Review on

“Limitations of Stabilizing Effects of Fundamentalists Facing Positive Feedback Traders”

Submitted to Economics: The Open-Access, Open-Assessment E-Journal

This paper develops a simple financial market model with two types of heterogeneous agents. For simplicity, the authors assume that there is only type of chartist who relies on a linear feedback trading rule and one representative fundamentalist who forms rational expectations. Moreover, trend followers face a bounded leverage, while fundamentalists’ demand is assumed to be unbounded. The authors show analytically that the presence of fundamentalists is not sufficient to avoid asset price bubbles. In particular, the behavior of linear feedback traders may outweigh the stabilizing effects of fundamentalists which may result in exploding prices.

While the paper contains a sophisticated mathematical analysis, its economic content is not convincing. Thus, I cannot suggest it for publication in Economics: The Open-Access, Open-Assessment E-Journal.

My main objections are as follows: First, the analysis is based on the assumption that fundamentalists always respond one period later than chartists, i.e. $D^F_t = -D^C_{t-1}$. That is a very strange assumption. Is there any empirical evidence for such a strong assumption? I don’t think that this assumption makes sense especially because fundamentalists are assumed to be rational. If I understand correctly, the model would always produce stable price dynamics when $D^F_t = -D^C_t$ is assumed. Second, authors claim to be the first showing analytically that fundamentalists may not always be able to stabilize markets. Note that many other agent based financial market models have proven analytically that fundamentalists may not compensate the destabilizing power of chartists. Hence, I don’t see the contribution of the paper. Third, the model presentation also needs to be substantially improved.