Chapter 9

# The Emotional Rollercoaster of Market Overreaction:

## Understanding the Psychological Drivers of Irrational Market Behaviour

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## ABSTRACT

*Market overreactions, driven by psychological and cognitive factors, have significant economic consequences, impacting individual investors and broader financial systems. This chapter explores how emotions like fear, anxiety, greed, and euphoria contribute to market volatility, alongside cognitive biases such as confirmation and anchoring. It also examines herding behavior, the influence of authority figures, and the role of media in shaping market sentiment. Additionally, it considers neurological and physiological factors like stress and dopamine responses in investor behavior. Through case studies, the chapter illustrates these drivers' real-world impacts and offers strategies for mitigating emotional and cognitive biases. Emphasizing diversification, risk management, and regulatory measures, it provides insights for investors and policymakers to navigate and stabilize market overreactions.*

## I. INTRODUCTION

Market behavior is often seen as a reflection of rational decision-making based on available information, yet history has shown that markets can be as much a product of emotion as of logic. The phenomenon of market overreaction is a compelling example of how emotions, rather than reason, can drive investor behavior, leading to significant deviations from fundamental values (Khatua & Pradhan, 2014). This emotional rollercoaster, characterized by euphoric highs and depressive lows, often results in extreme market movements that defy traditional economic theories (Hinvest, Alsharman, Roell, & Fairchild, 2021).

At the heart of this overreaction lies a complex interplay of psychological factors (Subedi & Bhandari, 2024) that influence investor decision-making. Cognitive biases such as overconfidence (Kartini & Nahda, 2021), herd mentality (Devadas & Vijayakumar, 2019) and loss aversion (Vuković & Pivac, 2024) can lead to irrational market behaviors. For instance, overconfidence might cause investors to overestimate their ability to predict market movements, leading to excessive risk-taking and inflated asset prices. Similarly, herd mentality can amplify market trends, as individuals follow the majority, often without critical analysis, creating bubbles or crashes (Aljifri, 2023). Loss aversion, where the pain of losses outweighs the pleasure of gains, can trigger panic selling during downturns, exacerbating market declines (Vuković & Pivac, 2024).

The emotional responses of investors are not only personal but also collective, magnified by media influence and social dynamics. News cycles, especially in the digital age, can amplify fears and hopes, leading to rapid swings in market sentiment (Cioroianu, et al., 2024). This collective emotional response can create feedback

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