Discussion of “Dealer Disagreement and Asset Prices in FX Markets” by Brandon Yueyang Han, Sophia Zhengzi Li and Zhaogang Song

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This Paper: Brief Summary

- general motivation: how does the divergence of investors' opinions affect asset returns? (Miller, 1977; Varian, 1985; Abel, 1989)
- A very well-executed paper with rich and clear-cut empirical results:

1. builds on the Markit Totem price quote dataset to study dealers disagreement and its impacts on FX market equilibrium
2. documents a downward-sloping term structure of dealers disagreement
3. finds that disagreement increases the FX returns, especially when the disagreement is concerning the directional tail risk of currencies

Key Rationale behind the Key Results

- sources of disagreement on realizations of x_{t+h}

  - $\mathbb{E}_{i,t}(x_{t+h}) = \lambda_i \hat{x}_{i,t+h} + \kappa_i s_{i,t}$

1. heterogeneous information (has short-run impacts and is mean-reverting)
2. heterogeneous beliefs (concerning the model uncertainty, i.e. the way of interpreting the information; with more persistent impacts)

- very steeply sloped term structure slope *within one month tenor of FX contracts* $\Rightarrow$ short-run disagreement driven by the information heterogeneity
- disagreement on the tail risk (FX risk reversals) predicts positive FX returns consistent with theories suggesting *positive risk premium* when short sale constraint is not binding

Roadmap of Comments

- Information vs. Dealer Heterogeneity
- Balance Sheet Risk of Dealers
- Emerging Markets
- Time Averaging Issue
- Surveyed Professional Forecasts
- Additional Details

Comment 1. Information Heterogeneity vs. Dealer Heterogeneity

- decline of dealer disagreement as tenor increases is rationalized with mean-reverting heterogeneous information
  - how persistent is a single dealer's forecast relative to forecasts of others?
  - forecast reshuffling a lot or some dealer having consistently dominant market power with greater cost efficiency of channelling FX transactions?
  - since top 3 dealer banks' share of FX trading is 40%
  - S.D. of price quotes = S.D. of cost differences of dealers in FX trades at least in the short run?
- *different mechanisms of impacts*: disagree on forecasts of FX forward rates and prices of derivatives vs. dealers' productivity heterogeneity
  - to provide evidence on differences of information access other than of differed dealers fundamentals
  - Fuster, Perez-Truglia, Wiederholt and Zafar (2022, Restat): information differences are endogenously chosen by forecasters

Comment 2. Balance Sheet Risk of FX Market Dealers

- Dealers are intermediaries of FX market orders
  - market liquidity provision affected by dealers' FX inventories and funding liquidity
  - liquidity risk matters in the short run, e.g. liquidity risk premium more pronounced for shorter term bonds (Goyenko et al., 2011; Diaz and Escribano, 2017)
  - liquidity risk exposure across dealers drives the short-run measured "disagreement" in FX markets?
  - interpretations of liquidity measures, e.g. the bid-ask spread, reflective of short-run transaction cost (Demsetz, 1968 QJE)
- dealers disagreement $\neq$ investors disagreement
  - so far in the appendix, the model about dealer disagreement may be extended to the FX market equilibrium
  - theory motivations more related to generic risky asset (Vayanos and Wang, 2012) but less so about the FX market

Comment 3. FX in Emerging Markets

- puzzling to see disagreement on risk reversals in EM lower than that of FX in advanced markets while larger on disagreement associated with volatility (straddles and strangles)
  - dealers having low info heterogeneity for FX in emerging markets may not *jointly* explain all these
  - high information advantage/quality vs. low dispersion of useful and relevant information
  - any selection effect? some cost-effective dealer is concentrating more on any particular currency pair products?
- more generally, possibility to see how exactly dealer forecasts are linked to their actual trades?
  - dealers' cost efficiencies in FX in emerging markets?

Comment 4. Time-averaging Issue

- Forecast disagreement is endogenous, time-varying, and very cyclical. Especially the "tail risk" disagreement matters the most

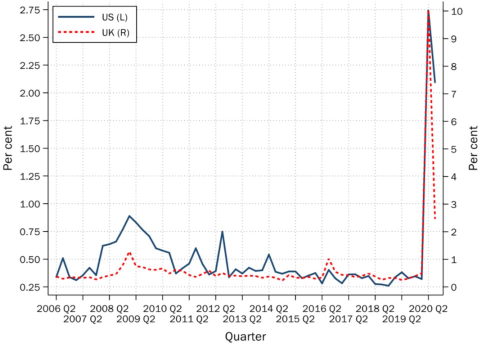

Fig. 5. Cross-sectional dispersion of GDP growth forecasts. Notes: Chart shows standard deviation of one-year-ahead annual real GDP growth forecasts. US data are from the Survey of Professional Forecasters conducted by the Philadelphia Fed (www.philadelphiafed.org/research-and-data/real-time-center/survey-of-professional-forecasters). The deadline for submitting responses to the SPF survey is usually in the first half of February, May, August, and November (see www.philadelphiafed.org/-/media/research-and-data/real-time-center/survey-of-professional-forecasters/spf-release-dates.txt). The submission deadline for the latest survey was 12 May 2020. UK data are from the Survey of External Forecasters conducted by the Bank of England (www.bankofengland.co.uk/monetary-policy-report/2020/january-2020/other-forecasters-expectations). The SEF is in the field for two weeks one month ahead of the Bank of England's publication of the Monetary Policy Report. This is usually the second half of January, April, July, and October. The latest SEF survey ended on 24 April 2020.

Source: Altig et al. (2020)

- time-averaging smooths over disagreement kinks? is the disagreement term structure slope robust to different periods?

Comment 5. Discrepancy Relative to Professional Forecasts

- Term structure slopes are completely opposite (downward vs. upward for disagreement based on professional forecasts)
  - Survey of Professional Forecasts: macro and financial stats forecasts surveyed among professional bank and market dealers/makers, e.g. Deutsche Bank, Goldman Sachs, HSBC Bank, JP Morgan, UBS
  - BlueChip forecasters: top business economists in the U.S.
  - "forecasters are the market participants", a sufficient condition to justify the slope differences of term structure of disagreement?
  - in addition, how exactly "wrong" using measures derived from professional forecasts?

Additional Details

- number of price quotes seems to be low at least for some months; can check the robustness by removing the max and min
- weak significance of disagreement measures on FX returns $\rightarrow$ measurement issue and perhaps lack of statistical power to test theory predictions?
- interesting to provide additional evidence on any potential strategic reporting of surveyed forecasts, e.g. who submits first and who follows and their relative position gap in price quotes
- can be better to model dealers disagreement and the asset market equilibrium jointly
- can further tone up on the relative contributions to the literature

A Fantastic and Interesting Paper, and Best of Wishes!