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Does Investor Sentiment Predict the Near-Term Returns of the Chinese Stock Market?*

MUHAMMAD A. CHEEMA[†,‡], YIMEI MAN[§] AND KENNETH R. SZULCZYK[¶]
[†]Division of Computational Mathematics and Engineering, Institute for Computational Science, Ton Duc Thang University, Ho Chi Minh City, Vietnam
[‡]Faculty of Finance and Banking, Ton Duc Thang University, Ho Chi Minh City, Vietnam
[§]School of Accounting, Finance and Economics, University of Waikato, Hamilton, New Zealand and
[¶]Department of Finance and Banking, School of Business, Curtin University, Miri, Sarawak, Malaysia

ABSTRACT

Recent evidence on the relationship between investor sentiment and subsequent monthly market returns in China shows that investor sentiment is a *reliable* momentum predictor since an increase (decrease) in investor sentiment leads to higher (lower) future returns. However, we suggest that momentum predictability of investor sentiment originates from the boom and bust period of 2006–2008 (the bubble period *hereafter*). The bubble period is characterized by several months of sustained optimism followed by several months of sustained pessimism, with the market consequently earning high (low) returns following high (low) sentiment months. Therefore, we find a strong positive association between investor sentiment and subsequent market returns during the bubble period. However, investor sentiment has a negligible impact on subsequent monthly market returns once we exclude the bubble period.

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I. INTRODUCTION

Investor sentiment is defined as investor optimism or pessimism about the future stock prices that cannot be explained by the existing facts (Baker and Wurgler 2006). In the literature, there is a growing consensus that investor sentiment is a contrarian predictor of stock market returns in the long run

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