Spurious regressions in technical trading: momentum or contrarian?*

Mototsugu Shintani[†], Tomoyoshi Yabu[‡] and Daisuke Nagakura[§]

Abstract

This paper investigates a spurious effect in forecasting asset returns when signals from technical trading rules are used as predictors. The simulation result shows that, even if the past information has no predictive power, buy or sell signals constructed from the difference between the short and long moving average of past values can be statistically significant when forecast horizon is relatively long. The theory implies that both momentum and contrarian are possible, while the probability of each case depends on the type of the test statistics employed. Several possibilities of preventing the spurious regression are also discussed. The proposed method is applied to the stock market index and foreign exchange rate to reconsider the predictive power of technical trading rules.

This version: January 2008

JEL Classification: C12, C22, C25, G11, G15.

Key words and phrases: Efficient market hypothesis, Nonstationary time series, Random walk, Technical analysis.

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*The authors gratefully acknowledge Shigeru Iwata and Joon Y. Park for their helpful comments and discussion. The views expressed in the paper are those of the authors and are not reflective of those of the Bank of Japan. Address correspondence to: Mototsugu Shintani, Department of Economics, Vanderbilt University, Nashville, TN 37235, USA; e-mail: mototsugu.shintani@vanderbilt.edu.

[†]Department of Economics, Vanderbilt University and Institute for Monetary and Economic Studies, Bank of Japan

[‡]Graduate School of Systems and Information Engineering, University of Tsukuba

[§]Institute for Monetary and Economic Studies, Bank of Japan