Fearing the Fed: How wall street reads main street

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1 Research questions

How does the stock market's response to MNAs vary? What is the driver of time-varying sensitivity?

2 Why are the research questions interesting?

• Stock prices respond to MNAs that reveal information about the economy.
• Anecdotal evidence suggests that the response of stock prices to MNAs is time-varying.
  - Good news about the economy is good for cash flows, but sometimes it's bad for discount rates.
  - The relative intensity of the latter affects the intensity of the net effect.
• The evidence of this explanation is lacking.
• The relationship between these two channels and the drivers of their time variation are unclear.

3 What is the paper's contribution?

***(1)* Literature on stock market's time-varying reaction to MNAs**
Previous: Comparing the stock market's reactions in recessions to those in expansions.
This paper: Besides in recessions,there are cyclical sensitivities during the expansion periods.

***(2)* Literature on mechanism of variation in sensitivities to macronews**
Previous: Finding positive risk premia in bond markets for macroeconomic announcements.
- Focusing on a channel by relating market movements to subsequent monetary policy actions.
This paper: The macroeconomic driver of time-varying sensitivity is monetary policy expectations.
- T-varying sensitivities are consistent with varyin expectations of monetary policy responses to macronews.

***(3)* Literature analyzing the relative importance of cash flows versus discount rates**
Previous: Variations in discount rate news account for most of the variation in asset prices.
- Cash flow news plays an important role in generating changes in asset prices.
This paper: The Fed plays a key role in how equity markets interpret news of cash flows and discount rates.

4 What hypotheses are tested in the paper?

H1: The stock market has countercyclical sensitivity to MNAs.
H2: Driving factor for time-varying sensitivity stock returns is monetary policy expectations.

a) Do these hypotheses follow from and answer the research questions?
• The hypotheses in the paper are grounded in economic theory and empirical observations.
Do these hypotheses follow from theory or are they otherwise adequately developed?
• The paper supports hypotheses with a regime-switching model, demonstrating their adequacy and relevance.
• Positive macronews lead the Fed to adopt a tightening monetary policy, offsetting stock valuations rises.
• During periods below trend, stocks have a greater response to macro news due to lower policy responses.

5 Sample: comment on the appropriateness of sample selection procedures.

For robustness, paper considers the Money Market Services real time data on expected U.S. macroeconomic fundamentals to measure MNA surprises. None of the results are affected.

6 Dependent and independent variables: comment on the appropriateness.

The dependent variable (stock returns) and the independent variable (the vector X_t contains various MNA surprises) is relatively straightforward.

7 Regression model specification: comment on the appropriateness.

The main advantage of the regression method in the paper is that it greatly reduces the problem of small sample size by including more data in the estimation of $beta$.

8 What difficulties arise in drawing inferences from the empirical work?

The paper seems to have no control variables or fixed effects added at all, in this case, do some exogenous problems exist?

9 Describe at least one publishable and feasible extension of this research.

Sector-Specific Responses: Investigating how different sectors of the stock market react to macroeconomic news and monetary policy changes.

References

[1] Faust, J., Wright, J., 2018. Risk premia in the 8:30 economy. Q. J. Finance 8, 1850010.

[2] Schorfheide, F., Song, D., Yaron, A., 2018. Identifying long-run risks: A Bayesian mixed-frequency approach. Econometrica 86, 617–654.