

Sentiment, Liquidity and Asset Prices

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Long Abstract:

In a frictionless marketplace, all gains from trade are realized. Thus, durable assets or securities are always traded in a manner which ensures that they are held by the parties that value them the most. In such an environment, asset prices reflect not only the current but also all future gains from trade. In contrast, in the presence of frictions, some trades may remain unrealized, and this can depress asset prices. In such an environment, there is a fundamental connection between market liquidity -- the efficiency with which the assets are re-allocated -- and asset prices. Moreover, if the frictions result from information asymmetries, there is ample room for equilibrium multiplicity. For example, if traders believe that the market in the future will be liquid, they expect to more easily trade the asset in the future (if they need to sell); this will tend to mitigate the adverse selection problem and generates more trade today. Instead, if traders believe there will be less trade in the future, they expect to hold on to the assets longer. This will make the adverse selection problem more severe and reduce trade today. Therefore, asset prices will depend on traders' expectations about the efficiency with which assets are allocated in the future, which equilibrium is expected to be played in the future. Thus, "market sentiment", liquidity and asset prices are tightly linked. Furthermore, sentiment can play an important role on liquidity, asset prices and their volatility.

In this paper we consider a market for durable assets whose quality, low or high, is only known to the current owners. Gains from trade arise stochastically over time since current owners are hit by a privately observed liquidity or productivity shock that depresses their value of holding the asset vis a vis other potential holders in the market. The problem is that the holders of low quality assets would want to pretend they are owners of high quality assets who happen to experience liquidity shocks. Their presence in the market reduces the willingness to pay of the buyers which might drop below the reservation price of liquidity hit owners of a high quality asset. If this is the case, then the only asset traded in equilibrium is the low quality asset. Instead, if the willingness to pay remains above the reservation price of the liquidity hit owners of high quality assets, then trade is efficient. Importantly, since buyers are long lived and anticipate that they might need to sell the asset in the future, their willingness to pay for the asset depends on their beliefs about future prices and liquidity. If they believe that there will be a liquid market in the future with high prices they will be willing to offer a higher price in the first place. We show that these concerns about the market in the future can lead to multiple equilibria. We first construct two equilibria, one with constant high prices and one with constant low prices. This provides a bound for the possible prices in the market. We then consider equilibria in which the current market sentiment (a sunspot really) determines if current prices and liquidity are high or if they are low.