Extreme Market Sentiments and Herding Behavior

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Abstract

This paper examines the effects of extreme investors' sentiments on herding behavior in five Central and Eastern European (CEE) stock markets. Our empirical research is designed to assess the asymmetric effects of two sentiment indicators, the ARMS Index and the RSI Index on herding behavior in specific industrial sectors from Poland, Hungary, Croatia, Romania, and Bulgaria. As extreme sentiments are more likely to induce herding behavior in overheated markets, we also test the impact of high optimism/pessimism on herding under excessive volatility. We report strong evidence in favor of extreme sentiment-enhanced herding. Estimation results are slightly sensitive to the choice of the sentiment indicator. During the global financial crisis, our findings indicate that high pessimism has induced herding behavior at an extensive scale in CEE stock market industries. Moreover, if investors are extremely optimistic or pessimistic when the market is characterized by high volatility, the herding effects are more pronounced. Our results are relevant both for investors, as herding behavior is likely to affect the portfolio optimization process, and for the CEE markets regulators as herd behavior is likely to prevent capital markets from achieving financial stability.

Keywords: Herding behavior, investors' sentiments, financial crisis, high volatility

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