Dialogue Social Science Review (DSSR)
www.thedssr.com

ISSN Online: 3007-3154
ISSN Print: 3007-3146

DIALOGUE SOCIAL SCIENCE REVIEW

Vol. 3 No. 6 (June) (2025)

Economic Policy Uncertainty and Investor Sentiment: An Empirical Investigation

Muhammad Saqlain
Department of Management Sciences, COMSATS University Islamabad, Wah Campus, Punjab, Pakistan. Email: saqlain9297@gmail.com

Faisal Nawaz
Department of Management Sciences, COMSATS University Islamabad, Attock Campus, Punjab, Pakistan. Email: faisalnawazmir@gmail.com

Abstract
In the context of increasing economic volatility, our study delves into the impact of Economic Policy Uncertainty (EPU) exposure on investor sentiment in China's A-share market. By utilizing firm-level data from 2014 to 2022, EPU exposure is estimated through the Fama-French Five-Factor model, enabling an implicit analysis of how macroeconomic uncertainty influences and reshapes the investor behavior. The analysis, based on the linear regression techniques and Two-Stage Least Squares (2SLS), identifies a vivid and significant negative correlation between EPU exposure and investor sentiment. Our findings underscore a destabilizing effect of policy fluctuations on the ongoing market perception and investors' response to it. The results demonstrate strong robustness across multiple validation checks and reinforce their relevance for analyzing the investor responses in emerging markets amid uncertain policy conditions.
Keywords: EPU Exposure, Investor Sentiment, China.

Introduction

Almost over the last two decades, China's remarkable economic system has potentially positioned itself as a dominant force in global financial markets. With unprecedented industrial development, capital market development and urbanization trends, the Chinese economy finally occupies a central role in reshaping global and regional economic trajectory. Within this perspective of long-term and persistent macroeconomic reforms and growth, investor sentiment has increasingly emerged as a fundamental force of market dynamics. Investor sentiment, broadly as the general view, mood, or confidence of market investors, plays a central role in influencing asset pricing, financial allocation, and market cash flow. In developing financial realms, where information asymmetry and behavioral biases are often more pronounced, sentiment tends to exercise a particularly strong influence on market directions.

In parallel, the issue of Economic Policy Uncertainty (EPU) has obtained notability as a critical potential factor in deciding the behavior of financial markets and economic actors. EPU denotes the level of market fluctuations surrounding future government policies, fiscal policies, trade measures, and macroeconomic management strategies. These uncertainties very often are caused by political transitions, policy changes, legislative overhauls, or unanticipated diplomatic developments. Unlike the traditional policy shocks, EPU dislocates firms' expectations by heightened market volatility about the future economic conditions, making it uneasy for firms and investors to predict policy shocks or mitigate potential risks.

Dialogue Social Science Review (DSSR)
www.thedssr.com

ISSN Online: 3007-3154
ISSN Print: 3007-3146

DIALOGUE SOCIAL SCIENCE REVIEW

Vol. 3 No. 6 (June) (2025)

EPU exposure, therefore, assesses the liabilities of individual firms or industries to policy shifts and market fluctuations. Firms with higher EPU exposure, get almost defenseless to variations in taxation, regulation and government budgetary spending. This exposure would definitely influence firm prices, running operations' costs, and long-term goal settings. In equity markets, the forecast of policy instability may discourage investor enthusiasm, ultimately causing a gap by slowing down in trading volumes, re-pricing risk, and increased volatility in market returns. Investors, facing vague signals regarding their future market conditions, may refrain from or delay their investment decisions. They may demand prior risk premiums' contracts, or transfer their portfolios toward some reliable assets, and these issues may collectively deteriorate overall market financial conditions.

In China, where the state retains considerable influence over both the regulatory environment and macroeconomic direction, the repercussions of EPU are particularly potent, investors are acutely conscious about the government policies, regulatory reforms, and investment laws. For example, sudden changes in real estate laws or capital flow restrictions may quickly overcome investors' psychology, leading to swift negative investor sentiment. In such environments, even incomplete information regarding the market volatility may put a worst impact on investor behavior and market returns, where decisions are often sentiment-driven rather than purely based on fundamentals.

Investor sentiment is a behavioral phenomenon, inherently connected to the way market investors perceive and respond to uncertainty. During times of low EPU, a sense of optimism often emerges, fostering risk-taking and driving growth in capital markets. Conversely, an increase in EPU typically results in a pessimistic approach in investor sentiment, which may result in typically worst risk aversion, lower liquidity, and decreased asset prices. This ongoing feedback loop, in which Economic Policy Uncertainty (EPU) shapes sentiment, and sentiment subsequently intensifies market responses, creates a fragile and complex atmosphere for financial stability. Notably, during times of heightened EPU, market participants may overreact, creating self-reinforcing cycles of pessimism and disinvestment that can lead to worst systemic consequences at a broader level. Existing empirical evidence brings out the macro-financial significance of EPU and investor sentiment. There are substantial connections between increased EPU and decreased stock returns, wider credit spreads, and decreased business investment, according to a number of studies that have shown these connections. Firms that are exposed to high EPUs often demonstrate decreased profitability, poorer employment growth, and lowered innovation activity. This is because management uncertainty about the future direction of policy constrains strategic efforts (Baker et al., 2016; Gulen & Ion, 2016). On the other side, markets that are driven by mood have the potential to become more disconnected from the fundamentals that lie underneath them, which makes them more susceptible to speculative

In this analytical environment, the current research seeks to conduct an in-depth empirical analysis of the link between EPU exposure and investor mood in China's A-share listed enterprises from 2014 to 2022. By considering firm-level exposures to policy uncertainty and their impact on market sentiment, the study adds to an implicit knowledge of how macro-policy contexts influence behavioral reactions in developing financial systems.

Dialogue Social Science Review (DSSR)
www.thedssr.com

ISSN Online: 3007-3154
ISSN Print: 3007-3146

DIALOGUE SOCIAL SCIENCE REVIEW

Vol. 3 No. 6 (June) (2025)

To do this, EPU exposure is quantified using the Fama-French Five-Factor model, which allows for a reliable firm-specific calculation of policy sensitivity. Investor sentiment is measured using a composite proxy that incorporates market data and behavioral variables. The link is then evaluated using both conventional linear regression and Two-Stage Least Squares (2SLS) estimates to remove endogeneity concerns and assure causal inference.

Through this study, unique insights have been brought to the discussion on the behavior of financial markets in countries that are in transition. Previous research has provided a substantial amount of evidence about the effects of EPU in developed economies; however, the behavioral processes that are at work inside China's developing financial system have not yet been thoroughly investigated. In light of China's one-of-a-kind institutional system, which is characterized by a combination of market-driven dynamics and state-oriented regulations, the psychological and financial reactions of investors to policy uncertainty need serious academic research.

Moreover, the conclusions of this research have significant repercussions for those who are responsible for formulating economic policy and for regulating the market. This study offers a basis for building policy frameworks that are more transparent, stable, and trustworthy. It does this by revealing the routes by which EPU influences investor confidence and, as a result, distorts the operation of the financial market. It is possible that increasing the predictability of policy and decreasing ambiguity might serve as essential instruments in anchoring investor expectations and developing capital markets that are more robust. When it comes to risk assessment, strategic asset allocation, and the creation of hedging strategies, having a detailed knowledge of EPU exposure may be of great assistance to managers and investors.

The purpose of this research is to show the subtle links that drive market sentiment and financial stability in one of the most prominent developing economies in the world. In a nutshell, the study aims to bridge the gap between macro-level policy uncertainty and micro-level investor behavior.

Literature Review

The intricate interaction between economic policy uncertainty (EPU) and investor sentiment has earned substantial researchers' attention in recent years, particularly within the ambit of behavioral finance and macroeconomic volatility. As global markets evolve under the duress of political unpredictability, monetary policy shifts, and structural transformations, the phenomenon of EPU has emerged as a central explanatory variable in determining asset pricing, risk assessment, and investment behavior. Yet, the behavioral reverberations of EPU, especially how it permeates investor psychology and catalyzes shifts in sentiment, remain a fertile domain for academic exploration, particularly in the context of transitional and emerging economies such as China.

The concept of EPU was crystallized by Baker, Bloom, and Davis (2016), who proposed a quantifiable index based on newspaper coverage frequency, tax code expiration schedules, and forecast disagreement. The index has been widely utilized in recent studies (Gulzar et al., 2025; Arshad et al., 2024). Their work underscored that policy ambiguity is not merely a backdrop to economic activity but an active determinant of macroeconomic dynamics. When uncertainty prevails regarding fiscal direction, regulatory enforcement, or trade negotiations, investors

ISSN Online: 3007-3154
ISSN Print: 3007-3146

struggle to forecast future cash flows or construct rational expectations, resulting in either excessive caution or speculative exuberance, both of which distort efficient market behavior.

Investor sentiment, conversely, is an affective and often irrational response to economic stimuli, encompassing emotions such as optimism, fear, and herd mentality. Behavioral economists like Shiller (2003) and Barberis et al. (1998) critically argued that sentiment can diverge from economic fundamentals, ultimately creating valuation anomalies as well as volatility spikes. In heightened EPU environments, sentiment becomes completely fragile, working as a pathway showing the uncertainty's worst effects on financial markets. The psychological discomfort triggered by vague policy shocks most often leads to overreactions, risk aversion, and careful portfolio shifting, behavior that undermines price stability and exacerbates market cycles.

Existing literature mostly shows a consistent, negative correlation of EPU exposure with investor sentiment across multiple economic sectors. For instance, Smales (2017) reveals that increase in EPU exposure coincide with declines in sentiment indicators and suddenly heightened market volatility. Similar conclusions were given by Brogaard and Detzel (2015), who accessed that elevated policy uncertainty translates into declining investor confidence and poor trading activities. In addition, the sensitivity of investor sentiment to EPU exposure is frequently getting serious attention in economies with poor institutional transparency or instable political setups, where policy signals are more ambiguous and trust in governance is variable.

As far as China is concerned, the relationship of EPU exposure with investor behavior carries excessive complexity because of the multidimensional nature of its economic setup. Unlike Western economic states, where policy frameworks are most often controlled and run by institutional check and balance on regular basis, China's centralized system works on persistent policy shifts that can dramatically alter its whole foreign direct investment landscapes. Empirical investigations into the financial markets of China (Wang et al., 2014; Huang et al., 2020) have comprehensively stressed that market sentiment responds negatively to government policy variations time and again, central bank communication, and macroeconomic goals targeted during key policy sessions. This heightened reactivity indicates the behavioral implications of EPU exposure, particularly for retail-dominated segments of the market where decision-making is typically sentiment-driven.

Industry-level heterogeneity in EPU exposure also expands this discourse. Research studies have shown that capital-intensive sectors such as energy, construction, and infrastructure are more susceptible to policy fluctuations, especially those concerning interest rates, government subsidies, or regulatory compliance. Alessandri and Mumtaz (2012) argue that sectors with high fixed costs and investment irreversibility are particularly liable during period of heightened uncertainty, which may ultimately lead to deferred investment decisions and negative investor behaviors. Meanwhile, technological and export-oriented industries tend to exhibit greater resilience because of their flexible cost mechanism or global diversification of revenue generation. These variations of exposures contribute to different degrees of sentiment contagion across different financial sectors.

Methodologically, scholars have employed a wide range of techniques in order to

ISSN Online: 3007-3154
ISSN Print: 3007-3146

quantify the EPU-sentiment nexus. While early studies relied on aggregate-level EPU indices, recent advancements have made a pathway for the firm-based estimation of EPU exposure using textual analysis, regression-based sensitivity measurements, and various factor models. The use of the Fama-French Five-Factor model, in particular, has now become prevalent to identify idiosyncratic EPU exposure across different firms by considering specific time period, facilitating more granular analysis of investor sentiment. Complementarily, investor sentiment is widely proxied by utilizing the composite indices incorporating variables such as trading volume, market volatility, mutual cash flows, and survey-based sentiments, which is a multidisciplinary approach capturing the elusive nature of investor sentiment more perfectly specified.

Importantly, the causal connection between EPU exposure and investor sentiment has also been refined through the application of robust econometric techniques. Structural Vector Auto-regressions (SVAR), Granger causality tests, and Two-Stage Least Squares (2SLS) models have been used to disentangle endogeneity and reverse causality. For example, Bali et al. (2017) employed instrumental variables to isolate exogenous variation in EPU, demonstrating its unidirectional effect on investor mood and subsequent market movements. These findings reinforce the notion that EPU functions not only as a risk-factor but also as a transmission mechanism for a wide level of behavioral shifts in the financial market.

Notably, most of the extant literature is disproportionately comprising of developed economies such as the United States, the Eurozone, and Japan. Emerging economies, despite exhibiting higher degrees of political and economic volatility and policy shifts, remain relatively almost unaddressed at broader level in this discourse. In the perspective of China, where policy initiatives such as Belt and Road Initiative, supply-side structural reforms, and financial deleveraging campaigns have introduced significant economic discontinuities, there is a dire need of investigating how EPU exposure significantly reshapes investor behavior and sentiment formation over time.

Furthermore, as global markets contend with overlapping crises, from pandemics and geopolitical re-alignments to climate risk and technological disruption, the relevance of EPU exposure and investor sentiment continues to escalate. The Chinese financial market, by virtue of its scale and policy-sensitive nature, presents a compelling case for studying the behavioral underpinnings of market volatility under uncertain policy conditions.

The prevailing body of research robustly establishes the detrimental effect of economic policy uncertainty on investor sentiment, particularly in settings characterized by opaque policymaking, nascent investor protections, and sentiment-driven trading dynamics. Nevertheless, there exists a distinct research gap in applying this framework to the unique financial architecture of China. The current study contributes to this literature by providing a firm-level empirical analysis of EPU exposure and its psychological and financial ramifications for investors, thereby offering a novel lens through which to understand market behavior in emerging economies under conditions of pervasive uncertainty.

In light of the adverse ramifications of economic policy uncertainty (EPU) exposure, an emerging body of empirical research underscores the notable influence of increased policy ambiguity on corporate strategic response. At a specific level, firms subjected to elevated degrees of EPU exposure tend to curtail completely either or postpone their capital investment decisions, primarily

Dialogue Social Science Review (DSSR)
www.thedssr.com

ISSN Online: 3007-3154
ISSN Print: 3007-3146

DIALOGUE SOCIAL SCIENCE REVIEW

Vol. 3 No. 6 (June) (2025)

because of the unforeseeable market cash flows and the excessive irreversibility of long-term financial commitments (Wang et al., 2014). This strategic retrenchment reflects an attempt to mitigate risk in environments where regulatory direction and policy fluctuate in a volatile or opaque manner. Furthermore, recent econometric analyses have elaborated a discernible inverse association between elevated EPU exposure and anticipated stock returns, highlighting that as uncertainty surrounding economic policy intensifies, investor expectations become increasingly pessimistic, driving down equity valuations (Chen et al., 2021).

Mirza and Ahsan (2020) assert that EPU operates not merely as a macroeconomic background variable but as a central determinant of systemic financial risk and market sentiment, influencing everything from firm valuation models to sectoral performance dynamics. The presence of heightened policy uncertainty serves to destabilize investor confidence, often exacerbating risk premiums and leading to volatility in equity markets.

Huang (2023) investigates the mediating role of investor sentiment in the relationship between China's EPU and the CSI 300 stock index returns. Utilizing Principal Component Analysis (PCA) to construct a sentiment index from six proxy variables, the study employs bootstrap analysis to assess mediation effects. The findings reveal that approximately 87% of EPU's impact on stock returns is mediated through investor sentiment, underscoring its significant role in financial market behavior.

Jiang and Wu (2025) employ a Time-Varying Parameter Structural Vector Autoregressive Model with Stochastic Volatility (TVP-SV-VAR) to explore the nonlinear relationships between EPU, investor sentiment, and exchange rate volatility. The study finds that EPU directly influences exchange rate volatility and indirectly affects it by altering investor sentiment, highlighting the complex and time-varying nature of these interactions. 3. Sentiment Divergence's Moderating Effect on EPU-Induced Stock Volatility

A study published in *Applied Economics* (2024) examines how sentiment divergence moderates the impact of EPU on stock market volatility. The research indicates that during periods of high sentiment divergence, the positive relationship between EPU and stock volatility weakens. This effect is more pronounced in liquid stocks and under poor market conditions, suggesting that investor sentiment heterogeneity can dampen the volatility typically associated with policy uncertainty. Liu & Ma (2024) apply a Time-Varying Parameter Vector Auto-regression (TVP-VAR) model to analyze the dynamic relationships between EPU, investor sentiment, and financial stability in China from 2008 to 2022. The study finds that EPU negatively impacts investor sentiment and financial stability, particularly during the global financial crisis. Additionally, investor sentiment positively influences financial stability, though this effect diminishes over time.

Yifeng (2024) explores the effect of internet-based investor sentiment on intraday overtrading in China's A-share market. Utilizing high-frequency sentiment indices derived from social media posts on the East-money forum Guba, the study finds that heightened investor sentiment leads to increased intraday overtrading, especially among institutional investors and during bullish market conditions.

Guo and Shi (2024) investigate the interplay between geopolitical risks, investor sentiment, and industry-specific stock market volatility in China using a quantile regression approach. The study reveals that geopolitical risks significantly affect

ISSN Online: 3007-3154
ISSN Print: 3007-3146

investor sentiment, which in turn influences stock market volatility across different industries, emphasizing the importance of considering geopolitical factors in financial market analyses.

The review of the above studies collectively enhances the complex and multifaceted correlation between EPU exposure and investor sentiment in China's financial markets. Key insights highlight that investor sentiment significantly mediates the impact of EPU exposure on stock returns and volatility, stressing its central role in financial market dynamics. The studies further access the correlations among EPU, investor sentiment, and market variables such as exchange rates and financial stability are nonlinear and evolve over time, necessitating models that can capture these complexities. Geopolitical risks and internet-based sentiment are also pondered in the perspective of their contribution to the market volatility and behavior-based patterns that were observed in China's markets, indicating the need to incorporate these factors into a comprehensive and implicit evaluation.

These findings indicate that future research studies must continue to identify and explore the dynamic connection between policy uncertainty and investor behavior, by employing advanced econometric models to analyze the evolving nature of these variables' relationships.

Additionally, drawing from these insights, our study postulates that investor sentiment, an inherently sensitive and behaviorally driven construct, is significantly shaped by the degree to which firms are exposed to economic policy shocks. The psychological climate within which investors operate becomes increasingly risk-averse when ambiguity around fiscal direction or regulatory frameworks dominates the informational landscape. Therefore, the following hypothesis is formulated as a focal point of our empirical investigation:

H1. Firms that are more exposed to economic policy uncertainty are expected to experience greater declines in investor sentiment than less-exposed firms.

Research Methodology

Data and Sample

Present study is considering the Chinese firms listed on Shanghai and Shenzhen stock exchange. Financial firms are excluded from the whole sample as they follow different regulations. B shares are also excluded because of their availability to foreign investors only. Sample ranges from 2014 to 2022. Data have been sourced from two sources. EPU data is obtained from the official website of Economic Policy Uncertainty whereas the data of all other variables is sourced from the CSMAR data base. All data is in annual frequency. After the scrutiny, final sample consists of 9441 firms.

Variable Measurement

EPU Exposure

Economic policy refers to the hurdles to certain economic parameters that result delays in economic activities and decision making. This uncertainty is not same for all the firms, this study is considering EPU exposure, which is the heterogeneity of stock exposure towards same EPU. For measuring EPU Exposure, we add the EPU index into the Fama and French (2015) five factor model. Following equation 1 presents the estimation of EPU Exposure.

Dialogue Social Science Review (DSSR)
www.thedssr.com

ISSN Online: 3007-3154
ISSN Print: 3007-3146

DIALOGUE SOCIAL SCIENCE REVIEW

Vol. 3 No. 6 (June) (2025)

$$R_{I,t} - Rf = Bo + B_{it}^{mkt}\, MKT_{i,t} + B_{it}^{smb}\, SMB_{i,t} + B_{it}^{hml}\, HML_{i,t} + B_{it}^{rmw}\, RMW_{i,t} + \\ + B_{it}^{cma}\, CMA_{i,t} + B_{it}^{epu}\, EPU_t + €_{i,t} \quad \textbf{(Equation 1)}$$

n equation 1,$B_{i,t}^{epu}$ represents the EPU Exposure, the bigger $B_{i,t}^{epu}$, the greater exposure towards economic policy uncertainty. Furthermore, $R_{i,t} - Rfr$ shows the excess return on stocks whereas, MKT, SMB, RMW, CMA, HML are part of Fama and French, (2015) five factor model, represents market, size, value, profitability and investment factor.

Investor Sentiment

Present study is using investor sentiment as dependent variable, following the methodology being used by Qian and Tan (2024), this study is measuring the investor sentiment through three components of investor heterogenous responses. Initially the Tobin's Q (TQR) is calculated. In equation 2, the error term represents the Tobin's Q. It is the residual that is obtained by regressing Tobin's Q on fundamental variables, including total assets, leverage and return on assets.

$$Tobins\ Q_{i,t} = a_o + B_1 TA_{i,t} + B_2 LEV_{i,t} + B_3 ROA_{i,t} + €_{i,t} \quad \textbf{(Equation 2)}$$

Second, ONR will be calculated through the opening price over the closing price of previous year minus 1.

Control Variables

The variables that are likely to influence the estimation results are required to be controlled. Present study is using multiple control variables namely firm size (Natural logarithm of total assets, leverage (total debts/ total assets), profitability (EBIT / Total Assets) and firm age, calculated through the calculated through the company's age as on the year of research minus the year of establishment and the market presence, measured through the natural logarithm of company's sales.

Econometric Model

In order to test the hypothesis (H1), this study estimates the equation (3) as follows.

$$IS_{i,t} = a_o + B_1 EPU\ Exposure_{i,t} + B_2 Control_{i,t} + INDUSTRY_i + YEAR_t + €_{i,t}$$

(Equation 3)

IS refers to the investor sentiment in year t, $EPU_{exposure}$ refers to the sensitivity of shares towards EPU. $Control_{i,t}$ represents various control variables being used in this study.

Empirical Results

Table 4.1 summarizes the key variables employed in this study. Investor Sentiment has a mean of -0.069 and a standard deviation of 1.136, indicating notable variability among observations. The sentiment values range from -2.34 to 3.615, suggesting that while most firms are centered around the average, some experience considerably higher or lower sentiment levels. This distribution aligns with our first hypothesis (H1), implying that differences in firm behavior are influenced by their level of EPU Exposure.

The mean value of EPU Exposure is 2.639, accompanied by a relatively low standard deviation of 0.367. Its values span from 1.481 to 3.278, reflecting a moderate level of variation across firms and over time. These results are in line

Dialogue Social Science Review (DSSR)
www.thedssr.com

ISSN Online: 3007-3154
ISSN Print: 3007-3146

DIALOGUE SOCIAL SCIENCE REVIEW

Vol. 3 No. 6 (June) (2025)

with the findings of Fu et al. (2020) and support our hypothesis, indicating a sound basis for subsequent analysis.

Table 4.1 Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
IS	9441	-.069	1.136	-2.34	3.615
EPU Exp	9441	2.639	.367	1.481	3.278
Board Ind	9441	0.38	0.679	.25	0.6
Leverage	9441	.875	.451	.106	2.007
ROA	9441	.03	.078	-.37	.198
Firm size	9441	22.055	1.089	19.657	25.598
Firm age	9441	21.472	4.545	14	36
Mkt presence	9441	21.294	1.276	18.581	25.117

Table 4.2 shows the results of pairwise correlation among key variables. There is correlation value of -0.101 with P-value of 0.000, representing significant negative relationship of EPU Exposure and investor sentiment. Same negative relationship of is consistent with the findings of (Cui et al., 2020c). Whereas investor sentiment and board independence have a positive correlation with the significant positive value of 0.070, representing that the higher board independence is more positively associated with investor sentiment during the period of uncertainty. These findings are consistent with the results reported by (Jiang & Wu, 2025b).

Table 4.2 Pairwise correlations

Variables	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
(1) IS	1.000							
(2) EPU Exp	-0.101 (0.000)	1.000						
(3 Board Ind	0.070 (0.000)	-0.025 (0.039)	1.000					
(4) Leverage	0.030 (0.011)	-0.015 (0.208)	-0.014 (0.169)	1.000				
(5) ROA	0.055 (0.000)	0.024 (0.046)	0.011 (0.282)	-0.306 (0.000)	1.000			
(6) Firm size	-0.194 (0.000)	0.007 (0.572)	-0.066 (0.000)	0.397 (0.000)	0.058 (0.000)	1.000		
(7) Firm age	-	0.002	0.007	-	-	-	1.000	

Dialogue Social Science Review (DSSR)
www.thedssr.com

ISSN Online: 3007-3154
ISSN Print: 3007-3146

DIALOGUE SOCIAL SCIENCE REVIEW

Vol. 3 No. 6 (June) (2025)

	0.004			0.039	0.006	0.088		
	(0.748)	(0.894)	(0.503)	(0.000)	(0.555)	(0.000)		
(8) Mkt presence	-0.138	0.005	-0.066	0.436	0.128	0.884	-0.070	1.000
	(0.000)	(0.651)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	

4.3. Baseline regression results

Comprehensive overview of the main findings regarding the degree of association between EPU Exposure and investor sentiment is displayed in Table 4.4. Firm and year fixed effects were adjusted.

In Table 4.3, column 1, the results reveal a significant negative association between EPU Exposure and investor sentiment (B = -0.892*, $p < 0.01$). This inverse relationship suggests that as firms become more exposed to economic policy uncertainty, investor confidence declines, leading to weaker sentiment. These findings are consistent with the conclusions of Chen et al. (2021) and support our first hypothesis.

Additionally, Nasraoui et al. (2024) argue that elevated levels of EPU weaken investor sentiment, thereby influencing trading behavior and reducing stock market liquidity. The study by Jiang and Wu (2025) further supports our analysis by identifying a non-linear relationship between EPU and investor sentiment. They note that the adverse impact of EPU varies across firms and over time, becoming more pronounced during periods of heightened uncertainty. These results are also in line with the earlier findings of Wang et al. (2014), further validating our conclusions.

Table 4.3: Baseline Regression Results

Variables	(1) IS
EPU Exp	-0.892***
	(0.264)
Leverage	0.529***
	(0.059)
ROA	1.529***
	(0.181)
Firm size	-0.510***
	(0.053)
Firm age	-0.006
	(0.005)
Mkt presence	0.147***
	(0.045)
Constant	9.772***
	(1.118)
Industry & Year FE	Yes
Observations	9,441
R-squared	0.110

Dialogue Social Science Review (DSSR)
www.thedssr.com

ISSN Online: 3007-3154
ISSN Print: 3007-3146

DIALOGUE SOCIAL SCIENCE REVIEW

Vol. 3 No. 6 (June) (2025)

Note: Standard errors in parentheses (*** p<0.01, ** p<0.05, * p<0.1

Conclusion

This research provides a fresh and in-depth perspective on the dynamic interplay between Economic Policy Uncertainty (EPU) exposure and investor sentiment, with a focused lens on China's A-listed financial firms. The empirical evidence reveals a clear and statistically significant negative correlation between EPU and investor sentiment, indicating that heightened policy uncertainty undermines market confidence. This adverse effect persists even after conducting a series of rigorous robustness checks designed to mitigate concerns around potential endogeneity, thereby reinforcing the credibility and consistency of the findings.

From a theoretical standpoint, this study enriches the existing body of behavioral finance literature by bridging the gap between macroeconomic uncertainty and investor psychology. It underscores the relevance of incorporating broader economic indicators, such as policy-related risks, when analyzing market sentiment and investor decision-making processes. This perspective shifts the focus beyond firm-level and microeconomic variables, offering a more holistic understanding of market dynamics in uncertain policy environments.

On a practical level, the implications are equally significant. The results serve as a critical reminder for policymakers, financial regulators, and market participants of the far-reaching consequences that ambiguous or inconsistent policy directions can have on financial market stability. Particularly in emerging or transitioning economies like China, where market structures and regulatory frameworks continue to evolve, maintaining a degree of policy clarity is essential to sustaining investor confidence and fostering a resilient financial ecosystem.

In conclusion, this study not only contributes novel empirical evidence to an important area of financial research but also offers actionable insights for improving policy design and investor relations in the context of economic uncertainty.

Contributions, Implications, and Limitations

This study makes several meaningful contributions to the literature on investor behavior, corporate governance, and macroeconomic uncertainty, particularly within the unique context of China’s A-share market. It offers fresh empirical evidence on how exposure to Economic Policy Uncertainty (EPU) affects investor sentiment in a transitional and developing financial system. By focusing on the Chinese capital market, where regulatory mechanisms and institutional structures differ significantly from those in advanced economies, this research expands the scope of understanding surrounding market psychology in emerging economies. Moreover, the application of advanced econometric techniques specifically, the Fama and French Three-Factor model and Two-Stage Least Squares (2SLS) regression, strengthens the methodological foundation of the study, enhancing the robustness and credibility of the observed relationships.

From a practical standpoint, the study presents valuable implications for various stakeholders. For corporate leaders and strategists, the findings emphasize the importance of preparing for adverse market sentiment during times of elevated policy uncertainty. Organizations are encouraged to go beyond formal governance mechanisms by developing adaptive strategies that foster resilience, proactive communication, and innovation. Regulatory authorities are also advised to

ISSN Online: 3007-3154
ISSN Print: 3007-3146

recognize the nuanced impact of EPU on market stability. Given that investor sentiment can deteriorate significantly during uncertain policy environments, there is a need for dynamic and transparent policy communication to maintain confidence in the market. Additionally, institutional investors and financial analysts may leverage these insights to better assess the vulnerability and adaptability of firms facing policy-related risks.

Despite its strengths, the study is not without limitations. The research scope is limited to A-share listed firms in China, which may restrict the generalizability of its conclusions to other emerging markets with differing investor behaviors and governance structures. Furthermore, while the proxies used for measuring EPU exposure and investor sentiment align with established methods, they may not fully capture the nuanced, qualitative dimensions of these constructs, such as emotional tone in media narratives or cognitive biases influencing investor reactions. These aspects remain fertile ground for future interdisciplinary research incorporating behavioral and psychological insights.

To sum up, our study contributes to a more comprehensive understanding of how macro-level uncertainty correlates with investor sentiment in the ongoing emerging financial markets. It calls for a more integrated approach to governance mechanism, regulation, and strategic planning in the face of uncertain policy environment, ultimately paving a pathway for a better and resilient financial markets.

References

Aboody, D., Even-Tov, O., Lehavy, R., & Trueman, B. (2018). Overnight returns and firm-specific investor sentiment. Journal of Financial and Quantitative Analysis, 53(2), 485–505.

Alessandri, T. M., Tong, T. W., & Reuer, J. J. (2012). Firm heterogeneity in growth option value: The role of managerial incentives. Strategic Management Journal, 33(13), 1557–1566.

Arshad, A., Gulzar, O., Shahid, O. B., & Nawaz, F. (2024). Exploring the mediating role of financial inclusion in the relationship between economic policy uncertainty and CO2 emissions: A global perspective. *Environmental Science and Pollution Research*, *31*(34), 46965–46978. https://doi.org/10.1007/s11356-024-33954-y

Baker, M., & Wurgler, J. (2006). Investor sentiment and the cross-section of stock returns. The Journal of Finance, 61(4), 1645–1680.

Baker, S. R., Bloom, N., & Davis, S. J. (2016). Measuring economic policy uncertainty. The Quarterly Journal of Economics, 131(4), 1593–1636.

Bams, D., Blanchard, G., Honarvar, I., & Lehnert, T. (2017). Does oil and gold price uncertainty matter for the stock market? Journal of Empirical Finance, 44, 270–285.

Berger, A. N., Kick, T., & Schaeck, K. (2013). Executive board composition and bank risk taking. Journal of Corporate Finance, 28, 48–65.

Bing Zhang. (2018). Economic policy uncertainty and investor sentiment: Linear and nonlinear causality analysis. Applied Economics Letters. https://doi.org/10.1080/13504851.2018.1545073

Bonaime, A., Gulen, H., & Ion, M. (2018). Does policy uncertainty affect mergers and acquisitions? Journal of Financial Economics, 129(3), 531–558.

Cakici, N. (2015). The five-factor Fama-French model: International evidence.

ISSN Online: 3007-3154
ISSN Print: 3007-3146

SSRN Electronic Journal.

Cao, J., Ee, M. S., Hasan, I., & Huang, H. (2024). Asymmetric reactions of abnormal audit fees jump to credit rating changes. The British Accounting Review, 56(2), Article 101205.

Carcello, J. V., Neal, T. L., Palmrose, Z., & Scholz, S. (2011). CEO involvement in selecting board members, audit committee effectiveness, and restatements. Contemporary Accounting Research, 28(2), 396–430.

Chen, Y., Shen, X., & Wang, L. (2021). The heterogeneity research of the impact of EPU on environmental pollution: Empirical evidence based on 15 countries. Sustainability, 13(8), 4166.

Claessens, S., & Yurtoglu, B. B. (2013). Corporate governance in emerging markets: A survey. Emerging Markets Review, 15, 1–33.

Cui, X., Wang, C., Liao, J., Fang, Z., & Cheng, F. (2021a). Economic policy uncertainty exposure and corporate innovation investment: Evidence from China. Pacific-Basin Finance Journal, 67, 101533.

Cui, X., Yao, S., Fang, Z., & Wang, H. (2020a, 2020b, 2020c, 2020d). Economic policy uncertainty exposure and earnings management: Evidence from China. Accounting and Finance, 61(3), 3937–3976.

Fu, J., Wu, X., Liu, Y., & Chen, R. (2020). Firm-specific investor sentiment and stock price crash risk. Finance Research Letters, 38, 101442.

Gao, H., Chen, W., Li, J., & Zhou, T. (2024). Economic policy uncertainty and foreign direct investment: Evidence from China. Structural Change and Economic Dynamics, 70, 178–191.

Gulzar, O., Arshad, A., & Shahid, O. B. (2025). Fostering resilience: exploring financial inclusion as a catalyst in mitigating economic policy uncertainty and safeguarding food security in developing countries. *Sustainability Accounting Management and Policy Journal*. https://doi.org/10.1108/sampj-08-2023-0591

Guo, P., & Shi, J. (2024). Geopolitical risks, investor sentiment and industry stock market volatility in China: Evidence from a quantile regression approach. The North American Journal of Economics and Finance, 72, 102139. https://doi.org/10.1016/j.najef.2024.102139

Huang, L. (2023). The impact of China economic policy uncertainty on CSI 300: An analysis of the mediating effect of investor sentiment. Advances in Economics Management and Political Sciences, 51(1), 41–49. https://doi.org/10.54254/2754-1169/51/20230608

Jiang, C., & Wu, Q. (2025a, 2025b). Economic policy uncertainty, investor sentiment, and exchange rate volatility: A study on the effects of non-linear linkages. Journal of Economic Policy Reform, 1–26.

Li, Y., & Li, W. (2021). Firm-specific investor sentiment for the Chinese stock market. Economic Modelling, 97, 231–246.

Liu, H., Zhang, R., & Wang, Y. (2024). The moderating effect of sentiment divergence on the EPU-stock volatility nexus: Evidence from China. Applied Economics, 56(10), 932–947. https://doi.org/10.1080/00036846.2024.2312264

Loughran, T., & McDonald, B. (2016). Textual analysis in accounting and finance: A survey. Journal of Accounting Research, 54(4), 1187–1230.

Mahmoudi, N., Docherty, P., & Melia, A. (2022). Firm-level investor sentiment and corporate announcement returns. Journal of Banking & Finance, 144,

ISSN Online: 3007-3154
ISSN Print: 3007-3146

106586.
Mirza, S. S., & Ahsan, T. (2020). Corporates' strategic responses to economic policy uncertainty in China. Business Strategy and the Environment, 29(2), 375–389.
Nagar, V., Schoenfeld, J., & Wellman, L. (2018). The effect of economic policy uncertainty on investor U.S. CR. Journal of Accounting and Economics.
Nasraoui, M., Ajina, A., & Kahloul, A. (2024). The influence of economic policy uncertainty on stock market liquidity: The mediating role of investor sentiment. The Journal of Risk Finance, 25(4), 664–683.
Nguyen, Q., & Kim, H. T. (2023). An exploration on policy uncertainty as a driver of R&D activity. Research in International Business and Finance, 64, 101883.
Qian, B., & Tan, Y. (2024). Firm-specific investor sentiment and stock price informativeness. Finance Research Letters, 66, 105680.
Salehi, M., Asadian, A., & Khansalar, E. (2023). The effect of intellectual capital on audit fees stickiness. Accounting Research Journal, 36(1), 55–76.
Sheikh, N. A., Wang, Z., & Khan, S. (2013). The impact of internal attributes of corporate governance on firm performance: Evidence from Pakistan. International Journal of Commerce and Management, 23(1), 38–55.
Sophie Wang, Q. S., Lai, S., Pi, S., & Anderson, H. (2022). Does directors' and officers' liability insurance induce empire building? Evidence from corporate labor investment. Pacific-Basin Finance Journal, 73, Article 101753.
Van Vo, L., & Le, H. T. T. (2017). Strategic growth option, uncertainty, and R&D investment. International Review of Financial Analysis, 51, 16–24.
Wang, Y., Chen, C. R., & Huang, Y. S. (2014). Economic policy uncertainty and corporate investment: Evidence from China. Pacific-Basin Finance Journal, 26, 227–243.
Xu, Z. (2019). Economic policy uncertainty, cost of capital, and corporate innovation. Journal of Banking & Finance, 111, 105698.
Yang, C., & Zhou, L. (2016). Individual stock crowded trades, individual stock investor sentiment and excess returns. The North American Journal of Economics and Finance, 38, 39–53.
Yang, Z., Yu, Y., Zhang, Y., & Zhou, S. (2019). Policy uncertainty exposure and market value: Evidence from China. Pacific-Basin Finance Journal, 57, 101178.
Yifeng, P. (2024). Internet sentiment exacerbates intraday overtrading, evidence from A-Share market. arXiv (Cornell University). https://doi.org/10.48550/arxiv.2404.12001
Zhang, C. (2024). Corporate governance, financial performance, and economic policy uncertainty: Evidence from emerging Asian economies. PLOS ONE, 19(12), e0312292.
Zhang, Z., Chen, R., & Luo, Q. (2021). Firm-specific investor sentiment, stock price synchronicity, and crash risk. Applied Economics Letters, 30(4), 450–455.