

# “Overreaction” of Asset Prices in an Economy with Incomplete Markets\*

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## Abstract

We introduce leverage-constrained financial intermediaries into a three-period pure exchange economy with incomplete markets. Market incompleteness generates arbitrage opportunities in asset markets. To pursue arbitrage profits, intermediaries finance positions in risky securities by borrowing from households. We analytically derive the conditions under which intermediaries raise their respective leverage positions ex ante and are forced to liquidate assets at discounted prices to satisfy their respective leverage constraints ex post. We demonstrate numerically that such an equilibrium exists.

**Keywords:** leveraged investments; incomplete markets; arbitrage opportunities

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