[q^0 - \bar{a}/\bar{\rho}] > 0$  for  $\eta \in (0, \eta^0)$ . A consequence of  $\varphi' > (\bar{a}/\bar{\rho})' - (a_e/\bar{\rho})'$  is  $\frac{d}{d\eta}[q^0 - \bar{a}/\bar{\rho}] > 0$  for  $\eta \in (\eta^0, 1)$ . Together, these properties imply such a function  $\beta$  exists. Then, we put

$$q^1(\eta) := \begin{cases} \hat{q}^0(\eta), & \text{if } \eta \leq \epsilon; \\ \bar{a}(\eta)/\bar{\rho}(\eta) + \beta(\eta), & \text{if } \eta > \epsilon. \end{cases} \quad (\text{C.2})$$

Note that  $\eta^1 := \inf\{\eta : q^1 \geq a_e/\bar{\rho}\} = 1$ . By the properties of  $\beta$  and  $\varphi$ , note the following

slope results:

$$(q^0)' > (q^1)' \quad \text{on } \eta \in (\epsilon, 1) \quad (\text{C.3})$$

$$(q^0)^{(k)}(\epsilon) = (q^1)^{(k)}(\epsilon) \quad \text{for all derivatives of order } k \geq 0. \quad (\text{C.4})$$

*Step 3: Useful monotonicity results.* Before continuing, we make the following claims:

$$\frac{\bar{a}}{\bar{\rho}} < q^1 = q^0 < \frac{a_e}{\bar{\rho}}, \quad \text{for } \eta \in (0, \epsilon); \quad (\text{C.5})$$

$$\frac{\bar{a}}{\bar{\rho}} \leq q^1 < q^0 < \frac{a_e}{\bar{\rho}}, \quad \text{for } \eta \in (\epsilon, \eta^0); \quad (\text{C.6})$$

$$\frac{\bar{a}}{\bar{\rho}} = q^1 < \frac{a_e}{\bar{\rho}} < q^0, \quad \text{for } \eta \in (\eta^0, 1). \quad (\text{C.7})$$

All inequalities in relationship (C.5), as well as the third inequality in relationship (C.6), hold by part (ii) of Lemma F.1. The first inequality in relationship (C.6) holds because  $\beta \geq 0$ , whereas the first equality in relationship (C.7) holds because  $\beta = 0$  on that set. The second inequality in relationship (C.6) holds due to (C.3). The second inequality in relationship (C.7) holds by the definition of  $\eta^1 = 1$ . The second inequality in relationship (C.7) holds since  $q^0(\eta^0) = a_e/\bar{\rho}(\eta^0)$  combined with  $(q^0 - a_e/\bar{\rho})' > (q^1 - a_e/\bar{\rho})' > 0$ , for  $\eta > \eta^0$ .

*Step 4: Construct candidate  $(q, \kappa)$ .* We proceed to combine our basis functions according to the convex combination

$$\tilde{q}(\eta, s) := (1 - \alpha s)q^0(\eta) + \alpha s q^1(\eta), \quad (\eta, s) \in \mathcal{D} = (0, 1) \times \mathcal{S}, \quad (\text{C.8})$$

where  $\alpha \in (0, 1)$  is fixed. For each  $s \in \mathcal{S}$ , define

$$\eta^*(s) := \inf\{\eta : \tilde{q}(\eta, s) \geq a_e/\bar{\rho}\}.$$

Note that  $\tilde{q}$  is  $C^2$  on  $(\eta^0, \eta^1) \times \mathcal{S}$ , which implies  $\eta^*$  is  $C^1$ . Note that  $\eta^*(s)$  is strictly

increasing by a combination of (C.6)-(C.7).<sup>34</sup> Put

$$q(\eta, s) := \begin{cases} \tilde{q}(\eta, s), & \text{if } \eta < \eta^*(s); \\ a_e / \bar{\rho}(\eta), & \text{if } \eta \geq \eta^*(s). \end{cases} \quad \text{and} \quad \kappa := \frac{\bar{\rho}q - a_h}{a_e - a_h}.$$

By construction, the pair  $(q, \kappa)$  satisfy equation (PO).

*Step 5: Properties of  $(q, \kappa)$ .* Let  $\mathcal{X} := \{(\eta, s) : \eta \in (\epsilon, \eta^*(s)), s \in \mathcal{S}\}$ . On this set, we have  $\kappa > \eta$ , or equivalently  $\bar{\rho}q > \bar{a}$ , by (C.6)-(C.7). In fact,  $\kappa$  is bounded away from  $\eta$  on  $\mathcal{X}$ , since  $\alpha < 1$  in (C.8). We also have the following derivative conditions on  $\mathcal{X}$ :

$$\partial_s q = \alpha(q^1 - q^0) < 0 \tag{C.9}$$

$$\partial_\eta q = (1 - \alpha s)(q^0)' + \alpha s(q^1)' > 0 \tag{C.10}$$

$$\partial_\eta q < q / (\kappa - \eta). \tag{C.11}$$

Inequality (C.9) holds by (C.6)-(C.7). Inequality (C.10) holds by (C.3) and Assumption 1(ii), which implies  $(q^1)' > 0$ . Inequality (C.11) is proven as follows. First, note that the function  $f(\eta, x) = \frac{(a_e - a_h)x}{\bar{\rho}(\eta)x - \bar{a}(\eta)}$  is strictly decreasing in  $x$  on  $x > \bar{a}(\eta) / \bar{\rho}(\eta)$ . Second, part (i) of Lemma F.1 implies

$$(q^0)' < \frac{(a_e - a_h)q^0}{\bar{\rho}q^0 - \bar{a}} = f(\cdot, q^0).$$

Given (C.3), we thus have  $\partial_\eta q < f(\cdot, q^0)$  for any value of  $s$ . Finally, since  $f$  is decreasing in its second argument, and  $q < q^0$  on  $\mathcal{X}$ , we have  $\partial_\eta q < f(\cdot, q)$ , which proves the claim.

We remark on one additional smoothness property that holds at  $\eta = \epsilon$ , due to condition (C.4):

$$\partial_\eta^{(k)} q(\epsilon, s) = (q^0)^{(k)}(\epsilon) \quad \forall s, \quad \text{for all derivatives of order } k \geq 0. \tag{C.12}$$

---

<sup>34</sup>Indeed, (C.6) shows that  $\tilde{q}(\eta, s) < a_e / \bar{\rho}(\eta)$  on  $(\epsilon, \eta^0) \times \mathcal{S}$ , which implies  $\eta^*(s) \geq \eta^0$  for all  $s \in \mathcal{S}$ . Then, use the fact that  $\eta^*$  is  $C^1$  to differentiate  $\tilde{q}(\eta^*(s), s) = a_e / \bar{\rho}(\eta^*(s))$  with respect to  $s$ , and use the fact that  $\partial_s \tilde{q} = q^1 - q^0$ , and finally rearrange to obtain

$$(\eta^*)'(s) \left[ \partial_\eta \tilde{q}(\eta^*(s), s) + \frac{a_e}{\bar{\rho}(\eta^*(s))} \frac{\rho_e - \rho_h}{\bar{\rho}(\eta^*(s))} \right] = q^0(\eta^*(s)) - q^1(\eta^*(s)).$$

If at any point  $s$ , we had  $(\eta^*)'(s) = 0$ , we would necessarily have  $q^0(\eta^*(s)) = q^1(\eta^*(s))$ . But this contradicts the fact from (C.6)-(C.7) that  $q^0 > q^1$  for all  $\eta > \epsilon$ , since  $\eta^*(s) \geq \eta^0 > \epsilon$ . Thus,  $(\eta^*)'(s) \neq 0$  for all  $s$ . We can also rule out  $(\eta^*)'(s) < 0$  by the fact that  $\eta^*(0+) = \eta^0$  and  $\eta^*(s) \geq \eta^0$  for all  $s$ . Thus,  $(\eta^*)'(s) > 0$  for all  $s$ .

Step 6: Construct candidate  $\sigma_s$ . Consider solving the following problem.

*Problem:* for each  $(\eta, s) \in \mathcal{X}$ , solve for  $y$  in the equation

$$y(\partial_s \log q)^2 = G, \quad (\text{C.13})$$

where

$$G := \frac{\eta(1-\eta)}{\kappa-\eta} \frac{a_e - a_h}{q} (1 - (\kappa - \eta)\partial_\eta \log q)^2 - \sigma^2.$$

Note that  $G$  is bounded, as  $\kappa$  is bounded away from  $\eta$  (step 5). Checking boundedness of the solution  $y$  thus boils down to checking  $\partial_s q$  at the boundaries of  $\mathcal{X}$ . By (C.9), as  $s \rightarrow 0$  or  $s \rightarrow 1$ ,  $\partial_s q \not\rightarrow 0$ , so  $y$  remains bounded. To check the result as  $\eta \rightarrow \epsilon$ , we first claim that  $\lim_{\eta \searrow \epsilon} \partial_\eta^{(k)} G = 0$  for all derivatives of order  $k \geq 0$ . This is a consequence of parts (i) and (vi) of Lemma F.1, whereby  $\partial_\eta^{(k)} G = 0$  for all  $k \geq 0$  on  $\eta < \epsilon$ , combined with result (C.12). Since we also have  $\partial_s q \rightarrow 0$ , we apply L'Hôpital's rule twice to compute  $\lim_{\eta \searrow \epsilon} G/(\partial_s \log q)^2 = 0$ , noting both times that  $\partial_{s\eta} \log q = \frac{\alpha}{q} [(q^1)' - (q^0)'] < 0$  is non-zero. Therefore, the solution  $y = G/(\partial_s \log q)^2$  is bounded on  $\mathcal{X}$ .

Clearly,  $\sqrt{y}$  will be a real number if and only if  $G \geq 0$ . To prove  $G \geq 0$ , note that  $\lim_{s \searrow 0} G = 0$ , meaning it suffices to prove  $\partial_s G \geq 0$ . Differentiating  $G$ , we get

$$\begin{aligned} \frac{\partial_s G}{\eta(1-\eta)} = & -\frac{a_e - a_h}{(\kappa - \eta)q} (1 - (\kappa - \eta)\partial_\eta \log q) \left[ (1 - (\kappa - \eta)\partial_\eta \log q) \left( \frac{\partial_s \kappa}{\kappa - \eta} + \frac{\partial_s q}{q} \right) \right. \\ & \left. + 2 \frac{(\kappa - \eta)\bar{a}}{\bar{\rho}q - \bar{a}} (\partial_s \log q)(\partial_\eta \log q) + 2(\kappa - \eta)\alpha \frac{(q^1)' - (q^0)'}{q} \right]. \end{aligned}$$

By properties (C.9)-(C.11), and the fact that  $\text{sgn}(\partial_s \kappa) = \text{sgn}(\partial_s q)$ , we prove  $\partial_s G > 0$  on  $\mathcal{X}$ . So not only is  $\sqrt{y}$  real, it is non-zero.

We set  $\sigma_s$  as follows:

$$\sigma_s(\eta, s) := \begin{cases} \sqrt{y(\eta, s)}, & \text{if } (\eta, s) \in \mathcal{X}; \\ \sqrt{y(\epsilon+, s)} = 0, & \text{if } (\eta, s) \in \{(\eta, s) : \eta \in (0, \epsilon), s \in \mathcal{S}\}; \\ \sqrt{y(\eta^*(s)-, s)}, & \text{if } (\eta, s) \in \{(\eta, s) : \eta > \eta^*(s), s \in \mathcal{S}\}. \end{cases} \quad (\text{C.14})$$

In passing, we note that we have also shown that  $\sigma_s > 0$  on a positive-measure set, as required in a sunspot equilibrium.

Step 7: Verify equation (22) is satisfied. By the construction of  $\sigma_s$ , equation (22) is satisfied on  $\mathcal{X}$ . On  $\{(\eta, s) : \eta \in (0, \epsilon), s \in \mathcal{S}\}$ , recall  $\partial_s q = 0$ , so (22) holds by property (i) of Lemma F.1. On  $\{(\eta, s) : \eta > \eta^*(s), s \in \mathcal{S}\}$ , recall  $\kappa = 1$ , so (22) is satisfied if and only if

the second term inside the minimum is non-negative. Substituting  $\kappa = 1$  and  $q = a_e/\bar{\rho}$ , hence  $\partial_s q = 0$ , into this term shows the non-negativity requirement is

$$\sigma^2 \leq \eta \bar{\rho} \frac{a_e - a_h}{a_e} (1 + (1 - \eta) \partial_\eta \log \bar{\rho})^2 \quad \text{for } \eta > \eta^*(s), s \in \mathcal{S}. \quad (\text{C.15})$$

On the other hand, property (v) of Lemma F.1, combined with the fact that  $\eta^*(s)$  is increasing, imply

$$\eta^*(s) \geq \frac{\rho_h}{\rho_e} \left( \frac{1 - a_h/a_e}{\sigma^2} \rho_e - 1 + \frac{\rho_h}{\rho_e} \right)^{-1}, \quad \forall s \in \mathcal{S}. \quad (\text{C.16})$$

Straightforward algebra demonstrates that (C.15) and (C.16) are equivalent, proving (22) holds.

*Step 8: Finish equilibrium construction.* Having determined  $q$ ,  $\kappa$ , and  $\sigma_s$ , we define  $\mu_\eta$  and  $\sigma_\eta$  by (11)-(12). It remains to determine  $\mu_s$ . We will pick  $\mu_s(\eta, s) = m(\eta, s)$ , where  $m$  is a  $C^2$  function with the following properties:  $\partial_s m < 0$ , and for some  $0 \leq s^0 < s^1 \leq 1$  thresholds,

$$(\text{if } s^0 > 0) \quad \inf_{\eta \in (0,1)} \lim_{s \searrow s^0} (s - s^0) m(\eta, s) = +\infty \quad (\text{C.17})$$

$$(\text{if } s^0 = 0) \quad \inf_{\eta \in (0,1)} \lim_{s \searrow s^0} m(\eta, s) > 0 \quad (\text{C.18})$$

$$\sup_{\eta \in (0,1)} \lim_{s \nearrow s^1} (s^1 - s) m(\eta, s) = -\infty. \quad (\text{C.19})$$

*Step 9: Verify stationarity.* Finally, we should demonstrate the time-paths  $(\eta_t, s_t)_{t \geq 0}$  remain in  $\mathcal{D}$  almost-surely and admit a stationary distribution. This step is very similar to Theorem 1 and is therefore omitted.  $\square$

**PROOF OF PROPOSITION 3.** Fix any  $\Sigma^* > 0$ . The proof is a simple consequence of the fact that  $\sigma_q$  must be unbounded as  $\kappa$  approaches  $\eta$ , which is as  $q$  approaches the worst-case price  $q^1$ . We fill in the technical details below.

We construct a sequence of equilibria – indexed by  $(\alpha, \epsilon, \zeta)$  – as follows. Recall the capital price construction in Proposition 2:

$$q = (1 - \alpha s) q^0 + \alpha s q^1, \quad \text{when } \kappa < 1,$$



where  $\alpha < 1$  is a parameter,  $q^0$  is the fundamental equilibrium price, and

$$q^1 = \begin{cases} q^0, & \text{if } \eta < \epsilon; \\ \bar{a}/\bar{\rho} + \beta, & \text{if } \eta \in (\epsilon, \tilde{\epsilon}); \\ \bar{a}/\bar{\rho}, & \text{if } \eta > \tilde{\epsilon}. \end{cases}$$

The function  $\beta$  is a positive mollifier that vanishes uniformly as  $\epsilon, \tilde{\epsilon} \rightarrow 0$ . We set  $\tilde{\epsilon} = \epsilon(1 + \epsilon)$ . Based on the discussion in the text, we may choose  $\mu_s$  such that equilibrium concentrates on any particular value of  $s$ . Thus, pick  $\mu_s$  such that  $s_t \geq \zeta$  almost-surely. Clearly, the choice of  $\mu_s$  depends on  $\alpha$  and  $\epsilon$ , but such a choice can always be made for any parameters.

Let  $p_{\text{low}} > 0$ ,  $p_{\text{high}} > 0$  be given with  $p_{\text{low}} + p_{\text{high}} < 1$ . First, note that there exist  $\alpha^*$ ,  $\zeta^*$ , and  $\epsilon^*$  such that  $\mathbb{P}[\eta_t \leq \tilde{\epsilon} \cap \kappa_t < 1] < p_{\text{low}}$  and  $\mathbb{P}[\eta_t \geq 1 - \tilde{\epsilon} \cap \kappa_t < 1] < p_{\text{high}}$  for all  $\alpha > \alpha^*$ ,  $\zeta > \zeta^*$ , and  $\epsilon < \epsilon^*$ . This is a consequence of the fact that in any stationary distribution, we have  $\lim_{x \rightarrow 0} \mathbb{P}[\eta_t < x] = \lim_{x \rightarrow 1} \mathbb{P}[\eta_t > x] = 0$  and the fact that  $\lim_{\alpha \rightarrow 1} \lim_{s \rightarrow 1} \kappa(\eta, s) < 1$  for all  $\eta$ .

At this point, fix such an  $\epsilon < \epsilon^*$ . Let a constant  $M > 0$  be given satisfying

$$M \leq (1 - p_{\text{low}} - p_{\text{high}}) \frac{(a_e - a_h)^2 \tilde{\epsilon}(1 - \tilde{\epsilon})}{a_e/\rho_h \Sigma^*}. \quad (\text{C.20})$$

Note that

$$\lim_{\alpha \rightarrow 1} \lim_{s \rightarrow 1} \sup_{\eta \in (\tilde{\epsilon}, 1 - \tilde{\epsilon})} \left| q(\eta, s) - \bar{a}(\eta)/\bar{\rho}(\eta) \right| = 0.$$

Consequently, we may pick  $\alpha > \alpha^*$  close enough to 1 and  $\zeta > \zeta^*$  close enough to 1 such that

$$\sup_{s \in (\zeta, 1)} \sup_{\eta \in (\tilde{\epsilon}, 1 - \tilde{\epsilon})} \left| q(\eta, s) - \bar{a}(\eta)/\bar{\rho}(\eta) \right| \leq M.$$

Finally, using equation (22) and substituting  $\kappa < 1$  from (PO), we have  $|\sigma(\frac{1}{0}) + \sigma_q|^2 = \frac{(a_e - a_h)^2 \eta(1 - \eta)}{q \bar{\rho}q - \bar{a}}$ . Note also that  $q \leq a_e/\rho_h$  is an upper bound. Then,

$$\mathbb{E}[|\sigma(\frac{1}{0}) + \sigma_{q,t}|^2] > (1 - p_{\text{low}} - p_{\text{high}}) \frac{(a_e - a_h)^2 \tilde{\epsilon}(1 - \tilde{\epsilon})}{a_e/\rho_h M}.$$

Using (C.20), we obtain  $\mathbb{E}[|\sigma(\frac{1}{0}) + \sigma_{q,t}|^2] > \Sigma^*$ . □

PROOF OF PROPOSITION 4. Revisiting the proof of Proposition 2, we compute on  $\{\kappa < 1\}$  and for each  $\eta > \epsilon$ ,

$$\partial_s[(\kappa - \eta)\partial_\eta \log q] = \alpha \left[ (\kappa - \eta) \frac{(q^1)' - (q^0)'}{q} + \frac{\bar{a}(q^1 - q^0)}{(a_e - a_h)q^2} \partial_\eta q \right] < 0.$$

The inequality uses (C.3) to say  $(q^1)' - (q^0)' < 0$ , and (C.6)-(C.7) to say  $q^1 - q^0 < 0$ , and (C.10) to say  $\partial_\eta q > 0$ . Therefore,  $(1 - (\kappa - \eta)\partial_\eta \log q)^{-1}$  is decreasing in  $s$  on  $\{\kappa < 1\}$  for each  $\eta > \epsilon$ . Since  $q$  and  $\kappa$  are independent of  $s$  on  $\{\eta < \epsilon\}$ , this proves  $(1 - (\kappa - \eta)\partial_\eta \log q)^{-1}$  is weakly decreasing in  $s$  on  $\{\kappa < 1\}$ . Using the fact that  $(\frac{1}{0}) \cdot \sigma_q = \frac{\sigma}{1 - (\kappa - \eta)\partial_\eta \log q} - \sigma$ , we obtain part (i).

Next, we prove part (iii). From (22), we can solve for return variance  $|\sigma_R|^2 := |\sigma(\frac{1}{0}) + \sigma_q|^2$  on  $\{\kappa < 1\}$  to get  $|\sigma_R|^2 = \frac{(a_e - a_h)^2}{q} \frac{\eta(1 - \eta)}{\bar{\rho}q - \bar{a}}$ . Differentiating with respect to  $s$ , we obtain

$$\partial_s |\sigma_R|^2 = -\eta(1 - \eta) \frac{(a_e - a_h)^2}{q(\bar{\rho}q - \bar{a})} \left[ \frac{1}{q} + \frac{\bar{\rho}}{\bar{\rho}q - \bar{a}} \right] \partial_s q > 0,$$

since  $\partial_s q = \alpha(q^1 - q^0) < 0$  by (C.9).

Finally, part (ii) is a consequence of parts (i) and (iii), because of the identity  $|\sigma_R|^2 - [(\frac{1}{0}) \cdot \sigma_q]^2 = [\sigma + (\frac{1}{0}) \cdot \sigma_q]^2$ .  $\square$

### C.3 Correlation between sunspots and fundamentals

What happens if sunspot shocks are correlated with fundamental shocks? To model this, we allow

$$ds_t = \mu_{s,t} dt + \sigma_{s,t}^{(1)} dZ_t^{(1)} + \sigma_{s,t}^{(2)} dZ_t^{(2)}.$$

In Section 3.2, we restricted attention to  $\sigma_{s,t}^{(1)} = 0$ . Without this assumption, equations (22) and (21) are modified to read:

$$0 = \min \left[ 1 - \kappa, \frac{a_e - a_h}{q} - \frac{\kappa - \eta}{\eta(1 - \eta)} \left( \frac{(\sigma + \sigma_s^{(1)} \partial_s \log q)^2 + (\sigma_s^{(2)} \partial_s \log q)^2}{(1 - (\kappa - \eta)\partial_\eta \log q)^2} \right) \right]$$

$$\sigma_q = \frac{(\frac{1}{0})(\kappa - \eta)\sigma \partial_\eta \log q + \sigma_s \partial_s \log q}{1 - (\kappa - \eta)\partial_\eta \log q}.$$

The rest of the equilibrium restrictions are identical.

For the present illustration, we additionally assume that  $\sigma_{s,t}^{(2)} = 0$ , i.e., sunspot shocks *only* load on fundamental shocks. What emerges is the possibility that sunspot shocks “hedge” fundamental shocks: we can have  $\sigma_s^{(1)} \partial_s \log q < 0$ , which lowers return volatil-

ity and raises asset prices. In the extreme, if  $\sigma_s^{(1)} \partial_s \log q \rightarrow -\sigma$ , the economy will converge to the Brownian Sunspot Equilibrium (BSE) of Section 2.1. At the other end, if  $\sigma_s^{(1)} \partial_s \log q \rightarrow 0$ , the economy resembles the fundamental equilibrium (FE) but with positive fundamental shocks and amplification of those shocks (this FE was  $q^0$  in our baseline construction in Section 3.2). Thus, by constructing our conjectured capital price function as a convex combination of the BSE and the FE, with weight  $1 - s$  on the BSE and  $s$  on the FE, we can ensure that  $\sigma_s^{(1)} \partial_s \log q$  endogenously emerges negative. Figure C.1 displays the equilibrium constructed this way.

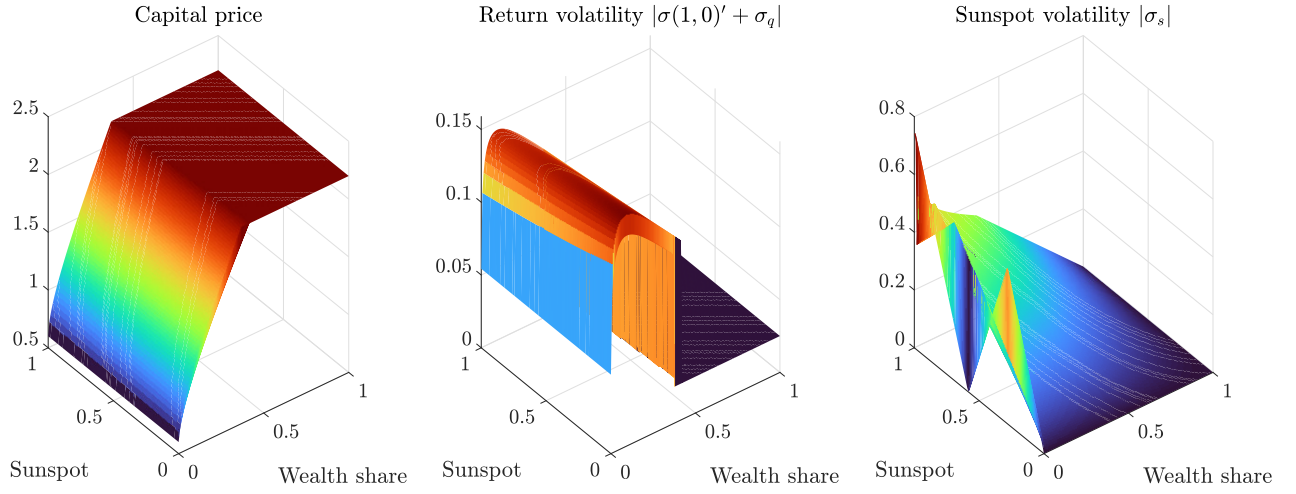


Figure C.1: Capital price  $q$ , volatility of capital returns  $|(1,0)' \sigma + \sigma_q|$ , and sunspot shock volatility  $|\sigma_s|$ . Parameters:  $\rho_e = \rho_h = 0.05$ ,  $a_e = 0.11$ ,  $a_h = 0.03$ ,  $\sigma = 0.025$ .

## C.4 Exogenous sunspot dynamics

In Section 3.2, we solved for a Markov GBSE that featured endogenous sunspot dynamics, i.e.,  $(\sigma_s, \mu_s)$  could potentially depend on  $\eta$ . Here, we show that sunspot equilibria can be built on top of exogenous sunspot dynamics as well. As we will show, this construction can be naturally viewed as the limit of equilibria in which the variable  $s$  has a vanishing contribution to fundamentals. With that in mind, we actually start from a more general setting in which  $s$  can impact fundamental volatility, and then we take the limit as this impact becomes vanishingly small.

Consider the following stochastic volatility model:

$$\begin{aligned} \frac{dK_t}{K_t} &= gdt + \sigma \sqrt{1 + \omega s_t} dZ_t \\ ds_t &= \mu_s(s_t)dt + \vartheta \sqrt{1 + \omega s_t} dZ_t \end{aligned}$$

where  $\vartheta > 0$  is an exogenous parameter and  $\omega \in \mathbb{R}$  measures the impact of  $s_t$  on capital growth volatility. Thus, the diffusion of  $s_t$ , namely  $\sigma_s(s) := \vartheta\sqrt{1+\omega s}$ , is specified exogenously. Also,  $\mu_s(s)$  is an exogenous function that is specified to ensure that  $s_t \in (s_{\min}, s_{\max})$ , for some pre-specified interval satisfying  $s_{\min} \geq 0$  and  $\kappa s_{\max} > -1$ . Such a choice can always be made, e.g., by putting  $\mu_s(s) = -(s_{\max} - s)^{-(1+\beta)} + (s - s_{\min})^{-(1+\beta)}$ . Note that  $s_t$  becomes a sunspot when  $\omega = 0$ . When  $\omega < 0$ , the state  $s_t$  is an inverse measure of capital's volatility.

For simplicity, we assume there is a single aggregate shock, i.e.,  $Z$  is a one-dimensional Brownian motion; this can easily be generalized to multiple shocks. Also for simplicity of expressions, we assume here that  $\rho_e = \rho_h = \rho$ . Then, an equilibrium capital price function  $q(\eta, s)$  must satisfy the PDE defined by the following system

$$\begin{aligned} \rho q &= \kappa a_e + (1 - \kappa) a_h \\ 0 &= \min \left[ 1 - \kappa, \frac{a_e - a_h}{q} - \frac{(\kappa - \eta)(1 + \omega s)}{\eta(1 - \eta)} \left( \frac{\sigma + \vartheta \partial_s \log q}{1 - (\kappa - \eta) \partial_\eta \log q} \right)^2 \right]. \end{aligned}$$

Technically, the multiplicity arises from the selection of the boundary conditions on  $q(\eta, s_{\min})$  and  $q(\eta, s_{\max})$ , which are not pinned down by any equilibrium restriction.

We perform two exercises. First, we show that there are multiple equilibria for a given set of parameters. We use  $\omega < 0$  here, along with  $s_{\min} = 0$  and  $s_{\max} = 2$ . In this case, the “natural” and intuitive solution is for  $q$  to increase with  $s$ , while volatility decreases. In Figure C.2, we pick a “low” boundary condition for  $q(\eta, 0)$  and the solution follows this intuition.<sup>35</sup>

However, agents could equally well coordinate on a “high” boundary condition, which results in the solution of Figure C.3.<sup>36</sup> Notice the capital price and return volatility exhibit a non-monotonicity in  $s$ . At low values of  $s$ ,  $q$  is decreasing in  $s$ , while return volatility increases. This behavior is made possible by the “coordination component” of the response to changes in  $s$  and not by the “fundamental component.”

Our second exercise considers the limit  $\omega \rightarrow 0$ . Figure C.4 shows the solution for  $\omega = -10^{-6}$ , again equipped with the “low” boundary condition for  $q(\eta, 0)$ . There remains a tremendous amount of variation in the equilibrium as  $s$  varies, illustrating convergence to a sunspot equilibrium. Thus, as promised, we are able to construct sunspot

<sup>35</sup>This “low” boundary condition is a weighted average between the solution with infinite volatility and the fundamental equilibrium solution. The fundamental equilibrium, which is the capital price solution that keeps  $s = 0$  fixed forever, is discussed in Appendix F. The infinite-volatility solution has  $\kappa = \eta$ , hence  $q = (\eta a_e + (1 - \eta) a_h) / \bar{\rho}(\eta)$ .

<sup>36</sup>This “high” boundary condition is a weighted average between the BSE of Section 2.1 (which is a potential solution to the equilibrium with  $\sigma = 0$ ) and the fundamental equilibrium solution.

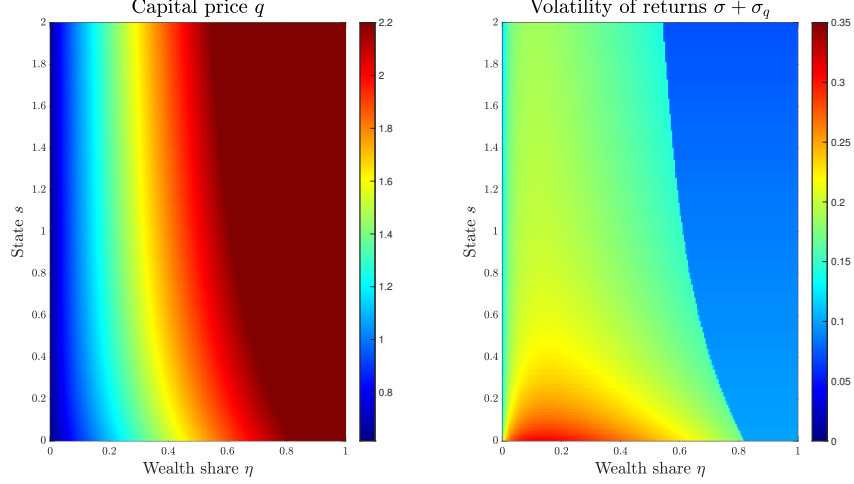


Figure C.2: Equilibrium with  $\omega = -0.25$ , and the “low” boundary condition for  $q(\eta, 0)$ , which is a 50% weighted-average of the fundamental equilibrium and the infinite-volatility equilibrium. Other parameters:  $\rho_e = \rho_h = 0.05$ ,  $a_e = 0.11$ ,  $a_h = 0.03$ ,  $\sigma = 0.1$ ,  $\vartheta = 0.25$ . The boundary condition at  $\eta = 0$  is set so that  $\kappa(0, s) = 0.01$  for all  $s$ .

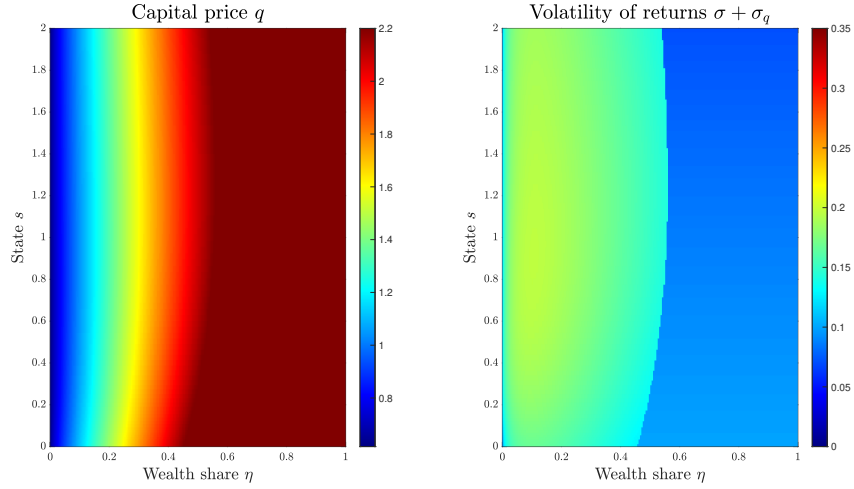


Figure C.3: Equilibrium with  $\omega = -0.25$ , and the “high” boundary condition for  $q(\eta, 0)$ , which is a 50% weighted-average of the fundamental equilibrium and a BSE. Other parameters:  $\rho_e = \rho_h = 0.05$ ,  $a_e = 0.11$ ,  $a_h = 0.03$ ,  $\sigma = 0.1$ ,  $\vartheta = 0.25$ . The boundary condition at  $\eta = 0$  is set so that  $\kappa(0, s) = 0.01$  for all  $s$ .

equilibria even if the dynamics  $(\sigma_s, \mu_s)$  are specified exogenously. In fact, it appears that the amount of price volatility is relatively insensitive to the real effects  $s$  has (i.e., the size of  $\omega$ ), which is reminiscent of the “volatility paradox” of [Brunnermeier and San-nikov \(2014\)](#) but one level deeper. Their paradox is that total volatility is only modestly sensitive to exogenous fundamental volatility; our paradox is that total volatility is only modestly sensitive to the *exogenous impact of  $s$  on fundamental volatility*.

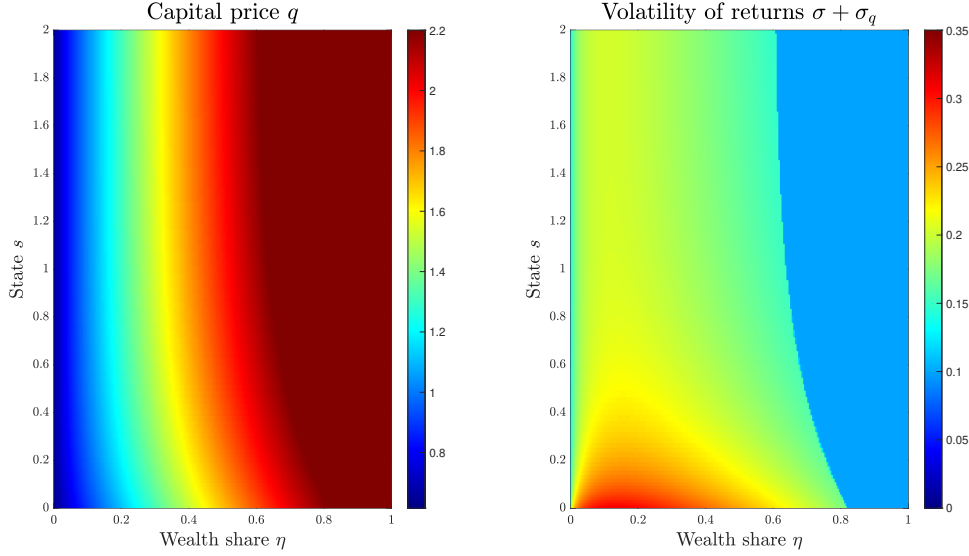


Figure C.4: Equilibrium with near-sunspot  $\omega = -10^{-6}$  and the “low” boundary condition for  $q(\eta, 0)$ , which is a 50% weighted-average of the fundamental equilibrium and the infinite-volatility equilibrium. Other parameters:  $\rho_e = \rho_h = 0.05$ ,  $a_e = 0.11$ ,  $a_h = 0.03$ ,  $\sigma = 0.1$ ,  $\theta = 0.25$ . The boundary condition at  $\eta = 0$  is set so that  $\kappa(0, s) = 0.01$  for all  $s$ .

## D Proofs for Section 4

PROOF OF LEMMA 4. In the text leading up to the statement of the lemma. □

PROOF OF THEOREM 2. Consider an auxiliary variable  $x_t \in (0, a/\rho + b)$  for some  $b > 0$ . Write the evolution of  $x$  as  $dx_t = x_t[\mu_{x,t}dt + \sigma_{x,t}dZ_t]$ . We are letting  $x_t$  be the state variable in this equilibrium.

Set  $q_t = \min[x_t, a/\rho]$ , and put  $\sigma_{x,t}^2 = h(x_t)$  and  $\mu_{x,t} = -\rho - g + h(x_t)$  when  $x_t < a/\rho$ . Nothing pins down  $(\sigma_x, \mu_x)$  when  $x_t > a/\rho$ , we may simply set them so that  $x_t$  never reaches the boundary  $a/\rho + b$ . Many such choices exist.

Next, based on  $h(0) > \rho + g$ , note that  $x_t$  behaves like a geometric brownian motion near  $x = 0$ , with positive drift  $\mu_x(0) > 0$  if and only if  $h(0) > \rho + g$ . Thus, we have proved such an equilibrium exists, but it remains to show any  $\pi \in [0, 1]$  is possible.

If  $h(a/\rho) = 0$ , then  $\mu_x(a/\rho) < 0$ , so that  $x_t$  never attains the point  $x = a/\rho$  if started below it. Thus,  $\pi = 1$  if  $h(a/\rho) = 0$ . One similarly shows that  $x = a/\rho$  is attainable if  $h(a/\rho) > 0$ , since then  $\sigma_q(x) > 0$  for all  $x \in (0, a/\rho]$ , whereas  $\mu_q(x)$  is bounded. Thus,  $\pi < 1$  if  $h(a/\rho) > 0$ .

To show that  $h(a/\rho) > 0$  does not imply  $\pi = 0$ , one may simply put  $\sigma_x(x) = 0$  and  $\mu_x(x) < 0$  on  $\{x \geq a/\rho\}$ . Then,  $x_t$  exits the efficient region  $\{x \geq a/\rho\}$  in finite time, so efficiency cannot be full probability in the stationary distribution.

Finally, to show that one can construct an equilibrium where inefficiency is completely transitory ( $\pi = 0$ ), consider putting  $h(a/\rho) > 0$ , so that  $x_t$  eventually exceeds  $a/\rho$  with probability 1, and putting  $\sigma_x(x) = 0$  and  $\mu_x(x) > 0$  on  $\{x \geq a/\rho\}$  so that  $x_t$  never leaves this region.  $\square$

# Online Appendix 2 (not for publication):

Where there is amplification, there are sunspots

Paymon Khorrami and Fernando Mendo

May 4, 2021

## E Model extensions and further analyses

### E.1 Beliefs about disaster states

In this section, we outline a richer class of sunspot equilibria, which also will help illuminate the mechanism at play. The entire set of sunspot equilibria studied here will be indexed by agents' beliefs about the "tail scenario" in the economy, i.e., what happens when experts are severely undercapitalized.

Mathematically, recall that we previously have assumed  $\kappa(0) = 0$ ; in other words, experts fully deleverage as their wealth vanishes. Some intuitive refinements like a small amount of idiosyncratic risk (Appendix E.2) or a small amount of commitment frictions (Appendix E.3) can justify the assumption  $\kappa(0) = 0$ . However, strictly speaking,  $\kappa(0) = 0$  turns out to not be necessary without these refinements, and it will be interesting to relax this assumption.

Consider any  $\kappa_0 \in (0, 1)$  and put  $\kappa(0) = \kappa_0$ . We will call  $\kappa_0$  the *disaster belief* in the economy. The sunspot equilibrium is similar to Proposition 1, with the generalization that the boundary condition to the ODE (15) is now  $\kappa(0) = \kappa_0$  rather than  $\kappa(0) = 0$ .<sup>37</sup>

**Proposition E.1.** *For a fixed tail belief  $\kappa_0 \in (0, 1)$ , there exists a Markov sunspot equilibrium, with  $\sigma_q(\eta) \neq 0$  on a positive measure subset of  $(0, 1)$ . As  $\kappa_0 \rightarrow 0$ , this equilibrium converges to the BSE. As  $\kappa_0 \rightarrow 1$ , the equilibrium converges to the FE.*

Based on Proposition E.1, proved at the end of this section, one can view both the BSE and the FE as outcomes of coordination on experts' deleveraging. If experts never sell any capital, there can be no price volatility, with  $\sigma_q = 0$  at all times. If agents

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<sup>37</sup>As in footnote 16, there is a closed-form solution when  $\rho_h = \rho_e$ , which is

$$q(\eta) = \frac{1}{\rho} \left[ (a_e - a_h)\eta + a_h + \sqrt{((a_e - a_h)\eta + a_h)^2 - a_h^2 + (a_e - a_h)^2 \kappa_0^2} \right], \quad \text{for } \eta < \eta^* = \frac{1}{2} \frac{a_e - a_h}{a_e} (1 - \kappa_0^2).$$

As  $\kappa_0$  decreases, the slope  $q'(\eta)$  increases, consistent with the idea that pessimism about the disaster state raises the sensitivity of equilibrium to sunspot shocks away from disaster. Clearly, this solution converges to the BSE solution in footnote 16 as  $\kappa_0 \rightarrow 0$ , and to the FE solution  $a_e/\rho$  as  $\kappa_0 \rightarrow 1$ .



expect  $\kappa_0 = 0$ , which translates to full deleveraging and large capital fire sales, then the BSE prevails. But for any  $\kappa_0 \in (0, 1)$ , an intermediate sunspot equilibrium will prevail, with a self-fulfilling amount of expert deleveraging and associated price dynamics. In this simple way, the boundary condition  $\kappa_0 \in [0, 1]$  spans an entire range of sunspot equilibria from more to less volatile. An illustration is in Figure E.1.<sup>38</sup>

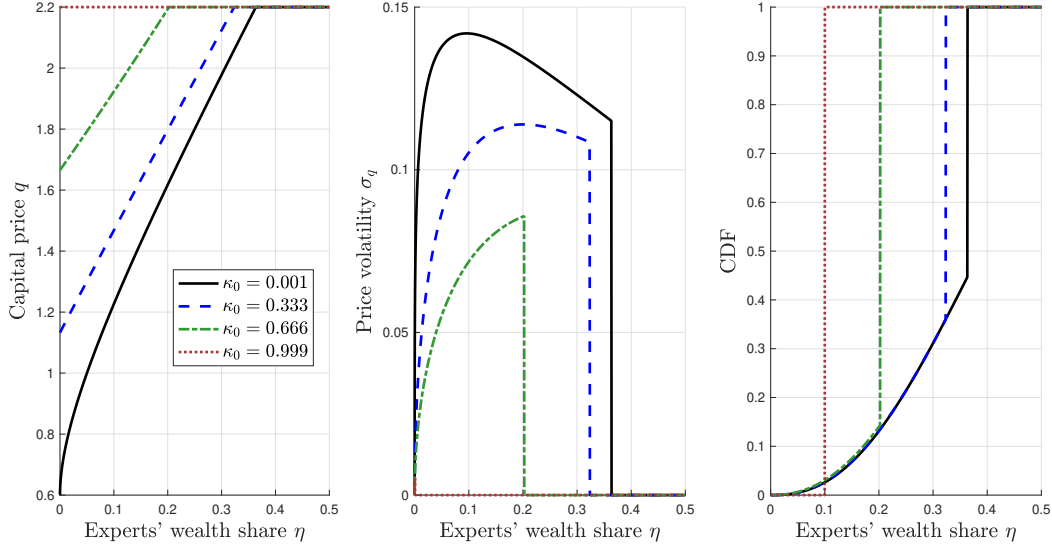


Figure E.1: Capital price  $q$ , volatility  $\sigma_q$ , and stationary CDFs of  $\eta$  for different levels of disaster belief  $\kappa_0$ . Parameters:  $\rho_e = \rho_h = 0.05$ ,  $a_e = 0.11$ ,  $a_h = 0.03$ . OLG parameters (for the CDF):  $\nu = 0.1$  and  $\delta = 0.04$ .

This result provides a clear illustration of the central property that the degree of capital fire sales is indeterminate in these models. Intuitively, greater optimism about other experts' ability to retain capital in the tail scenario induces smaller capital fire sales in response to sunspot shocks, which keeps volatility low, asset prices high, and justifies the optimism.

**PROOF OF PROPOSITION E.1.** In the first step, we prove existence of an equilibrium for fixed  $\kappa_0 \in (0, 1)$ . In the second step, we take the limits as  $\kappa_0 \rightarrow 0$  and  $\kappa_0 \rightarrow 1$ .

*Step 1: Existence.* Let  $F(x, y) := \frac{a_e - a_h}{y\bar{\rho}(x) - xa_e - (1-x)a_h}y$ . Fix  $\epsilon > 0$ . Consider the initial value problem  $y' = F(x, y)$ , with  $y(0) = (\kappa_0 a_e + (1 - \kappa_0) a_h) / \rho_h$ . As discussed in the text,  $y'(0+)$  is bounded, which is enough to ensure that  $F$  is bounded and uniformly Lipschitz on  $\mathcal{R} := \{(x, y) : 0 < x < 1, xa_e + (1 - x)a_h < y\bar{\rho}(x)\}$ . Thus, the standard Picard-Lidelf theorem implies that there exists a unique solution  $q^*$  to this initial value problem, for  $\eta \in (0, b)$ , some  $b$ . Standard continuation arguments can be used to show that either (i)

<sup>38</sup>This result is also convenient in some numerical situations. Since the BSE is just the limit of equilibria as  $\kappa_0 \rightarrow 0$ , we can construct an approximate numerical solution with  $\kappa_0$  very small (but not quite 0).

$b = 1$ , (ii)  $q^*(\eta)$  is unbounded as  $\eta \rightarrow b$ , or (iii)  $b$  satisfies  $ba_e + (1 - b)a_h = q^*(b)\bar{\rho}(b)$ . If case (ii) is true, since  $F > 0$  on  $\mathcal{R}$ , we will in fact have  $q^*(b-) = +\infty$ . Case (iii) is ruled out by the fact that  $F(b-, q^*(b-)) = +\infty$ . We are left with cases (i) or (ii).

In case (i), we will set  $\eta^* = \inf\{\eta \in (0, 1) : q^*(\eta) = a_e/\bar{\rho}(\eta)\}$ , with the convention that  $\eta^* = 1$  if this set is empty. Note that  $\eta^* < 1$  in this case: otherwise  $q^*(1-)\bar{\rho}(1-) < a_e$ , which implies  $F(1-, q^*(1-)) < 0$ , which by continuity of  $q^*$  and  $F$  implies an  $\eta^\circ \in (0, 1)$  such that  $\eta^\circ a_e + (1 - \eta^\circ)a_h = q^*(\eta^\circ)$ , which was just ruled out (case (iii)). In case (ii), we will set  $\eta^* = \inf\{\eta \in (0, b) : q^*(\eta) = a_e/\bar{\rho}(\eta)\}$ , with the convention that  $\eta^* = 1$  if this set is empty. Note that we also clearly have  $\eta^* < b < 1$  in this case.

Finally, set  $q(\eta) = \mathbf{1}_{\eta < \eta^*} q^*(\eta) + \mathbf{1}_{\eta \geq \eta^*} a_e/\bar{\rho}(\eta)$ . This function satisfies  $q' = F(\eta, q)$  on  $(0, \eta^*)$ ,  $q(0) = (\kappa_0 a_e + (1 - \kappa_0)a_h)/\rho_h$ , and  $q(\eta^*) = a_e/\bar{\rho}(\eta)$ . Thus, we have found a solution to the capital price satisfying all the desired relations. As discussed in the text, finding such a capital price is enough to prove that a Markov sunspot equilibrium exists.

Since equation (16) implies  $\sigma_q^2 > 0$  on  $(0, \eta^*)$ , in order to establish  $\sigma_q(\eta) \neq 0$  on a positive measure subset, it suffices to show that  $\eta^* > 0$ . But this is automatically implied by the boundary condition  $q(0) = (\kappa_0 a_e + (1 - \kappa_0)a_h)/\rho_h < a_e/\rho_h$  for  $\kappa_0 < 1$ , coupled with the continuity of the solution  $q(\eta)$ .

*Step 2: BSE and FE as limiting equilibria.* For each initial condition  $\kappa(0) = \kappa_0$ , let  $(q_{\kappa_0}, \eta_{\kappa_0}^*)$  be the associated equilibrium capital price and misallocation threshold (at which point households begin purchasing capital).

Define the candidate solution for the BSE,  $(q_0, \eta_0^*) := \lim_{\kappa_0 \rightarrow 0} (q_{\kappa_0}, \eta_{\kappa_0}^*)$ . It suffices to show that  $q_0$  satisfies (i)  $q'_0 = F(\eta, q_0)$  on  $(0, \eta_0^*)$ , (ii)  $q_0(0) = a_h/\rho_h$ , and (iii)  $q_0(\eta_0^*) = a_e/\bar{\rho}(\eta_0^*)$ . Write the integral version of the ODE:

$$q_{\kappa_0}(\eta) = \frac{\kappa_0 a_e + (1 - \kappa_0)a_h}{\rho_h} + \int_0^\eta F(x, q_{\kappa_0}(x))dx.$$

Next, we claim that  $q_{\kappa_0}(x)$  is weakly increasing in  $\kappa_0$ , for each  $x$ . Indeed,  $q_{\kappa_0}(0)$  is strictly increasing in  $\kappa_0$ . By continuity, we may consider  $x^* := \inf\{x : q_{\tilde{\kappa}_0}(x) = q_{\kappa_0}(x)\}$  for some  $\tilde{\kappa}_0 > \kappa_0$ . In that case, since  $F$  does not depend on  $\tilde{\kappa}_0$  or  $\kappa_0$ , we have  $q_{\tilde{\kappa}_0}(x) = q_{\kappa_0}(x)$  for all  $x \geq x^*$ . This proves  $q_{\tilde{\kappa}_0}(x) \geq q_{\kappa_0}(x)$  for all  $x$ . Combine this with the fact that  $\partial_q F < 0$  to see that  $\{F(x, q_{\kappa_0}(x)) : \kappa_0 \in (0, 1)\}$  is a sequence which is monotonically (weakly) decreasing in  $\kappa_0$ , for each  $x$ . Thus, by the monotone convergence theorem,

$$q_0(\eta) = \frac{a_h}{\rho_h} + \int_0^\eta F(x, q_0(x))dx,$$

which proves (i), by differentiating, and (ii), by substituting  $\eta = 0$ . Similarly,

$$q_{\kappa_0}(\eta_{\kappa_0}^*) = \frac{a_e}{\bar{\rho}(\eta_{\kappa_0}^*)}$$

$$\xrightarrow{\kappa_0 \rightarrow 0} q_0(\eta_0^*) = \frac{a_e}{\bar{\rho}(\eta_0^*)},$$

which proves (iii).

Define the candidate solution for the FE,  $(q_1, \eta_1^*) := \lim_{\kappa_0 \rightarrow 1} (q_{\kappa_0}, \eta_{\kappa_0}^*)$ . It suffices to show that  $\eta_1^* = 0$ , so that  $q_1(\eta) = a_e/\bar{\rho}(\eta)$  for all  $\eta$ . Note that  $q_{\kappa_0}(0) \rightarrow a_e/\rho_h$  as  $\kappa_0 \rightarrow 1$ . By continuity of  $(q_{\kappa_0}, \eta_{\kappa_0}^*)$  in  $\kappa_0$ , we also have  $q_{\kappa_0}(0) \rightarrow q_1(0)$  as  $\kappa_0 \rightarrow 1$ . Thus,  $q_1(0) = a_e/\rho_h$ . By the definition of  $\eta_1^* = \inf\{\eta : q(\eta) = a_e/\bar{\rho}(\eta)\}$ , we must have  $\eta_1^* = 0$ .  $\square$

## E.2 Idiosyncratic uncertainty

Here, we add idiosyncratic risk to capital. Doing so raises 3 substantive points: (1) small idiosyncratic uncertainty can provide an equilibrium refinement, by selecting equilibria with the property  $\lim_{\eta \rightarrow 0} \kappa = 0$ ; (2) large idiosyncratic uncertainty eliminates sunspot equilibria where  $\eta$  is the sole state variable (i.e., where sunspot shocks are iid); (3) idiosyncratic uncertainty allows us to study, in a non-trivial way, the stability properties of the “deterministic steady state” of our model.

**Setting.** In addition to the model assumptions listed in Section 1, individual capital now evolves as

$$dk_{i,t} = k_{i,t}[gdt + \tilde{\sigma}d\tilde{B}_{i,t}], \quad (\text{E.1})$$

where  $(\tilde{B}_i)_{i \in [0,1]}$  is a continuum of independent Brownian motions. Agents with indexes  $i \in [0, I]$  are experts, and those with  $i \in [I, 1]$  are households. As in Section 1, the aggregate stock of capital  $K_t := \int_0^1 k_{i,t} di$  grows deterministically at rate  $g$  (no aggregate shocks).

As before, suppose  $Z$  is a one-dimensional Brownian motion (a sunspot shock), independent of all  $\tilde{B}_i$ . Conjecture

$$dq_t = q_t[\mu_{q,t}dt + \sigma_{q,t}dZ_t].$$

We will focus on Markov equilibria in which  $\eta$  is the sole state variable. A *fundamental equilibrium* features  $\sigma_q \equiv 0$ . A *sunspot equilibrium* features  $\sigma_q$  which is not identically zero.

**Small uncertainty as equilibrium refinement.** The first result in this environment is that *any* equilibrium (even one with additional state variables beyond  $\eta$ ) must feature full deleveraging by experts, as they become poor, simply as a consequence of portfolio optimality. To see this, note that risk balance condition (RB), the combination of expert and household capital FOCs, is now modified to read

$$0 = \min \left[ 1 - \kappa, \frac{a_e - a_h}{q} - \frac{\kappa - \eta}{\eta(1 - \eta)} (\tilde{\sigma}^2 + \sigma_q^2) \right]. \quad (\text{E.2})$$

Note that  $a_e - a_h > 0$  and  $\tilde{\sigma}^2 + \sigma_q^2 > 0$ . Thus, as  $\eta \rightarrow 0$ , we must have  $\kappa \rightarrow 0$ . Since this holds for any arbitrarily small  $\tilde{\sigma}$ , we conclude that the equilibria with disaster beliefs  $\kappa_0 > 0$  (see Section E.1) are not robust.

**Lemma E.1.** *Any equilibrium with  $\tilde{\sigma} > 0$  has the property  $\lim_{\eta \rightarrow 0} \kappa = 0$ .*

**Large uncertainty eliminates iid sunspots.** In Section 2.2, we have demonstrated how sunspot equilibria with  $\eta$  as the sole state variable are incompatible with the presence of exogenous aggregate fundamental risk. Here, we show that the conclusion is similar if the exogenous risk is idiosyncratic rather than aggregate.

Even with idiosyncratic risk  $\tilde{\sigma}$ , one may follow the same analysis as Section 2.1 to show that equation (15) still determines  $q$  if  $\sigma_q \neq 0$ . In other words, the candidate sunspot equilibrium of this model has a solution  $(q, \kappa)$ , both as functions of  $\eta$ , which are independent of the amount of idiosyncratic risk  $\tilde{\sigma}$  (i.e., the same as in the BSE). Denote  $\eta^* := \inf\{\eta : \kappa(\eta) = 1\}$  the boundary point where households begin managing capital. This is also independent of  $\tilde{\sigma}$ .

Next, use equation (E.2) to solve for  $\sigma_q$ , given the solutions  $(q, \kappa)$ . We get

$$\sigma_q^2 = -\tilde{\sigma}^2 + \frac{\eta(1 - \eta)}{\kappa - \eta} \frac{a_e - a_h}{q}, \quad \text{if } \kappa < 1.$$

Since  $\sigma_q^2 \geq 0$  is required, an immediate consequence is that  $\tilde{\sigma}$  high enough eliminates the existence of any sunspot volatility. We collect these results in the following lemma.

**Lemma E.2.** *Let  $(q, \kappa, \eta^*)$  be given by the BSE of Proposition 1. If capital has idiosyncratic risk  $\tilde{\sigma}$ , and  $\tilde{\sigma}^2 \geq \sup_{\eta < \eta^*} \frac{\eta(1 - \eta)}{\kappa(\eta) - \eta} \frac{a_e - a_h}{q(\eta)}$ , any Markov equilibrium in  $\eta$  requires  $\sigma_q = 0$ .*

Intuitively, there is a trade-off between endogenous volatility  $\sigma_q$  and exogenous volatility  $\tilde{\sigma}$ . With higher idiosyncratic volatility  $\tilde{\sigma}$ , amplification of the aggregate sunspot shock is necessarily reduced. To understand this, consider Merton's optimal capital portfolio

when there is only idiosyncratic volatility

$$\frac{k_j}{n_j} = \frac{a_j/q + g - r}{\tilde{\sigma}^2}, \quad j \in \{e, h\}.$$

As  $\tilde{\sigma}$  increases the optimal capital demand becomes more inelastic to changes in the capital price  $q$ . Thus, for a given shift in the wealth distribution  $\eta$  and change in capital price  $q$ , the amount of capital that changes hands between experts and households will be dampened as  $\tilde{\sigma}$  increases. But it is exactly such capital purchases/sales which are the key ingredient to our sunspot volatility, allowing price fluctuations to be self-fulfilled. As  $\tilde{\sigma}$  increases, this mechanism is weakened, leading to a decrease in  $\sigma_q$ . Eventually, the mechanism is severed altogether because  $\sigma_q^2 < 0$  is not possible.

**Steady state stability.** In an attempt to differentiate ourselves from the literature, here we examine the traditional stability properties of this model. The addition of idiosyncratic risk provides a convenient environment for stability analysis, for the following reason. Stability properties are typically studied around the “steady state” of a deterministic equilibrium. In Section 2.1 (with  $\tilde{\sigma} = 0$ ), the volatile BSE precludes this, and studying a deterministic equilibrium instead puts us in the FE, which trivially has  $\kappa = 1$  always. With idiosyncratic risk, we can study a fundamental equilibrium in which capital prices evolve deterministically, even though  $\kappa < 1$  in steady state.

The crucial feature of the Markov BSE (in  $\eta$ ), preserved in this model, is that capital prices are determined by a function  $q$  such that  $q_t = q(\eta_t)$ . Supposing that to be true, a steady state is fully characterized by the value  $\eta = \eta^{ss}$  such that all non-growing variables are constant over time. This steady state is thus determined by the equation  $\dot{\eta} = 0$ , where

$$\dot{\eta} = \eta(1 - \eta) \left[ \rho_h - \rho_e + \tilde{\sigma}^2 \left( \left( \frac{\kappa}{\eta} \right)^2 - \left( \frac{1 - \kappa}{1 - \eta} \right)^2 \right) \right] + \delta(\nu - \eta).$$

It is straightforward to show that equilibrium features stable state variable dynamics, in the sense that  $\frac{\partial \dot{\eta}}{\partial \eta}|_{\eta=\eta^{ss}} < 0$ . However, because the “co-state”  $q$  is determined explicitly as a function of  $\eta$ , the steady state is not “stable” in the usual sense required by the multiplicity literature. Technically, there is only one stable eigenvalue of the dynamical system  $(\eta_t, q_t)$  near steady state  $(\eta^{ss}, q^{ss})$ .

**Lemma E.3.** *The steady state of the model with idiosyncratic risk is saddle path stable.*

**PROOF OF LEMMA E.3.** First, we show that  $q$  is a function of  $\eta$ , i.e.,  $q_t = q(\eta_t)$ . Goods market clearing is still characterized by the price-output relation (PO). With idiosyncratic

risk, the risk balance condition (RB) is now (E.2). The solution to the system (PO) and (E.2) can be computed explicitly. Indeed, define

$$\eta^* := \sup\{\eta : (a_e - a_h)\eta\bar{\rho}(\eta) = a_e\tilde{\sigma}^2\}.$$

Then,  $\kappa = 1$  for all  $\eta \in (\eta^*, 1)$ . For  $\eta \in (0, \eta^*)$ , we compute  $\kappa < 1$  as the positive root  $\tilde{\kappa}$  from

$$0 = (a_e - a_h)\tilde{\kappa}^2 + [a_h - \eta(a_e - a_h)]\tilde{\kappa} - \eta a_h - \frac{\eta(1 - \eta)(a_e - a_h)\bar{\rho}(\eta)}{\tilde{\sigma}^2}.$$

After determining  $\kappa$  for all values of  $\eta$ , capital price  $q$  can be computed from (PO), as an explicit function of  $\eta$ .

Given  $q_t = q(\eta_t)$ , the dynamics of  $q_t$  are given by  $\dot{q}_t = q'(\eta_t)\dot{\eta}_t$ , which only depends on  $\eta$  and not  $q$  (notice that  $\dot{\eta}_t$  also only depends on  $\eta$  and not  $q$ ). Consequently, the linearized system near steady state takes the form

$$\begin{bmatrix} \dot{\eta} \\ \dot{q} \end{bmatrix} = \begin{bmatrix} m_1 & 0 \\ m_2 & 0 \end{bmatrix} \begin{bmatrix} \eta \\ q \end{bmatrix}$$

for  $m_1, m_2 \neq 0$ . The eigenvalues of this system are  $m_1 < 0$  and 0. □

As a result of Lemma E.3, there is a unique transition path  $(\eta_t, q_t)_{t \geq 0}$  to steady state, given an initial condition  $\eta_0$ . In other words,  $q_0$  is pinned down uniquely. Our sunspot equilibria are not constructed by randomizing over a multiplicity of transition paths that arise due to steady state stability, which is the usual approach (Azariadis, 1981; Cass and Shell, 1983). This can be seen in a relatively transparent way by examining Lemma E.2, which shows how sunspot equilibria can exist in this model (if  $\tilde{\sigma}$  is small enough), despite the instability of the steady state.

### E.3 Limited commitment as equilibrium refinement

Here, we add a small limited commitment friction, in the spirit of Gertler and Kiyotaki (2010). The result: only equilibria with the property  $\lim_{\eta \rightarrow 0} \kappa = 0$  survive, similarly to equilibria with a small amount of idiosyncratic risk (Appendix E.2).

Suppose capital holders can abscond with a fraction  $\lambda^{-1} \in (0, 1)$  of their assets and renege on repayment of their short-term bonds. After doing this diversion, the capital holder would have net worth  $\tilde{n}_{j,t} := \lambda^{-1}q_t k_{j,t}$ .

To prevent diversion, bondholders will impose some limitation on borrowing. To see this, note that diversion delivers utility  $\log(\tilde{n}_{j,t}) + \xi_t$ , where  $\xi_t$  is an aggregate process

(independent of the identity  $j$  of the diverter). For diversion to be sub-optimal, it must be the case that  $\log(\tilde{n}_{j,t}) + \xi_t \leq \log(n_{j,t}) + \xi_t$ . As a result, bondholders impose the following leverage constraint to ensure non-diversion is incentive compatible:

$$\frac{q_t k_{j,t}}{n_{j,t}} \leq \lambda. \quad (\text{E.3})$$

We will study the equilibrium with constraint (E.3) additionally imposed, and then we will take  $\lambda \rightarrow \infty$  so that the limited commitment friction is vanishingly small.

Risk balance condition (RB) is now replaced by

$$0 = \min \left[ 1 - \kappa, \lambda\eta - q\kappa, \frac{a_e - a_h}{q} - \frac{\kappa - \eta}{\eta(1 - \eta)} |\sigma_R|^2 \right]. \quad (\text{E.4})$$

The most important feature of equation (E.4) is that leverage constrained experts ( $\lambda\eta = q\kappa$ ) must hold less than the full capital stock ( $\kappa < 1$ ).

Condition (E.4) implies that there exists a threshold  $\eta^\lambda := \inf\{\eta : \lambda\eta > q\kappa\}$  below which experts' leverage constraints bind. By combining  $\lambda\eta = q\kappa$  with condition (PO) for  $\kappa$ , we obtain an explicit formula for the capital price in this region:

$$q = \frac{1}{2} \left[ \frac{a_h}{\bar{\rho}} + \sqrt{(a_h/\bar{\rho})^2 + 4\lambda\eta(a_e - a_h)/\bar{\rho}} \right], \quad \text{if } \eta \leq \eta^\lambda. \quad (\text{E.5})$$

Taking the limit  $\eta \rightarrow 0$  in equation (E.5) shows that  $q \rightarrow a_h/\rho_h$  and thus  $\kappa \rightarrow 0$ . This proves that there is no flexibility for coordination on a worst-case capital price, unlike the leverage-unconstrained economy. The equilibrium is unique along this dimension, coinciding with  $\kappa_0 = 0$ .

As the limited commitment problem vanishes ( $\lambda \rightarrow \infty$ ), the leverage constraint becomes non-binding at all times (formally  $\eta^\lambda \rightarrow 0$ ).<sup>39</sup> But along the sequence,  $\kappa_0 = 0$  is uniformly required. (And if we focus on equilibria which are Markov in  $\eta$ , the entire equilibrium converges to the BSE of Proposition 1.) We collect these results.

**Lemma E.4.** *Among all equilibria, only those with the property  $\lim_{\eta \rightarrow 0} \kappa = 0$  survive a vanishingly-small limited commitment friction.*

Intuitively, the leverage constraint gives experts an additional motive to sell capital, which forces coordination on maximal selling in response to negative sunspot shocks. Said differently: due to the prospect of violating the leverage constraint, losses incurred

<sup>39</sup>This intuitive property can be shown easily by taking  $\lambda \rightarrow \infty$  in (E.5). For any fixed  $\eta \in (0, 1)$ , taking this limit implies  $q \rightarrow \infty$ , which is ruled out by price-output relation (PO).

from retaining capital when others are selling is larger than losses incurred from selling capital when others are retaining it. This property is reminiscent of “risk dominant” equilibria being selected by strategic uncertainty (Harsanyi and Selten, 1988; Frankel et al., 2003), but the exact modeling is different here.

#### E.4 Poisson Sunspot Equilibrium (PSE)

Rather than model sunspots as Brownian shocks, here we conjecture capital prices can “jump” for non-fundamental reasons. Mathematically, write

$$dq_t = q_{t-}[\mu_{q,t-}dt + \zeta_{q,t-}dJ_t],$$

where  $J$  is a Poisson process with intensity  $\lambda$  that does not affect physical capital at all. An equilibrium in which  $\zeta_q$  is not identically zero will be called the *Poisson Sunspot Equilibrium* (PSE).

In a Markov equilibrium, the sole state variable will still be experts’ wealth share  $\eta$ , which follows a jump process

$$d\eta_t = \mu_{\eta,t-}dt + \zeta_{\eta,t-}dJ_t.$$

Note that  $\zeta_{\eta,t-} := \eta_t - \eta_{t-}$  by definition. Because agents’ portfolios (capital and bonds) are predetermined, we can determine the wealth share jump from the jump in  $q$ , with the result being<sup>40</sup>

$$\zeta_\eta = (\kappa - \eta) \frac{\zeta_q}{1 + \zeta_q}. \quad (\text{E.6})$$

On the other hand, once the post-jump wealth share is known, the capital price is also known, since  $\eta$  is the sole state variable, i.e., we have  $q_t = q(\eta_t)$  for some function  $q$ .

---

<sup>40</sup> The derivation is as follows. Let variables with hats, e.g., “ $\hat{x}$ ”, denote post-jump variables. Note  $\hat{N}_e = \hat{q}\hat{K}\kappa - B$  and  $\hat{N}_h = \hat{q}\hat{K}(1 - \kappa) + B$ , where  $B$  is expert borrowing (and household lending, by bond market clearing). Then,  $\hat{\eta} = \hat{N}_e / (\hat{q}\hat{K}) = \kappa - B / (\hat{q}\hat{K})$  and by similar logic the pre-jump wealth share is  $\eta = \kappa - B / qK$ . Thus,  $\zeta_\eta = \hat{\eta} - \eta = B[1 / (qK) - 1 / (\hat{q}\hat{K})] = qK(\kappa - \eta)[1 / (qK) - 1 / (\hat{q}\hat{K})]$ . Using the fact that  $\hat{K} = K$  and the definition  $\zeta_q := \hat{q} / q - 1$ , we arrive at  $\zeta_\eta = (\kappa - \eta)[1 - (1 + \zeta_q)^{-1}]$ . This derivation assumes the presumably risk-free bond price does not jump when capital prices jump. Conceptually, there is no reason why this needs to be true, but it preserves its risk-free conjecture. If bond prices are allowed to jump at the same time, we would find different expressions.



Thus, if we denote the post-jump wealth share by  $\hat{\eta}$ ,

$$\zeta_q = \frac{q(\hat{\eta}) - q}{q}. \quad (\text{E.7})$$

This is the way to solve the two-way feedback between the wealth distribution and capital prices, similar to the Brownian model. Combining (E.6)-(E.7) yields  $\hat{\eta} - \eta = (\kappa - \eta) \frac{q(\hat{\eta}) - q}{q(\hat{\eta})}$ , which is analogous to the sunspot differential equation of the BSE. Indeed, as  $\hat{\eta} \rightarrow \eta$ , this system converges exactly to  $q'/q = (\kappa - \eta)^{-1}$ .

Because we do not model bankruptcy procedures, we must also make sure the jump renders experts solvent, meaning  $\zeta_{\eta,t-} > -\eta_{t-}$ , to preserve the risk-free status of the bond. If solvency cannot be ensured, then no self-fulfilling jump can take place.

Portfolio choices are still relatively simple, because the jump size is locally predictable, i.e.,  $\zeta_q$  is known just before the jump actually occurs. Thus, equations characterizing an equilibrium of this model are given by the following simple lemma.

**Lemma E.5** (Equilibrium with Jumps). *An allocation is a Markov equilibrium with jumps only if  $(q, \kappa, \hat{\eta}, \zeta_q, \zeta_\eta)$  are functions of  $\eta \in (0, 1)$  satisfying price-output relation (PO), equations (E.6)-(E.7), and the following:*

$$\begin{aligned} \hat{\eta} &= \eta + (\kappa - \eta) \frac{\zeta_q}{1 + \zeta_q} > 0 \\ 0 &= \min \left[ 1 - \kappa, \eta(1 - \eta) \frac{a_e - a_h}{q} - (\kappa - \eta) \frac{\lambda \zeta_q^2}{(1 + \frac{\kappa}{\eta} \zeta_q)(1 + \frac{1-\kappa}{1-\eta} \zeta_q)} \right], \quad \kappa(0) = 0. \end{aligned}$$

To show what the PSE looks like, we provide a numerical solution and plot some aspects below. The first panel of figure E.2 displays one simulation of the PSE, also comparing it with a simulation of the BSE. The second panel plots the stationary capital price densities (although note that the BSE “density” in fact has a point mass at  $\eta = \eta^*$ ). Capital prices in the PSE tend to remain at lower levels than in the BSE for our example.

## E.5 General CRRA preferences

We modify the model of Section 1 by generalizing preferences to the CRRA type. In particular, we replace the  $\log(c)$  term in utility specification (3) with the flow consumption utility  $c^{1-\gamma}/(1-\gamma)$ . For simplicity, we consider no OLG structure ( $\delta = 0$ ), but we continue to allow experts’ discount rate to exceed households’ ( $\rho_e \geq \rho_h$ ). We continue to look for a Markov equilibrium, with experts’ wealth share  $\eta$  as the state variable.

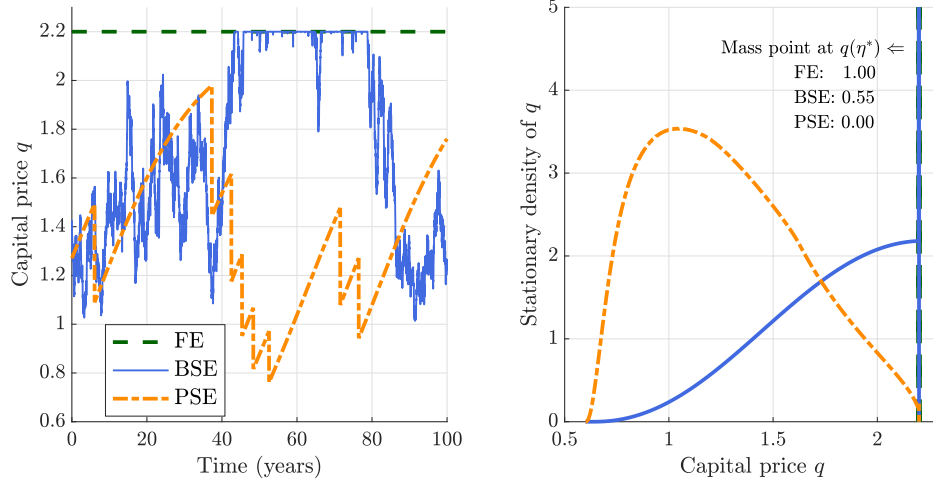


Figure E.2: Time series and stationary density of capital price  $q$  in a PSE, BSE, and FE. Parameters:  $\rho_e = \rho_h = 0.05$ ,  $a_e = 0.11$ ,  $a_h = 0.03$ . OLG parameters:  $\nu = 0.1$  and  $\delta = 0.1$ .

**Equilibrium.** The key equation (14) still holds, repeated here for convenience:

$$\left[1 - (\kappa - \eta) \frac{q'}{q}\right] \sigma_\eta = 0. \quad (\text{E.8})$$

The sunspot equilibrium is associated with the term in brackets being equal to zero. Unlike with logarithmic preferences, this condition does not pin down  $q(\eta)$  function, because we can no longer write  $\kappa(q, \eta)$  from the goods market clearing condition: the consumption to wealth ratio is not constant anymore, and depends on agents' value functions.

The value function can be written as  $V_i = v_i(\eta) K^{1-\gamma} / (1 - \gamma)$  where  $v_i(\eta)$  is determined in equilibrium. Then, consumption is  $c_i/n_i = (\eta_i q)^{1/\gamma-1} / v_i^{1/\gamma}$  where  $\eta_i$  corresponds to the wealth share of sector  $i$ . Then, goods market clearing becomes

$$q^{1/\gamma} \left[ \left( \frac{\eta}{v_e} \right)^{1/\gamma} + \left( \frac{1-\eta}{v_h} \right)^{1/\gamma} \right] = (a_e - a_h) \kappa + a_h. \quad (\text{E.9})$$

Optimal portfolio decisions imply that

$$0 = \min \left[ 1 - \kappa, \frac{a_e - a_h}{q} - \left( \frac{v'_h}{v_h} - \frac{v'_e}{v_e} + \frac{1}{\eta(1-\eta)} \right) (\kappa - \eta) \sigma_q^2 \right]. \quad (\text{E.10})$$

The HJB equation for  $i \in \{e, h\}$  has the familiar form  $\rho_i V_i = u(c) + \mathbb{E}[\frac{dV_i}{dt}]$ , which be-

comes

$$\rho_i = \frac{(\eta_i q)^{1/\gamma-1}}{v_i^{1/\gamma}} + \underbrace{\frac{v'_i}{v_i} \mu_\eta + \frac{1}{2} \frac{v''_i}{v_i} \sigma_\eta^2}_{:=\mu^{v,i}} + (1-\gamma)g. \quad (\text{E.11})$$

The dynamics of  $\eta$  satisfy

$$\sigma_\eta = (\kappa - \eta)\sigma_q \quad (\text{E.12})$$

$$\mu_\eta = \eta(1-\eta) \left( \varsigma_e \frac{\kappa}{\eta} \sigma_q - \varsigma_h \frac{1-\kappa}{1-\eta} \sigma_q + \frac{c_h}{n_h} - \frac{c_e}{n_e} \right) - \sigma_\eta \sigma_q \quad (\text{E.13})$$

and agent-specific risk prices satisfy

$$\varsigma_e = -\frac{v'_e}{v_e} \sigma_\eta + \frac{\sigma_\eta}{\eta} + \sigma_q \quad (\text{E.14})$$

$$\varsigma_h = -\frac{v'_h}{v_h} \sigma_\eta - \frac{\sigma_\eta}{1-\eta} + \sigma_q. \quad (\text{E.15})$$

A Markov equilibrium is a set of functions: prices  $\{q, \sigma_q, \varsigma_e, \varsigma_h\}$ , allocation  $\{\kappa\}$ , value functions  $\{v_h, v_e\}$  and aggregate state dynamics  $\{\sigma_\eta, \mu_\eta\}$  that solve the system (E.8)-(E.15).

The fundamental equilibrium corresponds to the solution for (E.8) where  $\sigma_\eta = 0$ , which implies deterministic economic dynamics. Then, the capital price has no volatility ( $\sigma_q = 0$ ), risk prices are zero ( $\varsigma_e = \varsigma_h = 0$ ), and experts hold the entire capital stock ( $\kappa = 1$ ). The capital price is then solved from (E.9), and the value functions satisfy

$$\rho_i = \frac{(\eta_i q)^{1/\gamma-1}}{v_i^{1/\gamma}} + \frac{v'_i}{v_i} \underbrace{\eta(1-\eta) \left( \frac{c_h}{n_h} - \frac{c_e}{n_e} \right)}_{=\mu_\eta} + (1-\gamma)g.$$

Conversely, the sunspot equilibrium corresponds to the solution for (E.8) with  $\frac{q'}{q} = (\kappa - \eta)^{-1}$  (and potentially  $\sigma_\eta \neq 0$ ).

**Disaster belief.** With logarithmic preferences, we proved that any sunspot equilibrium must satisfy  $\sigma_q(0+) = 0$ . This allowed us, in Section E.1, to construct sunspot equilibria with  $\kappa(0+) = \kappa_0$  for any  $\kappa_0 \in [0, 1)$ . With CRRA preferences, we attempt to construct the same class of equilibria, with  $\sigma_q(0+) = 0$  and  $\kappa_0 \in (0, 1)$ .

In order to have a non-degenerate stationary distribution, we have the following requirements. Since  $\sigma_\eta(0+) = \kappa_0 \sigma_q(0+) = 0$ , the state variable avoids the boundary  $\{0\}$

if  $\mu_\eta(0+) > 0$ . Using (E.10) for  $\kappa < 1$ , we have<sup>41</sup>

$$\frac{a_e - a_h}{q(0+)} = (\varsigma_e(0+) - \varsigma_h(0+))\sigma_q(0+)$$

which allows us to show that<sup>42</sup>

$$\mu_\eta(0+) = \kappa_0 \frac{a_e - a_h}{q(0+)} > 0.$$

In addition, we need  $\mu_\eta(\eta^*+) < 0$  where  $\eta^* := \inf\{\eta : \kappa(\eta) = 1\}$ . This requirement should be satisfied for  $\rho_e - \rho_h$  sufficiently large.<sup>43</sup>

**Numerical solution.** We do not provide an existence proof – which involves the existence of a solution to the ODE system – but construct numerical examples. For tractability, the numerical examples are constructed for  $\kappa_0 > 0$ , which keeps  $q'(0+) = q(0+)/\kappa_0$  bounded.<sup>44</sup>

The numerical strategy is the following. Construct a grid  $\{\eta_1, \dots, \eta_N\}$  with limit points arbitrarily close to but bounded away from zero and one. Conjecture value functions  $v_h(\eta)$  and  $v_e(\eta)$ . Impose  $\kappa(\eta_1) = \kappa_0$  and use (E.9) to solve for  $q(\eta_1)$ . At each interior grid point, use  $q' = q/(\kappa - \eta)$  and (E.9) to solve for  $\kappa(\eta)$  and  $q(\eta)$  until  $\kappa(\eta^*) = 1$ . In this region, recover  $\sigma_q$  from (E.10). For  $\eta \in (\eta^*, 1]$  impose  $\kappa(\eta) = 1$  and  $\sigma_q = 0$ , and solve capital price from (E.9). The rest of equilibrium objects are calculated directly from the system above. The guesses of the value functions are updated by augmenting the HJBs (E.11) with a time derivative and moving a small time-step backward, as in Brunnermeier and Sannikov (2016). The procedure terminates when the value functions converge to time-independent functions.

In Figure E.3, we plot the equilibrium objects as functions of  $\eta$ , for different levels of risk aversion  $\gamma$ . In Figure E.4, we make the same plots, for different levels of the disaster belief  $\kappa_0$ . Higher risk aversion (higher  $\gamma$ ) or more pessimism about disasters (lower  $\kappa_0$ ) generates sunspot equilibria featuring lower capital prices and higher volatility.

<sup>41</sup>Note that this implies  $\varsigma_e(0+) - \varsigma_h(0+)$  diverges.

<sup>42</sup>This expression also assumes that  $\varsigma_h(0+)$  remains bounded. This is a mild assumption since households own all capital.

<sup>43</sup>There is an important distinction between the restriction not to reach  $\eta = 0$  and  $\mu_\eta(\eta^*+) < 0$ . Without the first one, the equilibrium for any  $\kappa_0 > 0$  unravels, while without the second one, the equilibrium is still valid, but it has a degenerate stationary distribution at some value  $\eta^{ss} > \eta^*$ .

<sup>44</sup>With logarithmic utility, we obtain a limiting result in Proposition E.1, that as  $\kappa_0 \rightarrow 0$ , the equilibrium converges to the BSE with  $\kappa(0) = 0$ . With CRRA, we do not prove such a result analytically, but we do observe numerically what looks like convergence as  $\kappa_0$  becomes small.

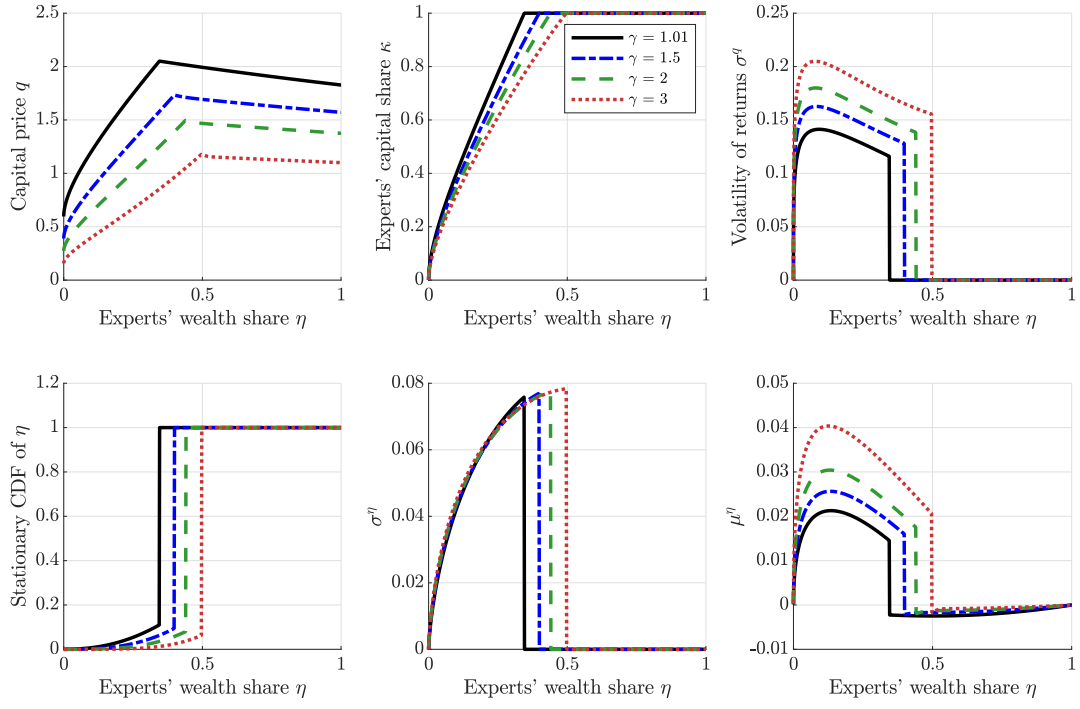


Figure E.3: Sunspot equilibrium for different risk aversion  $\gamma$ . The disaster belief is set to  $\kappa_0 = 0.001$ . Other parameters:  $a_e = 0.11$ ,  $a_h = 0.03$ ,  $\rho_e = 0.06$ ,  $\rho_h = 0.05$ ,  $g = 0.02$ .

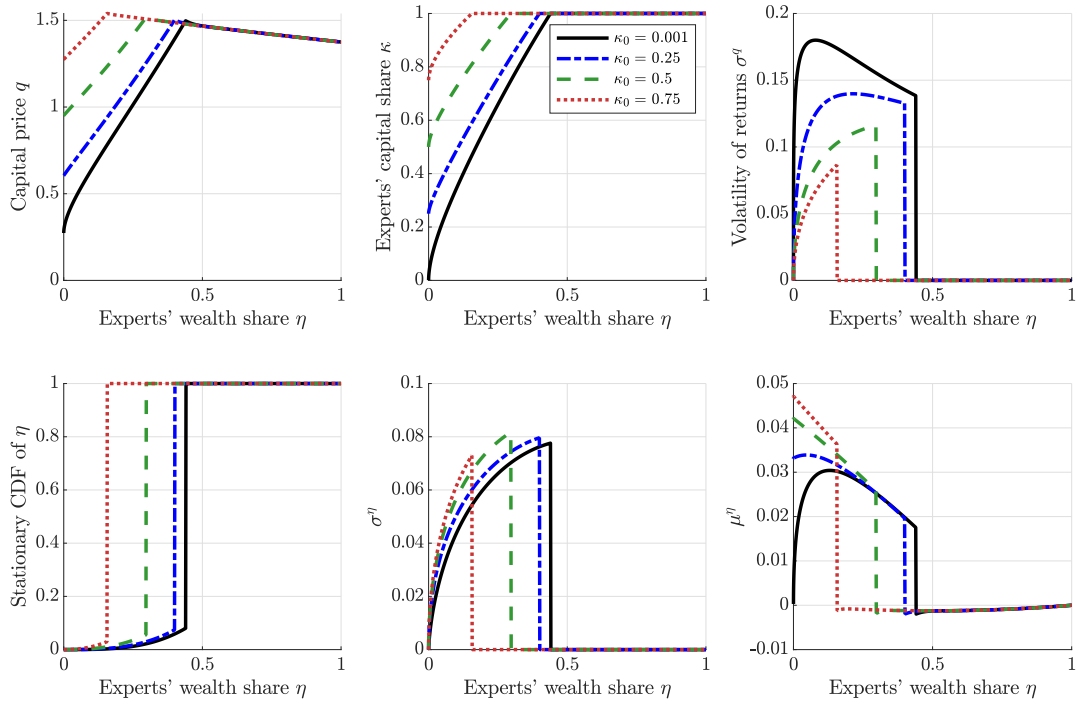


Figure E.4: Sunspot equilibrium for different disaster beliefs  $\kappa_0$ . Risk aversion is set to  $\gamma = 2$ . Other parameters:  $a_e = 0.11$ ,  $a_h = 0.03$ ,  $\rho_e = 0.06$ ,  $\rho_h = 0.05$ ,  $g = 0.02$ .

## F Markov Fundamental Equilibria

In this section, we investigate properties of equilibria where sunspot shocks  $Z^{(2)}$  are irrelevant. If all equilibrium objects are additionally functions of expert wealth share  $\eta$ , then the key equations describing such equilibria are (PO), (B.1), and (18), restated here for convenience:

$$q\bar{\rho} = \kappa a_e + (1 - \kappa)a_h \quad (\text{F.1})$$

$$0 = \min \left[ 1 - \kappa, \frac{a_e - a_h}{q} - \frac{\kappa - \eta}{\eta(1 - \eta)}(\sigma + \sigma_q)^2 \right]. \quad (\text{F.2})$$

$$\sigma_q = \frac{(\kappa - \eta)q'/q}{1 - (\kappa - \eta)q'/q} \sigma. \quad (\text{F.3})$$

Also, wealth share dynamics are given in (11)-(12), restated here for convenience:

$$\mu_\eta = -\eta(1 - \eta)(\rho_e - \rho_h) + \mathbf{1}_{\{\kappa < 1\}}(\kappa - 2\kappa\eta + \eta^2) \frac{a_e - a_h}{q} + \delta(\nu - \eta) \quad (\text{F.4})$$

$$\sigma_\eta = (\kappa - \eta)(\sigma + \sigma_q). \quad (\text{F.5})$$

We define a fundamental equilibrium as follows.<sup>45</sup>

**Definition 5.** Given  $\eta_0 \in (0, 1)$ , a *Markov fundamental equilibrium* consists of adapted processes  $(\eta_t, q_t, \kappa_t)_{t \geq 0}$  such that (F.1)-(F.3) hold, and (F.4)-(F.5) describe the dynamics of  $\eta_t$ .

### F.1 Properties of the non-sunspot solution with fundamental shocks

We describe here some properties of fundamental equilibria with fundamental volatility  $\sigma > 0$ , where we additionally impose the full-deleveraging condition  $\kappa(0) = 0$ .

**Lemma F.1.** *Assuming it exists, suppose  $(q, \kappa)$  is a fundamental equilibrium in  $\eta$  in the sense of Definition 5. Assume  $\kappa(0+) = 0$ . Define  $\eta^* := \inf\{\eta : \kappa = 1\}$ . Then, the following hold:*

- (i)  $(\bar{\rho}q - \eta a_e - (1 - \eta)a_h) \frac{q'}{q} = a_e - a_h - \sigma \sqrt{q \frac{\bar{\rho}q - \eta a_e - (1 - \eta)a_h}{\eta(1 - \eta)}},$  for all  $\eta \in (0, \eta^*)$ .
- (ii)  $\eta a_e + (1 - \eta)a_h < \bar{\rho}q < a_e,$  for all  $\eta \in (0, \eta^*)$ .
- (iii)  $\frac{q'(0+)}{q(0+)} = \frac{a_e}{a_h} - \frac{\rho_e}{\rho_h} + \rho_h \left( \frac{a_e - a_h}{\sigma a_h} \right)^2.$

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<sup>45</sup>We omit  $r_t$  from the definition, since it can be read off of (9), given other objects, and affects no other equation.

(iv) If  $\sigma$  is sufficiently small, then  $q' > \frac{a_e - a_h}{\bar{\rho}}$ , for  $\eta \in (0, \eta^*)$ .

(v) If  $\sigma$  is sufficiently small, then  $\frac{\rho_h}{\rho_e} \left( \frac{1 - a_h/a_e}{\sigma^2} - 1 + \frac{\rho_h}{\rho_e} \right)^{-1} < \eta^* < 1$ .

(vi) On  $\eta \in (0, \eta^*)$ , the solution  $q$  is infinitely-differentiable.

PROOF OF LEMMA F.1. Since a fundamental equilibrium is assumed to exist, we make use of equations (F.1) and (F.2). Recall that  $\bar{\rho} := \eta\rho_e + (1 - \eta)\rho_h$ . By analogy, let  $\bar{a} := \eta a_e + (1 - \eta)a_h$ .

- (i) Start from equation (F.2), and rearrange to obtain the result, where we have implicitly selected the solution with  $1 > (\kappa - \eta) \frac{q'}{q}$ .
- (ii) The first inequality, which is equivalent to  $\kappa > \eta$ , is a direct implication of equation (F.2). The second inequality, equivalent to  $\kappa < 1$ , is a restatement of the definition of  $\eta^*$ .
- (iii) Start from equation (F.2). Taking the limit  $\eta \rightarrow 0$ , and using  $\kappa(0+) = 0$ , delivers an equation for  $\kappa'(0+)$ . Differentiating (F.1), we may then substitute  $\kappa'(0+) = \frac{\rho_h q'(0+) + (\rho_e - \rho_h)q(0+)}{a_e - a_h}$ . Rearranging, we obtain the desired result.
- (iv) By part (iii), there exists  $\eta^\circ > 0$  and  $\bar{\sigma} > 0$  such that uniformly for all  $\sigma < \bar{\sigma}$ , we have  $q' > \frac{a_e - a_h}{\bar{\rho}}$  on the set  $\{\eta < \eta^\circ\}$ . On the set  $\{\eta^\circ \leq \eta < \eta^*\}$ , we know that  $\kappa - \eta$  is bounded away from zero, uniformly for all  $\sigma < \bar{\sigma}$ . Using the expression in part (i), the fact that  $q$  is bounded by  $a_e/\bar{\rho}$  uniformly for all  $\sigma$ , and the previous fact about  $\kappa - \eta = \bar{\rho}q - \bar{a}$ , we can write

$$q' = \frac{a_e - a_h}{\bar{\rho}q - \bar{a}}q - o(\sigma), \quad \eta \in (\eta^\circ, \eta^*).$$

Therefore,

$$q' + o(\sigma) = \frac{a_e - a_h}{\bar{\rho}q - \bar{a}}q = \frac{a_e - a_h}{\bar{\rho}} \frac{q}{q - \bar{a}/\bar{\rho}} > \frac{a_e - a_h}{\bar{\rho}}, \quad \eta \in (\eta^\circ, \eta^*),$$

where the last inequality is due to  $\bar{\rho}q > \bar{a}$  [part (ii)]. Taking  $\sigma$  is small enough implies the result on  $(\eta^\circ, \eta^*)$ , which we combine with the result on  $(0, \eta^\circ)$  to conclude.

- (v) Consider the function  $\tilde{q} := \bar{a}/\bar{\rho}$ , whose derivative is  $\tilde{q}' = \frac{a_e - a_h}{\bar{\rho}} - \frac{\bar{a}}{\bar{\rho}} \frac{\rho_e - \rho_h}{\bar{\rho}} < \frac{a_e - a_h}{\bar{\rho}}$ . Combining this result with part (iv), we obtain  $q' > \tilde{q}'$ . If  $\tilde{q}$  was the capital price,

then equation (F.1) implies the associated capital share  $\tilde{\kappa} = \eta$ . On the other hand, the fact that  $q' > \tilde{q}'$  implies  $\kappa' > \tilde{\kappa}' = 1$ , which implies  $\eta^* < 1$ .

Next, consider  $\eta \in (\eta^*, 1)$  so that  $\kappa = 1$ . By equation (F.2), with  $q = a_e/\bar{\rho}$ , we must have

$$\sigma^2 \leq \eta \bar{\rho} \frac{a_e - a_h}{a_e} \left( 1 + (1 - \eta) \frac{\rho_e - \rho_h}{\bar{\rho}} \right)^2, \quad \eta \geq \eta^*.$$

This is equivalent to

$$1 \leq \eta \frac{\rho_e}{\rho_h} \left( \frac{a_e - a_h}{a_e \sigma^2} \rho_e - 1 + \frac{\rho_h}{\rho_e} \right), \quad \eta \geq \eta^*.$$

Substituting  $\eta = \eta^*$ , and rearranging, we obtain the first inequality. There is no contradiction with  $\eta^* < 1$ , due to the assumption that  $\sigma$  can be made small enough.

- (vi) Note that  $F(\eta, q) := q \left[ \frac{a_e - a_h}{\bar{\rho}(\eta)q - \bar{a}(\eta)} - \sigma \left( \frac{\eta(1-\eta)(\bar{\rho}(\eta)q - \bar{a}(\eta))}{q} \right) \right]$  is infinitely differentiable in both arguments on  $\{(\eta, q) : \eta \in (0, 1), \bar{\rho}(\eta)q > \bar{a}(\eta)\}$ . Thus, the result is a simple consequence of differentiating part (i), noting that by part (ii) we have  $\bar{\rho}(\eta)q(\eta) > \bar{a}(\eta)$ , and then using induction.  $\square$

Although the existing literature always imposes  $\kappa(0+) = 0$ , this is actually not a necessary feature of a fundamental equilibrium.<sup>46</sup> If we let  $\kappa_0 \in (0, 1)$  be a given “disaster belief” about experts’ deleveraging and we suppose  $\kappa(0+) = \kappa_0$  (similar to Appendix E.1 for the sunspot case with  $\sigma = 0$ ), there is no inherent contradiction to equilibrium. Existence of such an equilibrium boils down simply to existence of a solution to a first-order ODE. Thus, a variety of fundamental equilibria could exist, and indeed we provide a numerical example after the following lemma and proof.

<sup>46</sup>Brunnermeier and Sannikov (2014) justify  $\kappa_0 = 0$  in their online appendix: “because in the event that  $\eta_t$  drops to 0, experts are pushed to the solvency constraint and must liquidate any capital holdings to households.” This is technically not needed; as shown in Lemma F.2 of Appendix F.1, the dynamics of  $\eta_t$  will not allow it to ever reach 0, so there is no contradiction to equilibrium with both  $\kappa_0 > 0$  and  $\sigma > 0$ . Although we do not prove an existence result, Appendix F.1 presents several numerical examples. The continuum of fundamental equilibria, indexed by  $\kappa_0$ , may be of independent theoretical interest.

In some sense, the literature has picked the worst possible fundamental equilibrium (minimal-price, maximal-volatility) by imposing  $\kappa_0 = 0$ . This can be partly justified by the refinement results of Sections E.2 and E.3, which carry over to the case with  $\sigma > 0$ , i.e., only the belief  $\kappa_0 = 0$  survives vanishingly-small idiosyncratic risk or a vanishingly-small limited commitment friction.



**Lemma F.2.** *A fundamental equilibrium with disaster belief  $\kappa_0 \in (0, 1)$  exists if the free boundary problem*

$$(\bar{\rho}q - \eta a_e - (1 - \eta)a_h) \frac{q'}{q} = a_e - a_h - \sigma \sqrt{q \frac{\bar{\rho}q - \eta a_e - (1 - \eta)a_h}{\eta(1 - \eta)}}, \quad \text{on } \eta \in (0, \eta^*), \quad (\text{F.6})$$

$$\text{subject to } q(0) = \frac{\kappa_0 a_e + (1 - \kappa_0)a_h}{\rho_h} \quad \text{and} \quad q(\eta^*) = \frac{a_e}{\bar{\rho}(\eta^*)}, \quad (\text{F.7})$$

*has a solution.*

**PROOF OF LEMMA F.2.** A fundamental equilibrium in state variable  $\eta$  exists if and only if equations (F.1), (F.2), and (F.3) hold, and if the time-paths  $(\eta_t)_{t \geq 0}$  induced by dynamics  $(\sigma_\eta, \mu_\eta)$  avoid  $\eta = 0$  almost-surely. We will demonstrate these conditions.

Suppose (F.6)-(F.7) has a solution  $(q, \eta^*)$  corresponding to  $\kappa_0 \in (0, 1)$ . If there are multiple solutions, we pick the one such that  $q(\eta) < a_e/\bar{\rho}(\eta)$  for all  $\eta \in (0, \eta^*)$ , which is always possible because the boundary conditions (F.7) imply  $\bar{\rho}(0)q(0) < \bar{\rho}(\eta^*)q(\eta^*)$ . Set  $q(\eta) = a_e/\bar{\rho}(\eta)$  for all  $\eta \geq \eta^*$ . Define  $\kappa = \frac{\bar{\rho}q - a_h}{a_e - a_h}$ . Note that (F.1) is automatically satisfied. Note that (F.3) is also satisfied automatically, by applying Itô's formula to the solution  $q(\eta)$  and using  $\sigma_\eta = (\kappa - \eta)(\sigma + \sigma_q)$ .

We show (F.2) holds separately on  $(0, \eta^*)$  and  $[\eta^*, 1)$ . Using (F.1) and (F.3) in the ODE (F.6) and rearranging, we show that (F.2) holds when  $\kappa < 1$ . The boundary condition  $q(\eta^*) = a_e/\bar{\rho}(\eta^*)$  is equivalent to  $\kappa(\eta^*) = 1$ , which shows that  $\kappa(\eta) < 1$  for all  $\eta < \eta^*$ . Therefore, we have proven that (F.2) holds on  $(0, \eta^*)$ .

If  $\eta^* = 1$ , then we are done verifying (F.2); otherwise, we need to verify (F.2) on  $[\eta^*, 1)$ . On this set,  $\kappa = 1$ , so we need to verify

$$\eta \frac{a_e - a_h}{q} \geq (\sigma + \sigma_q)^2 \quad \text{for all } \eta \geq \eta^*. \quad (\text{F.8})$$

First, we show that it suffices to verify this condition exactly at  $\eta^*$ . Indeed, on  $(\eta^*, 1)$ , we have  $\kappa = 1$  and  $q = a_e/\bar{\rho}$ . Substituting these and (F.3) into (F.8), we obtain

$$(\text{F.8}) \text{ holds} \Leftrightarrow \left( \frac{a_e - a_h}{a_e \sigma^2} \rho_e - \frac{\rho_e - \rho_h}{\rho_e} \right) \eta \geq \frac{\rho_h}{\rho_e} \quad \text{for all } \eta \geq \eta^*.$$

But since the left-hand-side is increasing in  $\eta$ , if it holds at  $\eta = \eta^*$ , it holds for all  $\eta > \eta^*$ .

Now, writing (F.8) at  $\eta^*$ , using (F.3) to replace  $\sigma_q$ , and using ODE (F.6) to replace

$\eta^* \frac{a_e - a_h}{q(\eta^*)} = \sigma[1 - (1 - \eta^*)q'(\eta^* -)/q(\eta^*)]^{-1}$ , we need to verify

$$(F.8) \text{ holds} \Leftrightarrow \frac{\sigma}{1 - (1 - \eta^*)q'(\eta^* -)/q(\eta^*)} \geq \frac{\sigma}{1 - (1 - \eta)q'(\eta^* +)/q(\eta^*)} \Leftrightarrow q'(\eta^* -) \geq q'(\eta^* +).$$

We clearly have  $q'(\eta^* -) \geq q'(\eta^* +)$  by the simple fact that  $q < a_e/\bar{\rho}$  for  $\eta < \eta^*$  and  $q = a_e/\bar{\rho}$  for  $\eta \geq \eta^*$ .

Finally, it remains to verify that  $\eta_t$  almost-surely never reaches the boundary 0. Near  $\eta = 0$ , the dynamics in (F.4)-(F.5) become

$$\begin{aligned}\mu_\eta(\eta) &= \kappa_0 \frac{a_e - a_h}{q(0+)} + \delta v + o(\eta) \\ \sigma_\eta^2(\eta) &= \kappa_0 \frac{a_e - a_h}{q(0+)} \eta + o(\eta).\end{aligned}$$

By the same analysis as in Theorem 1, the boundary 0 is unattainable.  $\square$

What happens in an equilibrium of Lemma F.2 in which  $\kappa_0 > 0$ ? Behavior at the boundary  $\eta = 0$  is substantially different than the  $\kappa_0 = 0$  case, because equation (F.2) can only hold there if  $\sigma_q \rightarrow -\sigma$  as  $\eta \rightarrow 0$ . Capital prices “hedge” fundamental shocks to capital, in a brief region of the state space  $(0, \eta^{\text{hedge}})$ . Said differently, given the formula (F.3), the fact that  $\sigma_q(0+) = -\sigma$  implies  $q'(0+) = -\infty$ , so that prices rise as experts lose wealth in a region of the state space. The hedging region is exactly what incentivizes experts to take so much leverage (indeed, expert leverage  $\kappa/\eta$  blows up near 0). For  $\eta > \eta^{\text{hedge}}$ , this behavior reverses, and the equilibrium behaves very much like the equilibrium with  $\kappa_0 = 0$ . Overall, there is no inconsistency with equilibrium even though  $q' < 0$  in the region  $(0, \eta^{\text{hedge}})$ .<sup>47</sup>

Figure F.1 displays several examples of equilibria with different choices of  $\kappa_0 > 0$ . The solid black lines, which are equilibrium outcomes with  $\kappa_0 = 0.001$ , corresponds approximately to the equilibrium choice made by Brunnermeier and Sannikov (2014). The other curves, with higher disaster beliefs  $\kappa_0$ , are new to the literature. Similar to the the sunspot results of Section E.1, more optimistic disaster beliefs raise capital prices and reduce capital price volatility.

<sup>47</sup>One may think that  $q'(0+) = -\infty$ , and more generally that  $q' < 0$  in some region of the state space, could imply that  $\kappa$  hits  $\eta$  at some point. However, this cannot happen. Indeed, since  $\kappa_0 > 0$ , we have that  $q(0+) > \tilde{q}(0+)$ , where  $\tilde{q}(\eta) := ((a_e - a_h)\eta + a_h)/\bar{\rho}$  is the price function consistent with  $\kappa = \eta$ .

To see this, assume there is an  $\hat{\eta} \in (0, 1)$  such that  $\kappa(\hat{\eta}) = \hat{\eta}$  (or equivalently,  $q(\hat{\eta}) = \tilde{q}(\hat{\eta})$ ). If there is more than one, consider the minimum among them, so  $q(\eta) > \tilde{q}(\eta)$  for all  $\eta \in (0, \hat{\eta})$ . From the  $\tilde{q}(\eta)$  definition, we have  $\tilde{q}'(\eta) = (a_e - a_h)/\bar{\rho} - ((a_e - a_h)\hat{\eta} + a_h)(\rho_e - \rho_h)/\bar{\rho}^2 < \infty$ , while from (F.6) it must be that  $q'(\hat{\eta}-) \rightarrow \infty$ . This is a contradiction.

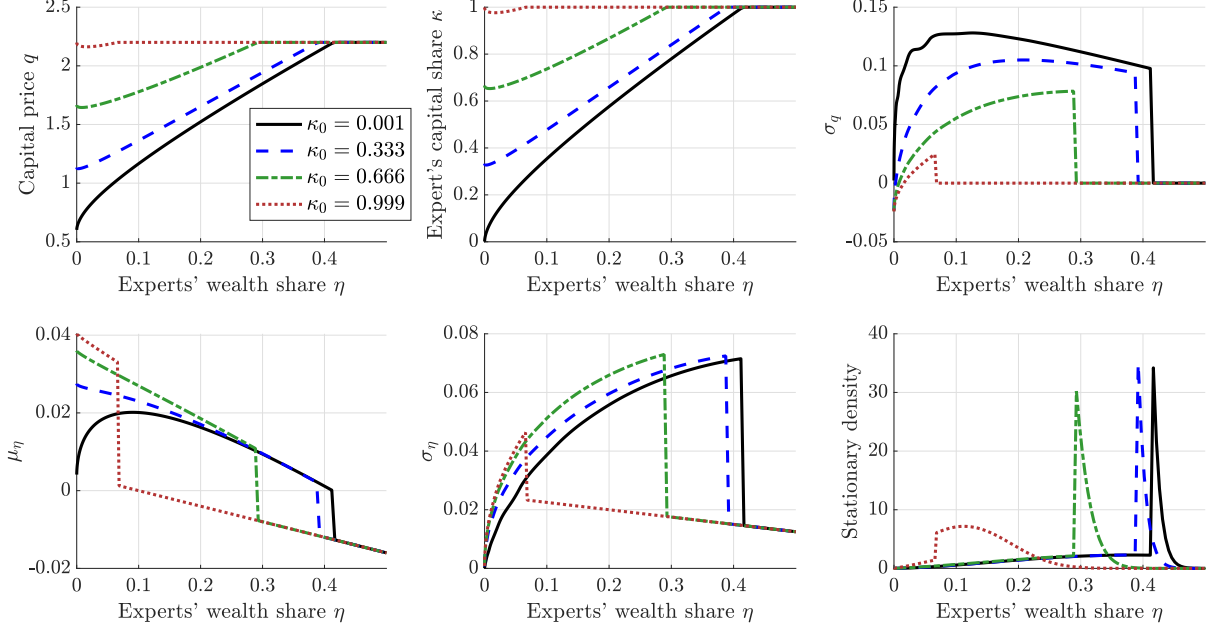


Figure F.1: Fundamental equilibria with different disaster beliefs  $\kappa_0$ . Parameters:  $\rho_e = \rho_h = 0.05$ ,  $a_e = 0.11$ ,  $a_h = 0.03$ ,  $\sigma = 0.025$ . OLG parameters:  $\nu = 0.1$  and  $\delta = 0.04$ .

## F.2 The “hedging” equilibrium

The equilibria described in Appendix F.1 are “normal” in the sense that a positive exogenous shock increases asset prices and experts’ wealth share. But technically, agents do not care about the direction prices move when they make their portfolio choices. They only care about risk which is measured in return variance; this can be seen in the optimality condition (F.2) where  $(\sigma + \sigma_q)^2$  appears. An immediate implication is that two types of equilibria are possible: the “normal” one has  $\sigma + \sigma_q > 0$ ; an alternative equilibrium has  $\sigma + \sigma_q < 0$ .<sup>48</sup>

We term this latter equilibrium the “hedging” equilibrium because asset price movements move oppositely to exogenous shocks. In fact, asset price responses are so strong in opposition that experts actually gain in wealth share upon a negative fundamental shock. This can only happen because of coordination: experts and households simply believe negative shocks are good news for asset prices, so they rush to purchase capital, which percolates through equilibrium relationships to justify beliefs about price increases. Such coordination stands in contrast to the normal equilibrium, in which negative shocks beget fire sales that push down asset prices.

Mathematically, we need only solve a slightly different capital price ODE. Whereas

<sup>48</sup>For a conjecture of this specific type of indeterminacy, see footnote 16 of Kiyotaki and Moore (1997).

ODE (F.6) holds in the normal equilibrium, the hedging equilibrium requires

$$(\bar{\rho}q - \eta a_e - (1 - \eta)a_h) \frac{q'}{q} = a_e - a_h + \sigma \sqrt{q \frac{\bar{\rho}q - \eta a_e - (1 - \eta)a_h}{\eta(1 - \eta)}}, \quad \text{on } \eta \in (0, \eta^*). \quad (\text{F.9})$$

The difference between (F.9) and (F.6) is merely the sign in front of  $\sigma$ , which ensures different signs for  $\sigma_q$ . Finally, note that just like the normal equilibria, hedging equilibria could exist for  $\kappa_0 \neq 0$ . Figure F.2 compares a normal equilibrium to a hedging equilibrium.

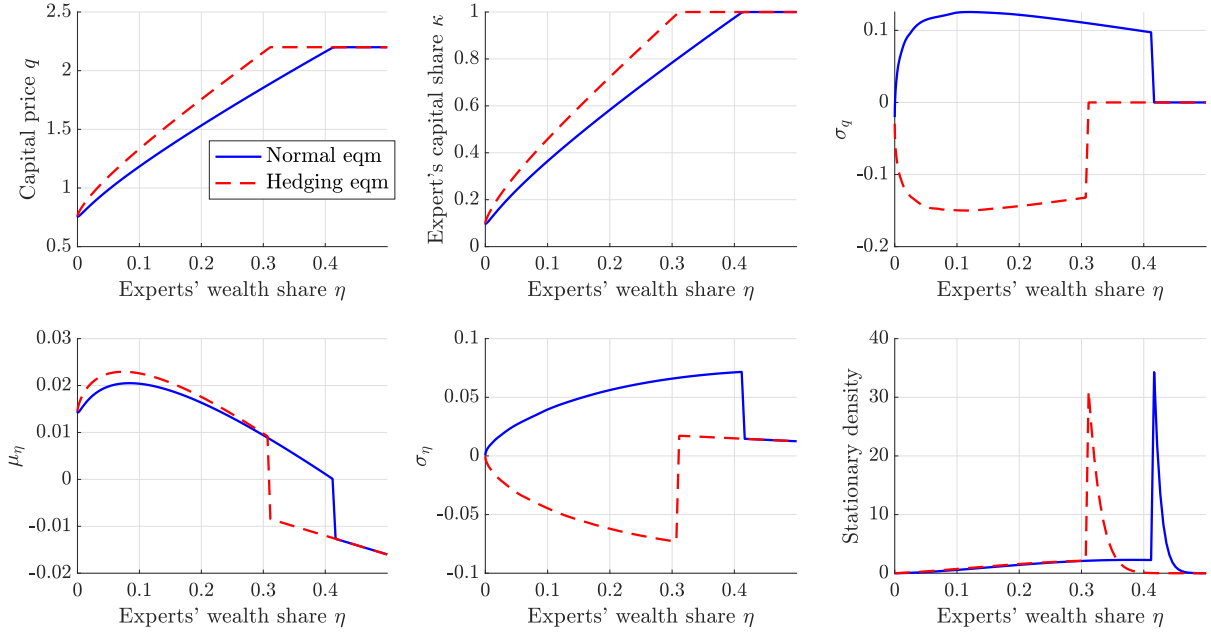


Figure F.2: Two equilibria (normal versus hedging) both with disaster belief  $\kappa_0 = 0.1$ . Parameters:  $\rho_e = \rho_h = 0.05$ ,  $a_e = 0.11$ ,  $a_h = 0.03$ ,  $\sigma = 0.025$ . OLG parameters:  $\nu = 0.1$  and  $\delta = 0.04$ .