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Variations in effects of monetary policy on stock market returns in the past four decades

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Abstract

Stock prices are sensitive to monetary policy. However, the sensitivities are not stable over time. A drastic change in monetary policy can alter effects of monetary policy on stock returns. This study finds that stock prices can be affected by current changes, unexpected changes, or near-future changes in the funds/discount rates, due to different policy goals or targets in different periods. Specifically, this study provides empirical evidence that monetary policy influences the stock market in different ways in the 1960s, the 1970s, the Volcker and Greenspan periods.
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1. Introduction

The relationship between changes in the effective federal funds/discount rates and stock prices attracted numerous studies in the past three decades. Empirical evidence in the literature suggests that fluctuations in stock prices, from a long-run perspective, merely reflect alterations in some principal economic factors. As an indicator of fundamental economic changes, fluctuations in stock prices have received close attention from the Federal Reserve and become an influential factor in the determination of monetary policy (Bernanke & Gertler, 1999; Rigobon & Sack, 2001). In their research, Rigobon and Sack (2001) find a significant contemporaneous and simultaneous response of monetary policy to stock

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market movement, that is, “a 5% rise (fall) in the S&P 500 index increasing the likelihood of a 25 basis point tightening (easing) by about a half”.

On the other hand, many studies report that changes in the federal funds/discount rates can significantly affect or predict stock market returns by influencing forecasts of some financial variables (Patelis, 1997). Generally speaking, an increase in the funds/discount rates pushes up market-determined interest rates, then leads to a higher cost of capital and lower profitability, causing a negative response from the stock market. The significant impact of monetary policy has been detected by daily and intraday stock return data (Cook & Hahn, 1988; Jensen & Johnson, 1993; Smirlock & Yawitz, 1985; Waud, 1970), monthly and quarterly data (Jensen & Johnson, 1995), and international stock return data (Conover, Jensen, & Johnson, 1999a, 1999b; Conover, Jensen, Johnson, & Mercer, 2005; Durham, 2001). When innovations in the federal funds rate and nonborrowed reserves are used as the proxies for monetary policy, Thorbecke (1997) finds evidence that monetary policy exerts large effects on ex-ante and ex-post stock market returns. Further, Jensen and Mercer (2002) report that changes in the funds/discount rates can significantly affect the cross-section of expected stock returns.

Some studies find that the relationship between monetary policy and stock returns is consistent. For example, Conover et al. (2005) conclude that periods of expansive monetary policy are associated with strong stock performance, whereas periods of restrictive monetary policy generally coincide with weak stock performance, and “the mid-1990s” is the only exception over the period of July 19, 1962 to January 2, 2001. However, according to Durham (2001, 2003a, 2003b), the impact of monetary policy on stock returns is “less sturdy” and highly sensitive to alternative proxies of both monetary policy and stock returns as well as the selection of the sample period. In his cross-country study (2001), Durham finds that changes in the discount rate have a significant impact on stock returns for the sample period of 1956–2000. Nevertheless, the impact is insignificant for a subperiod of 1956–1970. His results suggest that the relationship between monetary policy and stock market returns may be unstable or time-varying. Although this instability issue is important, there are no further studies in the literature to analyze how and why the relationship varies over time.

The instability of the effect of monetary policy on stock prices may be a result of drastic changes in monetary policy. There were many shifts in the U.S. monetary policy in the Federal Reserve history. In different economic periods, policy makers face different economic tasks, therefore, they have to use creative tools and approaches to formulating and implementing monetary policy. This time-varying nature of monetary policy specifies different forms of the relationship between monetary policy and stock market returns over different periods. In addition, sensitivity of stock market returns to economic fundamentals may be different under different economic and political conditions. Given the instability on both sides of the equation, this paper hypothesizes that the functional forms and significance of monetary policy on stock market returns vary over time. The major objectives of this study are to define different measures (functional forms) to quantify the relationship between monetary policy and stock prices, and empirically examine how these different measures change over time in the recent four decades.

2. Measures of monetary policy impact on stock market returns

In order to be consistent with variables used in previous studies of the relationship between monetary policy and stock returns, this study uses the effective federal funds rate (funds rate) and discount rate as proxies of monetary policy. The first measure of monetary policy effect on stock market returns is the sensitivity of current changes in stock prices to current alterations in the funds rate. The correlation is

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