Global Macro

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Global Return Variation

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Working Paper

A central question in finance regards whether or not capital markets are efficient. As Gene Fama noted in the 1970s, "an efficient capital market is an important component of a capitalist system". In such a system, the ideal is a market where prices are accurate signals for capital allocation. That is, when firms issue securities to finance their activities, they can expect to get 'fair' prices, and when investors choose among the securities that represent ownership of firms' activities, they can do so under the assumption that they are paying 'fair' prices. In short, if the capital market is to function smoothly in allocating resources, prices of securities must be good indicators of value."

Some argue that global equity markets are inefficient. For instance, many characterize the rise and fall of the Japanese stock market in the early 1990s as a bursting bubble. Or on the other hand, many argue that the volatile returns in emerging markets reflect psychology and market sentiment instead of changes in "fair" value. This paper presents evidence on the efficiency or rationality of global equity markets.

Market efficiency is a point hypothesis which we know is false. This analysis tries to determine to what degree the markets are inefficient.

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