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Macro Roundup Article

Headline: The Fed and Risk Premiums

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Tweet: .@JohnHCochrane cites research by @ProfStefanNagel and Serhiy Kozak that almost all of the entire effect of policy-driven interest-rate movements on stock prices comes from riskless rates with no effect on risk premia.

Summary: It’s perfectly natural that lower interest rates lower stock expected returns and raise stock prices. The question is, how much. Is there a “risk premium” [or “reach for yield”] effect in addition to the “interest rate” effect? If the Fed lowers the risk free rate, stock prices do go up. But in the Wall Street view, the risk premium goes down with the risk free rate and stocks go up even more. Not so, says a recent excellent paper, “Movements in Yields, not the Equity Premium: Bernanke-Kuttner Redux” by Stefan Nagel and Zhengyang Xu. The bulk of the stock market reaction in FOMC announcement windows is explained by changes in the default-free term structure of yields, without equity premium effects. The previous famous result on this question, by Bernanke and Kuttner, came to the opposite conclusion. Nagel and Xu explain the difference. By using a VAR, Bernanke, and Kuttner use how all stock price changes represent risk premiums (a lot) and interest rates (not so much) to estimate that decomposition on announcement days. But Fed shocks may be different from the shocks that move asset prices on other days.

Related Articles: Equity Risk Premiums: Determinants, Estimation, and Implications

Primary Topic: Financial Markets

Topics: Financial Markets, GDP, Op-Ed/Blog Post

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