4 The Impact of Consumer Sentiment on the Number of New Home Sales

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4.1 Introduction

In financial markets the assumption that investors act fully rationally and build their decisions on all available information has often been challenged by phenomena that appear to contradict this paradigm, such as excessive volatility or mean reversion of stock prices. One explanation for these phenomena are the actions of so called noise traders (Black, 1986). Noise traders suffer from cognitive biases, such as overconfidence or overreaction. They rely to some degree on sentiment and disturb the market with their irrational trading. Baker and Wurgler (2007) define investor sentiment as a prospect about the development of future cash flows and investment risks based on information that is not justified by fundamentals. This misguided belief may be based, for example, on general market commentaries.

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18 These cognitive biases have been researched by psychologists such as Tversky and Kahneman (1974, 1981), DeBondt and Thaler (1985), Barberis et al. (1998).

Efficient market theory assumes that the mispricing caused by noise traders is quickly eliminated by the countertrading of sophisticated arbitrageurs. But the trading of noise traders is unpredictable as the beliefs of noise traders are uncertain. According to Daniel et al. (2001) arbitrageurs are risk-averse; in the short run, however, they face the risk that sentiment becomes more extreme and prices deviate further from their fundamental values. The so called systematic “noise trader risk” (DeLong et al. 1990) and the accruing transaction costs (Shleifer and Vishny, 1997) prevent sophisticated arbitrageurs to fully offset the mispricing. Thus, noise trading has a persistent impact on financial markets.

Real estate markets are substantially different from financial markets. They are characterized by heterogeneity, illiquidity, high transaction costs and a lack of information (Lin and Vandell, 2007). Unlike for stocks, for properties no perfect substitute exists. This makes a comparison of prices difficult. Further, a new home requires a high capital commitment and is not easily resold quickly. Information on fundamentals is asymmetric between the seller and the buyer of the property. In contrast to the builder the buyer does not exactly know the quality and basic structure of the building.

According to Palomino (1996), noise traders in financial markets primarily invest in small stocks that tend to be less liquid and more

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19 Fama (1965) developed the efficient market hypothesis, Samuelson (1965) published a proof of the hypothesis and Fama (1970) improved the theory.