Speculation Sentiment

I provide a novel and direct test that shows speculative demand shocks push asset prices away from fundamentals. I form the Speculation Sentiment Index using observable arbitrage trades in leveraged exchange-traded funds (ETFs). Arbitrage activity originates from unobservable speculative demand shocks that create relative mispricing between a leveraged ETF and its underlying derivative securities. The index proxies for the direction and magnitude of market-wide speculative demand shocks. The Speculation Sentiment Index predicts aggregate asset returns and it is associated with market-wide mispricing and arbitrage activity.