RESEARCH BRIEF • JUNE 2024

Inflation and Trading

Based on BFI Working Paper No. 2024-61, "Inflation and Trading," by Philip Schnorpfeil, Goethe University Frankfurt; Michael Weber, University of Chicago; and Andreas Hackethal, Goethe University Frankfurt

Beliefs about how inflation impacts asset returns vary widely across investors, who are often overly optimistic. Information about past returns during periods of high inflation causes investors to update their beliefs, which feeds into their return expectations and subsequent trading behavior.

Inflation poses a substantial risk for investors in **financial markets**. Despite many theories about how inflation affects the value of stocks and other investments, information about how investors respond to inflation is limited. Motivated by this, in this paper, the authors study how inflation impacts investors' return beliefs and trading choices.

The authors conduct a **survey experiment** with 2,800 German investors in February 2022, when inflation in Germany was at a 30-year high of 5.3 percent before surging past 11 percent. The authors survey participants concerning their beliefs about the relationship between inflation and asset returns and provide participants in their two treatment groups with information about asset returns during past inflationary periods in Germany. Investors in a second treatment group also receive information about possible drivers of asset returns during inflationary periods. Importantly, the authors also observe participants' trading decisions using trading data. They find the following:

- Investors vary widely in their prior beliefs about how inflation impacts asset returns, with most being overly optimistic about the impact of inflation on returns. Many are not fully aware of strategies for safeguarding their assets against inflation.

BFI Blackboard

Inflation: the rate at which the general level of prices for goods and services rises, eroding purchasing power.

Financial markets: venues where buyers and sellers participate in the trading of assets such as stocks, bonds, currencies, and derivatives.

Survey experiment: a research method that combines survey techniques with experimental design to investigate how changes in the presentation of questions or information might influence people's attitudes, beliefs, or behaviors.

- When investors are provided with historical data showing actual asset returns during previous periods of high inflation, it significantly alters their return expectations. Specifically, information highlighting poor stock performance during past inflationary periods leads to more pessimistic return expectations.
- In addition to shifting their beliefs, investors also shift their trading *behaviors* in response to information about how inflation impacts returns. Learning about past asset returns during inflationary periods leads to a decrease in stock purchases.
- Combining information about past returns with explanations about the drivers of those returns (as in the author's second treatment group) is more effective at changing beliefs and behaviors than simply providing information about past returns.
- The treatment effects vary depending on investors' prior beliefs. Those with initially more optimistic views about returns during inflation adjusted their expectations more significantly after receiving the historical return information.
- Investors' long-term views on inflation and asset returns are significantly shaped by their perceptions of past returns during inflationary periods. These perceptions also influence their financial decisions, reflecting the strong role of **mental models** in economic decision-making.

This research has useful applications for household financial planning and **asset pricing**. Importantly, the authors note that their results on how investors respond to inflation are likely generalizable to other settings, as prior research finds that Germans respond to inflation information in a way similar to households in the United States and other European countries.

Mental model: simplified frameworks or sets of assumptions that individuals use to understand and predict economic behavior and outcomes.

Asset pricing: the process of determining the fair value of financial assets based on their risk and expected return.

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