

Uncertainty about What's in the Price

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May 16, 2022

Abstract

Speculators face uncertainty about which signals are already reflected in the price. We present a model in which speculators update the probability that their information is truly novel rather than stale based on recent price movements and market makers are aware that speculators may be trading on stale news. The model predicts an asymmetric price response to past price movements: after a recent price increase, buy volume—because it may result from speculators trading on stale news—has a lower price impact than sell volume (and vice versa after a recent price decrease). In consequence, return skewness is negatively related to lagged returns. Using a comprehensive sample of order flow imbalances, we find strong support for these and auxiliary predictions.

JEL classification: G11, G14

Keywords: Strategic trading, learning from prices

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