

Security markets and the information content of monetary policy turning points

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Abstract

Substantial evidence shows that a significant relationship exists between Federal Reserve monetary policy signals and subsequent security returns. Recent evidence, however, suggests that Fed rate changes do not signal shifts in monetary policy and therefore have no real policy significance. In this study, we investigate whether certain Fed signals, characterized as turning points in the monetary cycle, have real policy significance. Our evidence suggests that the Fed's signal that a turning point is occurring is unambiguous, predicts a substantial shift in Fed monetary policy, and provides costless and meaningful information about future security market returns.

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There is little doubt that Federal Reserve actions occupy a prominent role in financial market participants' information sets. The relevance of Fed policy actions is evidenced by the numerous studies that have found significant short-term interest rate and security price responses to policy signals (e.g., Smirlock & Yawitz, 1985; Cook & Hahn, 1988; Wagster, 1993). These short-term reactions are generally characterized as stemming from an "announcement effect." The identification of an announcement effect associated with Fed policy actions implies that policy signals convey information to the financial markets that is relevant for security pricing. While one would expect that the information conveyed by a Fed policy signal would relate to future monetary

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policy variables, Thornton (1998a) finds evidence refuting this contention. This evidence raises questions regarding whether signaled changes in Fed policy correspond with actual changes in monetary and reserve aggregates (i.e., are Fed policy signals credible).

Several more recent studies suggest that Fed signals also provide information about subsequent long-term security returns (e.g., Jensen & Johnson, 1995; Patelis, 1997; Thorbecke, 1997; Conover, Jensen, & Johnson, 1999). These studies identify a systematic relationship between long-term stock and bond returns and previous Fed policy changes. Specifically, the studies indicate that security returns are generally higher during periods following an expansive policy signal and are generally lower following a restrictive policy signal. While several studies have confirmed the existence of security return patterns associated with Fed policy signals, the timing of the security return patterns and their relationship with actual changes in monetary policy variables have not been addressed in the literature.

In this study, we consider two issues stemming from the research discussed above: (1) Are Fed policy signals credible and (2) What do the security patterns look like over time, and how do they relate to actual changes in monetary policy variables? By considering these two issues jointly, we provide a clearer indication of the relationship between Fed policy signals, monetary policy measures, and security returns.

Our study extends previous studies in several ways. First, while Thornton (1998a) evaluates movements in monetary aggregates following each change in the discount rate, we focus only on discount rate changes that signal “turning points” in the monetary cycle. Specifically, we argue that rate changes that are in the opposite direction of the previous change (a turning point rate change) signal that the Fed is shifting its policy stance, while rate changes in the same direction as the previous change simply confirm that the then-current policy stance will continue. Thus, we believe it provides a new and alternative view to focus on “turning point” rate changes to determine whether policy signals convey information about future Fed actions.

Second, we evaluate movements in monetary policy variables over both a short-term and a long-term window in order to further assess the relationship between policy signals and subsequent Fed actions. It is conceivable that a decision today by the Fed to adjust its policy stance might lead to observable changes in monetary and reserve aggregates with considerable lag. If this is indeed the case, this could help to explain Thornton’s (1998a) findings of no significant short-term movements in the variables before versus after rate changes.¹

Third, while several previous studies (e.g., Jensen, Mercer, & Johnson, 1996, Booth & Booth, 1997, and Johnson, Buetow, Jensen, & Reilly, 2003) have documented long-term security return patterns following Fed policy signals, these studies have not examined the timing of the return patterns. Thus, it is unclear whether the return patterns result primarily from security prices moving shortly after the Fed announcement or whether the movements are lagged considerably from the timing of the announcement.

Fourth, by examining the return patterns in concert with movements in monetary policy variables, we can determine the degree of correspondence in the two. Specifically, we can determine whether the evidence is consistent with the view that the security return patterns around policy signals result because of Fed induced changes in monetary policy variables. Thus, this is the first study that attempts to provide an explanation for the observed security return patterns around policy changes.

¹ Thornton (1998a) examines movements from minus 5 weeks to plus 5 weeks around rate changes.

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