What moves international stock and bond markets?

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Gino Cenedese[1] and Enrico Mallucci[2,3]
Bank of England[1], Centre For Macroeconomics[2], London School of Economics[3]

Even though there has been a considerable debate about the relationship between international bond and equity flows and asset prices, surprisingly little is known about the relation between these flows and the ultimate drivers of changes in asset prices. This paper fills this gap in the literature using data from international mutual funds. Mutual funds play an increasingly important role in the landscape of international capital flows and have attracted the interest of policy makers because of their pro-cyclical behaviour, and their role in the international transmission of shocks.

First, we decompose international equity and bond market returns into changes in expectations of future dividends, inflation, interest rates, exchange rates, and discount rates, and study their relative importance in driving unexpected returns. We find that in our sample of 31 advanced and emerging economies news about future cash flows is the main driver of international stock returns. This evidence is in contrast with the typical result reported only for the US that discount rate news is the main drivers of excess returns in the equity markets. Inflation news is instead the main driver of international bond returns.

Second, we analyse how each of these different components is associated with international mutual fund flows. We find evidence consistent with short-run trend chasing and short-run overreaction to excess return shocks. Mutual fund investors, however, are not mechanical momentum traders. International investors, and especially institutional investors, chase returns by buying appreciating assets only when this appreciation is permanent and associated with an upward revision of expected future cash flows. When the appreciation is temporary and associated with a downward revision of expected future returns, the investors tend to sell these assets. Finally, we confirm that international bond flows to emerging markets are sensitive to revisions in expectations of future interest rates.