

# What explains the stock market's response to QE policy?

## Evidence from a decomposition of the S&P500 index<sup>\*</sup>

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### Abstract

This paper analyses the effects of Quantitative easing (QE) on the US stock market by decomposing the S&P500 index into two components, its risk-neutral fundamental value, and the equity premium. The causal effects of QE are identified by using an instrumental variable (IV) that is based on high-frequency price revisions of the medium-long end of the yield curve, triggered by Federal Open Market Committee (FOMC) policy announcements. The IV is constructed by controlling for non-monetary shocks using a novel two step approach. Findings from a Structural Vector Autoregression (SVAR) model suggest that a QE policy shock increases the stock index, due to a rise in the risk-neutral fundamental component and a fall in the equity premium component. Both components display persistence, with the equity premium response declining gradually over two years.

**JEL classification:** E52, G12

**Keywords:** Quantitative easing shocks, non-monetary shocks,  
stock prices, equity premium

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# 1 Introduction

Quantitative easing (QE) emerged as a key policy tool for central banks when the policy rate was stuck at the Zero lower bound following the global financial crisis. Its main purpose was to transmit monetary policy to the economy by lowering medium-long term interest rates. Over time, QE has become a standard part of the central bank toolbox, yet relatively little is known about the significance of mechanisms through which it impacts the macroeconomy. In the case of asset prices, the underlying mechanisms of monetary transmission range from the effect of policy on the path of future cash flows, the risk-free rate and equity premium associated with holding risky assets. Are all of these mechanisms relevant for the transmission of QE policy through asset prices? If yes, then which mechanism is more important?

I shed light on these questions by analysing the effect of QE on stock markets, focussing on the dynamic responses of the US S&P500 index and its components. The two components are derived from the fundamental value of the stock index through the asset pricing equation of the present value model. In particular, the first component is the stock index's risk-neutral fundamental component, defined as the sum of discounted dividends at the risk-free rate, that captures the effect of QE via its effect on expected discounted profitability of firms. The second component is the equity premium component, that captures the effect of QE through changes in risk premia by altering the additional return required to invest in riskier assets. The difference between the stock index and the fundamental value is the residual which is a catch-all term consistent with a range of explanations.<sup>1</sup> Evidence from bond markets points to the role played by QE in reducing financial stress by compressing term premia (Gagnon et al., 2011; Krishnamurthy and Vissing-Jorgensen, 2011; Hanson and Stein, 2015; Rogers et al., 2018). I examine the extent to which QE compressed equity premium in the stock market. Theoretically, it is possible that QE affects stock markets only through a change in the risk-neutral fundamental

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<sup>1</sup>For example, it could be mis-pricing due to presence of agents with heterogeneous beliefs (Beckers and Bernoth, 2016) or rational bubbles under risk-neutrality (Galí and Gambetti, 2015). I assume the transversality condition holds, which implies that in the infinite time horizon, the expected discounted value is zero.

component and has no effect on compensation for risk. This has important policy implications for using QE to lower the risk premium during episodes of heightened financial market stress.

The empirical evaluation relies on a Structural Vector Autoregression (SVAR) model that includes standard macroeconomic aggregates along with components of stock prices to gauge their response to a QE policy shock. The identification utilizes an external instrument for the unobserved monetary policy shock, an increasingly popular choice for the identification of shocks in a VAR model.<sup>2</sup> The instrument is constructed using high frequency changes in yields of risk-free futures contracts around monetary policy announcements (Cook and Hahn, 1989; Gürkaynak et al., 2004; Swanson, 2021). One of the assumptions required to identify the impulse responses to a monetary policy shock is that the instrument is correlated *only* with the shock of interest (Stock and Watson, 2018; Miranda-Agrippino and Ricco, 2023). This is because non-zero correlation of the instrument with non-monetary shocks may result in theoretically implausible impact and dynamic responses of macroeconomic variables to a monetary shock. Typically, the monetary literature has focussed on unexpected news about future economic prospects or endogenous responses to past shocks by the central bank (Romer and Romer, 2000; Campbell et al., 2012; Melosi, 2017; Miranda-Agrippino and Ricco, 2021; Nakamura and Steinsson, 2018; Jarociński and Karadi, 2020) and more recently, on risk premium shocks (Cieslak and Schrimpf, 2019; Cieslak and Pang, 2021). For instance, along with an announcement of additional asset purchases, the central bank may reveal private information that deteriorates the risk sentiment of market participants or their beliefs about expected economic conditions, with the latter often referred to as 'information effects'. Hence, I use a two step procedure to construct the instrument prior to using it for identification. First, I test for the presence of information effects, as is standard in the literature. In particular, I regress the change in yields around policy announcements on internal forecasts of the Federal Reserve and obtain its residual. This series contains variation in yield surprises uncorrelated with information effects. Second, I perform a correction for risk premium shocks that zeroes out residual yield surprise

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<sup>2</sup>This approach was popularized by Stock and Watson (2012); Mertens and Ravn (2013); Gertler and Karadi (2015).

of any event where the co-movement between financial market surprise and risk premium surprise is negative. This is in the spirit of the correction used by [Jarociński and Karadi \(2020\)](#) for cleansing information effects from yield surprises. I call the instrument derived from the two step approach as the *information and risk corrected* instrument.

The SVAR model estimates identified using the information and risk corrected instrument show that the two steps taken to eliminate non-monetary shocks from the instrument are crucial for resolving empirical puzzles in the impulse responses (IRFs) of various variables. Based on median IRFs estimated using Bayesian methodology, I find that a QE policy shock increases the growth in S&P500 index by roughly 6% points. In addition, it leads to a persistent increase in dividends, and decline in equity premium up to 12 months. This translates into an increase in the risk-neutral fundamental component by about 12% points and a decline in the equity premium component by about 3.2% points. Hence, the response of the risk-neutral fundamental component is approximately four times larger than the response of the equity premium component. In terms of dynamics, both components display persistence but the equity premium component declines gradually and therefore, the share of equity premium response within stock price response declines gradually roughly twelve months out into the future. This result confirms the Federal Reserve's ability to tackle financial panics, when risk premium is high in financial markets.

In addition to the main results, I also present evidence for the effect of a QE policy shock on risk-neutral fundamental of industry specific Fama-French portfolios. First, I find that QE shocks have a larger impact on stock prices of high tech and health sector with little or no effect on utilities and energy. In addition, the impact on durables is significant while there is no effect on the non-durables sector, which is in line with the fact that monetary policy should have a greater effect on rate sensitive industries of the economy. Second, the risk-neutral fundamental component response is large only for durables and others category. This indicates that technology dominated sectors such as high-tech, telecommunications, and health are potentially impacted more by risk premium than risk-neutral fundamental value of the asset. Hence, the two components are likely to have heterogeneous effects on

various industries.

This paper contributes to the literature on three counts. First, it improves our understanding of the relative importance of the two mechanisms of transmission for QE policy by quantifying the effect of each component. This relates to the literature that examines the effectiveness of monetary policy shocks on the decomposition of stock prices via the asset pricing equation ([Galí and Gambetti, 2015](#); [Beckers and Bernoth, 2016](#); [Jordà et al., 2019](#); [Paul, 2020](#)). The major departure from this literature is that I use the decomposition to analyse the effect of QE policy shocks. Similar to [Beckers and Bernoth \(2016\)](#), I explicitly incorporate the role of equity premium in the decomposition. The theoretical link between monetary policy and risk attitudes has been well documented in the literature ([Borio and Zhu, 2012](#); [Bauer et al., 2023](#); [Kekre and Lenel, 2022](#); [Kashyap and Stein, 2023](#)). This ranges from search for yields, consumption volatility, change in future uncertainty about the economy, heterogeneity in households' marginal propensity to risk, etc. Specific to stocks, equity premium has been shown to be an important channel through which monetary policy shocks impacts stock prices ([Patelis, 1997](#); [Thorbecke, 1997](#); [Bernanke and Kuttner, 2005](#); [Jordà et al., 2019](#); [Ozdagli and Velikov, 2020](#); [Pflueger and Rinaldi, 2022](#)). I add to this strand of the literature by quantifying the importance of equity premium in stock market response to a QE policy shock. In addition, I use an equity premium measure constructed from options data ([Martin, 2017](#)). This provides a lower bound on expected excess returns that are likely to hold tightly in the data and has the advantage that it correctly captures the timing of jumps in equity premium prior to, and during every crisis episode, in particular a higher premium during the dot-com bubble.

Second, this paper shows the relevance of risk correction in construction of the instrument for identifying the effect of a QE policy shock. Many studies use high frequency surprises in yields for constructing an external instrument ([Altavilla et al., 2019](#); [Cesa-Bianchi et al., 2020](#); [Bauer and Swanson, 2023b](#)). Ideally, if a high frequency yield surprise were to result from a monetary policy shock, it should lead to a negative co-movement in stock-yield surprises and a positive co-movement in risk premium-yield surprises. Using daily change in a risk premium measure around

FOMC announcements, I document the existence of events where the co-movement in risk premium-yield surprise is negative even when the co-movement in stock-yield surprises is negative. This surprising finding is the motivation behind a further correction for risk in the yield to construct the external instrument, which is in addition to correction for information shocks. I show that this risk and informationally robust instrument resolves empirical puzzles in output, equity premium and stock index. The risk correction is crucial to identify the equity premium response. Hence, I contribute to the literature by showcasing the presence of risk premium shocks on FOMC event days that are usually classified as an event consistent with monetary policy shocks. I also propose a simple risk correction in the form of a risk-corrected poor man proxy.

Third, a growing literature has examined heterogeneity in the effects of monetary policy on different dimensions such as riskiness, and debt structure ([Bernanke and Kuttner, 2005](#); [Ippolito et al., 2018](#); [Anderson and Cesa-Bianchi, 2020](#); [Gürkaynak et al., 2022](#)). I contribute to this literature by providing empirical evidence of heterogeneity in QE policy effects on industry level risk-neutral fundamental stock value.

The papers closest to this study are [Cieslak and Schrimpf \(2019\)](#), [Beckers and Bernoth \(2016\)](#) and [Jordà et al. \(2019\)](#). [Cieslak and Schrimpf \(2019\)](#) use sign restrictions for identification to decompose asset returns into monetary and non-monetary shocks. In contrast, I demonstrate an alternative identification strategy for examining the impact of monetary policy shocks in the presence of risk premium shock. [Beckers and Bernoth \(2016\)](#) examine the importance of equity premium in the response of the stock index to a monetary policy shock. I diverge from their analysis in two aspects. First, I examine the impact of QE policy shocks in contrast to conventional policy shocks. Second, I construct the measure of equity premium using options data rather than forecasts from a VAR. This has the advantage that one abstracts from the worry of capturing the entire information set of market participants in the VAR model. Finally, [Jordà et al. \(2019\)](#) also study the impact of conventional policy on the decomposition. They use responses of ex-post excess returns to derive the responses of equity premium under the assumption that the impact response of

equity premium to monetary policy shocks is zero. By explicitly incorporating an indicator for equity premium, my results do not require this assumption.

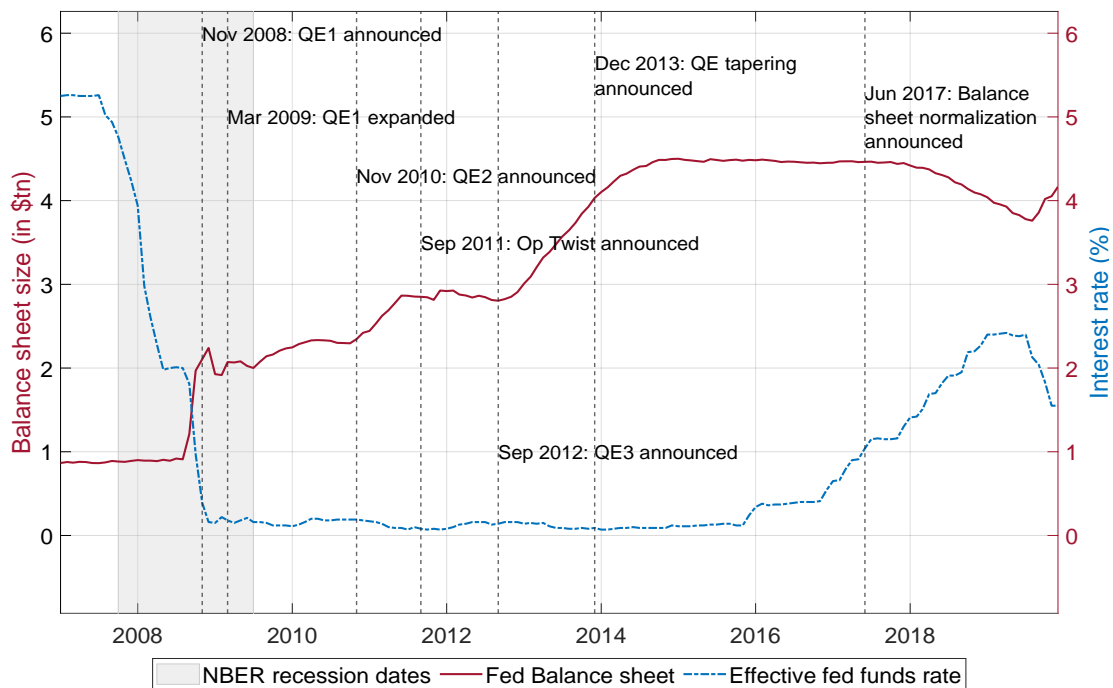
The paper proceeds as follows. Section 2 provides a brief description of quantitative easing programs effected by the Federal Open Market Committee (FOMC). Section 3 defines the components derived from the asset pricing equation and describes computation of their dynamic response to a monetary policy shock. Section 4 provides description of the data and details on the external instrument being used in the SVAR-IV methodology. Section 5 provides details about the estimation method. Section 6 presents the results and its discussion. Section 7 concludes the paper with a summary.

## 2 Quantitative easing in the US

Quantitative easing is an umbrella term used for large scale asset purchases of government sponsored enterprise (GSE) bonds, mortgage backed securities and treasury notes by the US Federal Reserve. It introduced quantitative easing in late 2008 as a response to the spike in financial stress precipitated by the collapse of big lending institutions. Prior to the onset of the financial crisis, the US economy was already experiencing a slowdown since Q3:2007. During such phases of the business cycle, the Federal Reserve typically reduces the Federal Funds rate (FFR) with the aim of lowering the cost of borrowing, thereby supporting consumption and investment. Since 1990, the FOMC cut rates by an average of 580 basis points (bps) during an economic slowdown ([Bernanke, 2016](#)). Since its meeting in September 2007 and up to October 2, 2008, the Federal reserve had already cut FFR by 375 bps. At the onset of the financial crisis in October 2008, the FOMC further slashed the policy rate by 175 basis points (bps) to bring the total reduction to 550 bps, bringing the target rate to 0-25 bps. Although this brought the total decline in FFR very close to the average reduction during recessions, there were two issues particular to this crisis. First, the target range was now at the zero lower bound; any further reduction would take the economy to a negative interest rates environment. [Burke et al. \(2010\)](#) discuss the practical and legal constraints of conducting Fed policy

using conventional tools in this environment. Second, [Joyce et al. \(2012\)](#) argues that the transmission of this decline in rates immediately after the financial crisis did not happen because of the broken link between the policy rate and market interest rates. These considerations underscore the advantages of adopting QE policy that specifically targeted longer maturities of the yield curve, ultimately becoming a crucial policy tool for the Federal Reserve post 2008. Figure 1 plots the time series of assets held by the Federal reserve at monthly frequency from January, 2007 - December, 2019. Over a span of 7 years, these policies quintupled the size of the Fed's balance sheet from roughly \$0.9 tn to about \$4.5 tn in 2014. Interest rates normalization began in late 2015, while QE policy rewind began only in October, 2017. Table 7 in the appendix provides a breakup of the purchases for various asset classes.

Figure 1: Timeline of Fed policy tools since the Global Financial Crisis



**Note:** This figure documents the expansion of Federal Reserve Board's balance sheet as the Federal Funds rate hit the zero lower bound. The sample length is from Jan, 2007-Dec, 2019. Shaded area represents recession periods identified by the NBER's Business cycle dating committee.

The asset purchases were conducted under four distinct rounds beginning with QE1 in November, 2008 and ending with QE3 in October, 2014. The primary goal under each phase ranged from maintaining financial stability in the first phase to explicitly targeting the twin goals of achieving 2% inflation and full employment



in the later phases. I briefly summarize the four phases. The first round, QE1, was a \$1.725tn program that also saw the fastest pace of asset purchases at about \$120bn a month. The aim was to provide a cushion to the economy against the huge shock faced by the financial sector after the collapse of big banks and lenders. It restored functioning in the mortgage market as well as reduced credit spreads in other segments of bond markets. The second round began in November, 2010 with a focus on giving a boost to economic growth and ensuring that inflation increases to the target of 2%. The Maturity Extension Program or Operation Twist was the only sterilized round of QE. The aim was to flatten the treasury yield curve by selling treasury securities with maturity of less than 3 years and purchase an equivalent amount of treasuries with maturities of 6 years to 30 years. The final round of QE, QE3, was initiated because the FOMC was concerned about the slow pace of economic recovery and its consequences for the labour market. In December, 2013, the FOMC provided a glide path to the conclusion of QE in the coming months. It formally concluded bond buying in October, 2014, only after it was satisfied with the pace of economic recovery. Policy rates were lifted for the first time in December, 2015 but the size of the balance sheet remained above \$4 tn for a long time as proceeds from purchases were reinvested in specific asset segments. Balance sheet normalization was announced only in June 2017, after which assets held by the Federal Reserve declined gradually.

### 3 Stock price decomposition

In this section, I describe the decomposition of stock prices and define the formula used for constructing their response to a monetary policy shock. I begin by fixing notation. Let the stock index and its fundamental component be denoted by  $Q_t$  and  $Q_t^F$ . Let the *risk-neutral* part of the components be  $Q_t^{F,RN}$ ,  $R_t$  denote gross returns,  $R_t^f$  as the risk-free rate, equity premium by  $ep_t$  and dividends by  $D_t$ . I define the *fundamental component* as the present discounted value of expected cash flows, i.e., the sum of discounted expected cash flows accrued for holding the stock. This can be seen via the accounting identity of stock returns:

$$Q_t = R_{t+1}^{-1}(Q_{t+1} + D_{t+1}) \quad (1)$$

$$\begin{aligned} \Rightarrow Q_t &= \sum_{k=1}^{\infty} \mathbb{E} \left( \prod_{j=1}^k \left( \frac{1}{R_{t+j}} \right) D_{t+k} + \lim_{k \rightarrow \infty} \frac{Q_{t+k}}{\prod_{k=1}^{\infty} R_{t+k}} \right) \\ \Rightarrow Q_t &= Q_t^F = \sum_{k=1}^{\infty} \mathbb{E} \left( \prod_{j=1}^k \left( \frac{1}{R_{t+j}} \right) D_{t+k} \right) \end{aligned} \quad (2)$$

where the second step follows from a forward iteration of the first equation and applying the expectations operator. The last step follows from the assumption that growth of prices cannot rise faster than growth of returns. This is the standard transversality condition required for  $Q_t$  to be well-defined. The equation shows that any fluctuation in the stock index can be mapped to movements in its expected future dividends and/or the expected return.

Note that the above equation is an accounting identity, has no economic content and holds both ex-ante and ex-post. Note also that it is non-linear and has a long history of being linearised to allow use of linear time series methods following [Campbell and Shiller \(1988\)](#). Letting the lower-case letters denote a variable in log terms, one can derive the linearised version for equation 1 using Taylor expansion around a constant  $\frac{Q}{D} = e^{q-d}$  and write the relationship between stock index and fundamental component in log terms as:

$$q_t = q_t^F \quad (3)$$

$$\begin{aligned} &= c + \sum_{k=1}^{\infty} \rho^{k-1} [(1 - \rho) \mathbb{E}_t d_{t+k} - \mathbb{E}_t r_{t+k}] \\ \Rightarrow q_t &= c + \sum_{k=1}^{\infty} \rho^{k-1} [(1 - \rho) \mathbb{E}_t d_{t+k} - r_{t+k}^f - ep_{t+k}] \\ \Rightarrow q_t &= q_t^{F,RN} - \sum_{k=1}^{\infty} \rho^{k-1} [\mathbb{E}_t ep_{t+k}] \\ \Rightarrow q_t &= q_t^{F,RN} - q_t^{EP} \end{aligned} \quad (4)$$

where  $c = \ln\left(1 + \frac{Q}{D}\right) - \rho(q - d)$ ,  $\lim_{k \rightarrow \infty} \rho^k(q_{t+k}) = 0$  is the log-equivalent of the transversality condition mentioned above and  $\rho = \frac{Q}{Q+D}$ .<sup>3</sup> Here, the second step uses the fact that  $E(r_t) = r_t^f + ep_t$ . The equity premium ( $ep_t$ ) is the additional expected return required to incentivize the agent to hold the stock. In standard asset pricing models, it can be shown to be the product of the quantity of risk and price of risk. The price of risk is common across asset classes. In the third step, I begin defining the components that I use to present results. I define the *risk-neutral fundamental component* as the present discounted value of expected (log) cash flows discounted at the risk-free rate. The *equity premium component* is the geometric sum of expected equity premium. Equation (4) states that any increase in  $q_t$  reflects either an increase in the risk-neutral fundamental component through change in  $d_{t+k}$  or a lower  $r_{t+k}^f$ , and/or lower equity premium component through changes in  $ep_{t+k}$ .

### 3.1 Construction of dynamic response of asset prices

To examine the dynamic response of asset prices and its components to a monetary shock  $\varepsilon_t^m$ , I take the derivative of the log-linearised version of equation (3) at time  $(t + j)$ :

$$\begin{aligned}
\frac{\partial q_{t+j}}{\partial \varepsilon_t^m} &= \frac{\partial q_{t+j}^F}{\partial \varepsilon_t^m} \\
\Rightarrow \frac{\partial q_{t+j}}{\partial \varepsilon_t^m} &= \frac{\partial q_{t+j}^{F,RN}}{\partial \varepsilon_t^m} - \sum_{k=1}^{\infty} \rho^{k-1} \frac{\partial ep_{t+k+j}}{\partial \varepsilon_t^m} \\
\Rightarrow \frac{\partial q_{t+j}}{\partial \varepsilon_t^m} &= \frac{\partial q_{t+j}^{F,RN}}{\partial \varepsilon_t^m} - \frac{\partial q_{t+j}^{EP}}{\partial \varepsilon_t^m}
\end{aligned} \tag{5}$$

where  $\varepsilon_t^m$  is the monetary policy shock. This equation shows that a monetary policy shock impacts stock prices through two mechanisms. First, through its effect on the risk-neutral fundamental component via the effect on expected dividends

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<sup>3</sup>According to Cochrane (2005),  $\frac{Q}{D} \sim 25$  in historical US data. In the sample I use, this ratio is much higher at  $\frac{Q}{D} \sim 50$ . Hence, I set  $\rho = 0.98$  in empirical analysis of this paper.

by altering the future profitability of the asset and direct effect on the discount rate. Second, through the effect on future equity premium. Technically, the effect of monetary policy shocks on equity premium is ambiguous because it leads to a change in both the expected returns as well as the risk-free rate in the same direction. However, a burgeoning literature shows that there is a positive link between monetary policy shocks and riskiness, theoretically (Borio and Zhu, 2012; Cieslak and Schrimpf, 2019; Caballero and Simsek, 2022; Kekre and Lenel, 2022) as well as empirically (Bernanke and Kuttner, 2005; Hanson and Stein, 2015; Jordà et al., 2019; Cieslak and Pang, 2021; Pflueger and Rinaldi, 2022; Bauer et al., 2023). Moreover, QE policy is less likely to encounter a countervailing force in the form of changing risk-free rates since the latter was stuck at the zero lower bound and remained low even after lift-off in 2015. Therefore, I expect a positive effect of QE policy shock on equity premium and the equity premium component.

## 4 Empirical strategy

In keeping with the objectives of the study, the VAR includes variables that allow construction of structural impulse response functions of each component in equation (5). I utilize the S&P500 index as an indicator for the stock market ( $Q_t$ ). To proxy for the cash-flow of stock, I use dividends ( $D_t$ ) sourced from Shiller’s website. I convert dividends and stock index into real terms by dividing the series by the Personal Consumption Expenditure (PCE) price index, as is standard in the literature. For the risk-free rate ( $r_t^f$ ), I use the Federal funds rate. The measure of equity premium ( $ep_t$ ) is constructed using options data for the S&P500 index, as described in Martin (2017). Appendix D contains a description of the steps used to construct this measure. Relative to other alternatives, it has the advantage that it correctly captures every episode of a spike in premium in the market, especially during the dot-com bubble. Other alternatives do not capture the spike during the dot-com bubble as well and are relatively slower in capturing shifts in risk sentiment. Apart from these variables, a mix of macro-aggregates and financial indicators are included to control for the economic environment. This includes standard variables such as industrial

production ( $Y_t$ ) and aggregate price ( $P_t$ ). I use the excess bond premium ( $ebp_t$ ) as a measure of financial conditions. In particular, it captures market sentiment about US corporate credit risk (Gilchrist and Zakrajšek, 2012). Finally, the ten year rate is the long-term rate ( $i_t^l$ ) included to be a monetary indicator for QE policy. A long-term rate is a better indicator for QE policy relative to a medium-term rate (for instance, one or two year rate) because it shifted the weighted average maturity duration of Federal Reserve holdings from about 1.5 years in October, 2008 to roughly 8 years in December, 2019.<sup>4</sup> Data for industries is sourced from Kenneth French’s website. The dataset contains returns on 10 industry portfolios with and without dividends. The broad 10 industry classification includes non-durables, durables, manufacturing, energy, hi-tech, telecom, retail, health, utilities and others.<sup>5</sup> Since returns are available both with and without dividends, it can be used to obtain series on real prices and real dividends for each industry as described in Hodrick (1992). Other details on the variables and their data source is given in Table 6.

The dynamic response of a monetary shock is computed using a vector autoregression (VAR) model at monthly frequency. The estimation of the VAR model is done using Bayesian methodology and I impose a standard Normal Inverse Wishart (NIW) prior Litterman (1986); Kadiyala and Karlsson (1997) with optimal hyperparameter selection approach of Giannone et al. (2015). The idea implements the belief that each variable in the system is well approximated by a random walk model with drift. The prior help in incorporating a greater number of variables and lags relative to the frequentist approach. This is especially useful since a small number of variables in the VAR or an inappropriate number of lags may pose an issue for correctly capturing dynamics of the system. Define the vector  $x_t = [y_t, p_t, i_t^l, ebp_t, \Delta q_t, r_t^f, \Delta d_t, ep_t]^l$  and let the structural model be of the following form:

$$Ax_t = B_0 + \sum_{i=1}^k B_i x_{t-i} + \varepsilon_t, \quad \varepsilon_t \sim N(0, \Sigma_\varepsilon) \quad (6)$$

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<sup>4</sup>Source: Federal Reserve Board

<sup>5</sup>The classification uses Standard Industry Classification (SIC) codes to construct the portfolios. Details of the groups are available [here](#) The others category includes diverse industries, so it is difficult to identify some characteristics specific to this grouping.

where  $B_i$  is a  $(8 \times 8)$  matrix of coefficients and  $\varepsilon$  is the  $(8 \times 1)$  vector of uncorrelated structural shocks. The reduced form can be derived under the assumptions of invertibility:

$$x_t = C_0 + \sum_{i=1}^k C_i x_{t-i} + u_t, \quad u_t \sim N(0, \Sigma_u) \quad (7)$$

where  $C_i = A^{-1}B_i$  and  $u_t = A^{-1}\varepsilon_t$ . The posterior median IRFs and confidence bands are generated based on the Gibbs sampling procedure with 2000 draws and 20% burn-in period. The impulse responses to structural shocks are computed as per the Vector Moving Average (VMA) representation:

$$\begin{aligned} x_t &= \mathbf{D}(\mathbf{L})\varepsilon \\ &= \sum_{i=0}^k D_i \varepsilon_{t-i} \end{aligned} \quad (8)$$

where  $\mathbf{D}(\mathbf{L}) = [\mathbf{I} - \mathbf{C}(\mathbf{L})]^{-1}A^{-1}$ .

The variables included in the VAR model ensure that I observe the stock index and both components. The theoretical dynamic responses of components in equation (5) are infinite sums and require an approximation. I therefore use an approximation of the infinite sum with 10 years of responses.<sup>6</sup>

## 4.1 External instrument

The residuals from a VAR model are a linear combination of structural shocks. Hence, it is vital to identify the structural shock of interest for examining dynamic responses. I utilize the external instrument approach for identifying the monetary

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<sup>6</sup>The results are robust to using a higher number of months for approximating the infinite sum.

policy shock, popularized by [Gertler and Karadi \(2015\)](#) in the monetary literature. The QE policy shock is the structural shock associated with the long-term interest rate. Any external instrument,  $z_t$ , must satisfy two assumptions in order to identify a shock of interest  $\varepsilon_t^m$  ([Stock and Watson, 2012](#)):

$$\mathbb{E}(\varepsilon_t^m . z_t) \neq 0 \quad (9)$$

$$\mathbb{E}(\varepsilon_t^m . z_t) = 0 \quad (10)$$

The first assumption is instrument relevance - the instrument must be contemporaneously correlated with the structural shock. The second assumption relates to instrument exogeneity - the instrument must be contemporaneously uncorrelated with other structural shocks. Violation of the second condition will imply that the dynamic responses of variables included in the VAR capture the combined effect of shocks rather than the causal effect of the shock of interest. Details of the operational steps of the methodology are provided in appendix E. The above assumptions assume invertibility of the structural moving average ([Stock and Watson, 2018](#)).<sup>7</sup> Since I am only interested in examining the response of a single shock, an assumption milder than full invertibility can be used to obtain the shock of interest. [Miranda-Agrippino and Ricco \(2023\)](#) formalize a condition that combines with equations (9-10) for recovering structural shocks in an SVAR-IV framework under partial invertibility:

$$\mathbb{E}(\varepsilon_{t-j}^{m,NI} . z_t) = 0 \quad \forall j \neq 0 \text{ for which } \mathbb{E}(\varepsilon_{t-j}^{m,NI} . u_t^I) \neq 0 \quad (11)$$

where  $\varepsilon_{t-j}^{m,NI}$  are non-invertible shocks respectively. This ‘limited lead-lag exogeneity condition’ states that any valid instrument must be uncorrelated with past and future non-invertible shocks while allowing for the possibility of the instrument to be correlated with the leads and lags of invertible shocks.

The instrument used in this paper is sourced from [Swanson \(2021\)](#). The paper estimates 3 factors from surprises in contracts of Fed Funds Futures, Eurodollar

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<sup>7</sup>This is equivalent to stating that all structural shocks can be written as a linear combination of VAR residuals.

futures and Treasury yields at different maturities<sup>8</sup> around monetary announcements of the Federal Reserve. These contracts contain expectations about the policy rate and are a popular source of obtaining exogenous variation in monetary policy. I utilize the Large Scale Asset Purchases (LSAP) factor, renamed the QE factor in this paper, that loads heavily on the five year and ten year treasury yields as these maturities are most likely to be affected by QE policy.

A potential issue with using instruments based on such contracts is that during the event window, they may also be affected by non-monetary shocks that originate from the policy decision and the summarized description of economic conditions described in the press announcement. This is because when a central bank communicates its policy decision, it reveals not only the monetary policy decision, but also reveals its beliefs about the expected future state of the economy. The financial contracts price in all this information, which violates assumption 10 required to identify the causal effects of the QE policy shock. Two important non-monetary shocks have been previously discussed in the literature. First, market participants' adjustment of expectations about economic fundamentals based on the FOMC's comments about the expected path of the economy, popularly known as information effects ([Romer and Romer, 2000](#); [Campbell et al., 2012](#); [Melosi, 2017](#)).<sup>9</sup> Second, risk premium shocks that may play an important role in movement of yields at the medium-long end of the yield curve. Here, I define risk premium shocks as an exogenous shift in the price of risk and independent of exogenous changes in economic fundamentals ([Cieslak and Schrimpf, 2019](#)). Note that one of the mechanisms through which unconventional policies operate is the risk premium channel. Hence, mere presence of non-zero premium changes is not an issue. It is the correlation of the instrument with risk premium shocks that can confound the causal effect of monetary policy shocks.

To think more about the effect of non-monetary shocks on the instrument, let's begin by summarizing the expected signs of shocks on changes, or surprises, in yields,

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<sup>8</sup>In particular, the contracts include 1-month and 3-months federal funds futures, 2-, 3- and 4-months Eurodollar futures, and as 2-, 5- and 10-year Treasury yields.

<sup>9</sup>[Bauer and Swanson \(2023a\)](#) have shown this effect to be consistent with revelation of the Federal Reserve's response to publicly available news with a stronger response to incoming macro news during some periods in the business cycle. Controlling for publicly available information can account for this "response to news effect" ([Bauer and Swanson, 2023b](#)).



stock price and risk premium around monetary policy announcements. Table 1 contains all the expected signs. A QE policy shock is likely to reduce yields due to portfolio rebalancing (Krishnamurthy and Vissing-Jorgensen, 2011) between risky and non-risky assets, owing to existence of imperfect substitutability (Vayanos and Vila, 2021). Stock prices increase due to higher expected future cash flows as a result of expected revival in economic growth. The risk premium is expected to decline, as discussed in section 3. Negative information shocks are likely to lower yields if the effect on lower expected cash flows is greater than the effect on lower expected real interest rate as a result of potential monetary easing. Similarly, stock price responses to pessimistic information is negative. Negative information causes a rise in risk premium because it raises the expected return required to hold the asset. Finally, risk premium shocks lower yields due to flight to safety, decreases stock prices and increase risk premium.

Table 1: Expected effect of shocks on market surprises

	$\Delta$ Yield	$\Delta$ Stock price	$\Delta$ Risk premium
Quantitative easing shock ( $\varepsilon_t^m \downarrow$ )	$\downarrow$	$\uparrow$	$\downarrow$
Negative growth shock ( $\varepsilon_t^g \downarrow$ )	$\downarrow$	$\downarrow$	$\uparrow$
Positive risk premium shock ( $\varepsilon_t^{rp} \uparrow$ )	$\downarrow$	$\downarrow$	$\uparrow$

**Note:** This table shows the expected signs on surprises in yield of a long-term bond, stock prices and risk premium in an event window around monetary policy decisions to a monetary policy shock  $\varepsilon_t^m$ , growth shock  $\varepsilon_t^g$  and risk premium shock  $\varepsilon_t^{rp}$ .

The table provides three key messages: first, monetary policy shocks lead to a negative link between stock and yield surprises, and a positive link between risk premium and yield surprises. Second, positive information shocks and negative risk premium shocks both induce a positive co-movement between stocks and yields, and a negative link between risk premium and yields. Third, the three series of market surprises provide two sets of co-movements to examine whether the market reaction is consistent with a monetary policy shock or a non-monetary shock. If only a single shock were to emanate from the FOMC announcement, associating the yield surprise of any particular event with either a monetary policy shock or a non-monetary shock requires an examination of *only* one of the two sets of available co-movements. In conjunction with yield surprises, either stock surprises or risk premium surprises

may be used. Indeed, [Jarociński and Karadi \(2020\)](#) use the co-movement between stocks and yields surprises to identify the causal effect of policy shocks. The idea of inspecting three market surprise series becomes useful in situations where a combination of shocks materialize on the same FOMC announcement day. On such event days, two market surprises may not provide enough information to correctly associate the event with a monetary policy or non-monetary shock; they may reveal only a partial picture of the combination of shocks. I illustrate below the extent to which this happened since the beginning of the QE period.

Table 2 reports data for FOMC events associated with the ten biggest surprises in the LSAP factor. Column (1) contains data on the LSAP factor as a measure of yield surprises while columns (2-3) contain measures of market surprises in stock market and risk premium. These measures are high frequency changes in the S&P 500 index sourced from [Bauer et al. \(2023\)](#) and a measure of daily changes in risk premium respectively. The latter is a variant of the risk appetite index in [Bauer et al. \(2023\)](#) and I use the first principal component of nine indicators on volatility and credit spreads. A positive value reflects an increase in risk premium on any given day as the indicators load positively on indicators of credit spread and volatility. The index's units are in standard deviation from the mean. Details of loadings of various indicators are in appendix G. Column (4) specifies the type of shock that one would associate with the FOMC event based *only* on the stock-yield co-movement - a distinction between monetary shock and non-monetary shock. A negative co-movement points towards a monetary policy shock while a positive co-movement implies either an info shock or a risk premium shock. Column (5) uses surprises in risk premium to verify this classification by using two co-movements among the three market surprises. The idea is that if it is indeed an event associated with a particular policy shock, it should result in a co-movement between surprises in risk premium and yields that is consistent with expected signs in Table 1. Instead, I find that many of the events that are initially associated with a particular shock based on the stock-yield co-movement, are inconsistent with the risk-yield co-movement. This points towards presence of a combination of shocks. In fact, there were 29 FOMC event days (out of 85) during 2009-19 where the stock-yield co-movement is negative along with a negative risk-yield co-movement.

Table 2: Classification of 10 largest LSAP events into a monetary or a non-monetary shock

date	LSAP factor	S&P500	Risk premium	stock-yield	risk-stock-yield
18/03/2009	-5.63	1.75	3.77	MPS	N
24/06/2009	0.80	-0.58	-1.11	MPS	N
03/11/2010	0.81	-0.39	-0.96	MPS	N
21/09/2011	-1.29	-0.19	-0.23	Info/RP	N
13/09/2012	1.01	0.60	-0.72	Info/RP	Y
20/03/2013	0.77	0.10	-0.35	Info/RP	Y
19/06/2013	1.96	-0.04	-0.39	MPS	N
18/09/2013	-2.55	1.16	0.17	MPS	N
18/03/2015	-0.77	1.51	0.81	MPS	N
29/04/2015	0.87	0.15	0.34	Info/RP	N

**Note:** This table determines the classification of events with biggest surprises in the LSAP factor into monetary policy and non-monetary shocks. Column (4) uses the stock-yield co-movement for this purpose. Column (5) uses additional information from changes in risk premium to verify this classification. In some cases, the classification in column (4) is incorrect.

Y: yes; N: no

MPS: Monetary policy shock; Info: Information shock; RP: Risk premium shock

Table 3 presents details from the press statement of a few FOMC events listed above where additional narrative evidence points towards the pricing of non-monetary shocks by market participants. For instance, in March 2009, the [FOMC](#) expanded the QE-I program by \$1.15 tn, which was an unexpected positive surprise. However, it also stressed on a bleak economic environment for the current and next year, which may have led to negative information effects or a risk-off sentiment in the market. The expansionary unexpected policy announcement along with a positive risk premium shock is a plausible explanation for these market movements. In June 2009, the [FOMC](#) noted the slowing pace of economic contraction and stabilization of financial conditions. The risk premium index shows improvement in risk sentiment and the risk-stock-yield co-movement is consistent with combination of monetary and non-monetary shocks. Note that these shifts in risk sentiment are unrelated to a shift in monetary policy regime because the monetary policy stance was accommodative since September 2008.

To summarize, market surprises in yields are potentially correlated with monetary, information, and risk premium shocks. Combining information in yield surprises with surprises in stocks and risk premium helps assess the dominance of monetary or non-monetary shocks during that event. Either stock or risk premium surprises should be enough to disentangle the two types of shocks. However, during some

events, stocks and risk premium surprises move in directions that cannot be explained by a single shock. In fact, risk premium surprises show existence of events which are initially associated with monetary shocks based on stock-yield co-movement but are in fact consistent with correlation of the instrument with a combination of monetary policy and non-monetary shocks based on stock-risk-yield co-movement.

Table 3: Events with presence of non-monetary shocks

Dates	Combination of shocks		FOMC statement
	MPS	Non-MPS	
March 2009	↓	↓	Discusses deteriorating economic situation during the global financial crisis. QE-I expanded.
June 2009	↑	↑	Discusses signs of stabilization in HH spending and inventories.
Nov 2010	↑	↑	Discusses slow pace of economic recovery. QE-II announced.
<b>Note:</b> ↓ Non-MPS could be either a negative information shock or a positive risk premium shock			

The likely correlation of the LSAP factor with non-monetary shocks poses a challenge for using it as an external instrument as it violates the assumption of instrument exogeneity (equation 10). It implies that the structural dynamic responses to the monetary policy shock estimated in the VAR may be biased as any decrease in the LSAP factor either reflects an expansionary monetary policy shock, a positive information shock or a negative risk premium shock. If it is driven by a combination of the two types of shocks, then it is possible that we will not be able to recover the causal effect of monetary policy shocks by simply accounting for one type of non-monetary shock. For instance, the response of the stock index will be a combination of the positive effect of the expansionary shock and the negative effect of non-monetary shocks. Hence, the estimated effect may be incorrect in both direction and magnitude.

I derive an information and risk corrected instrument with a two step procedure that accounts for the potential correlation of the LSAP factor with information and risk premium shocks. In the first step, I account for information effects. The literature uses either market based (Jarociński and Karadi, 2020) or survey based approaches (Romer and Romer, 2000; Miranda-Agrippino and Ricco, 2018). The survey based approach controls for information content in the LSAP factor using a regression

while the market based approach uses negative co-movement in stock-yield surprises. I use the survey based approach because it allows retention of more information relative to the market based approach. Nonetheless, I use the market based approach in a robustness exercise. For the regression, I utilize data from Greenbook<sup>10</sup> of the Federal Reserve Board of Governors. These are internal forecasts prepared by the Federal Reserve staff. While the data is available to the members of FOMC one week prior to the policy announcement, it is released to the public only after a lag of 5 years. Hence, these forecasts reflect the information set of the central bank which the market tries to extrapolate after the policy decision is announced. The dataset includes fixed event quarter on quarter projections (in annualized percentage points) for 15 macroeconomic macro aggregates. The major aggregates include measures of output, inflation and unemployment. The projections trace the expected path of these measures up to 9 quarters ahead. I begin by aligning the forecasts data with every FOMC meeting. For every meeting, the market surprises are regressed on the latest greenbook data available to the FOMC according to the following equation:

$$y_m = \alpha_0 + \sum_{j=-1}^k \alpha_j F_m x_{q+j} + \sum_{j=-1}^k \beta_j [F_m x_{q+j} - F_{m-1} x_{q+j}] + \nu_m \quad (12)$$

where  $k = 3$  is the maximum horizon,  $y_m \in \{\text{LSAP factor}, \Delta \text{ risk premium}\}$ ,  $x \in \{\text{Real GDP, Real deflator, unemployment rate}\}$  is a vector of forecast data from the Fed's Greenbook. The backcast of variables is also included in the regression in order to control for the real-time prevailing conditions that is likely to impact the decision making of the FOMC (Romer and Romer, 2004). The residual,  $\nu_m$ , contains variation in  $y_m$  that is exogenous to the central bank's private information on forecasts. Hence, the residual of the regression is the information corrected version of  $y_m$ . Note that it is not desirable to control for risk premium shocks using risk premium surprises and including it in the same regression as used to control for information effects. This requires that surprises in risk premium are not impacted by monetary policy shocks.

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<sup>10</sup>The Greenbook is part of the Tealbook since January, 2010. The data is sourced from the Philadelphia Fed's Tealbook Data Set.

However, this assumption on risk premium surprise is highly likely to fail in the data. A detailed discussion about these assumptions is provided in appendix [F](#).

In the second step, I control for potential correlation between the LSAP factor and risk premium shocks. I use only that variation in the residual where the co-movement between informationally robust instrument and informationally robust risk premium surprises is negative. I call this the information and risk corrected instrument. Note that an informationally robust version of risk premium measure is used ([Reichlin et al., 2022](#)), instead of the raw series, in order to isolate variation in risk premium that is independent of information shocks. This ensures that in the second step, the focus is only on removing risk premium shocks.

## 5 Results

### 5.1 Instrument with information and risk-correction

I begin with discussing the presence of information content in the LSAP factor. The regressors include the Greenbook’s quarter on quarter forecasts and revisions of real GDP, GDP deflator and unemployment rate. Since all forecasts and revisions are highly correlated and it is difficult to pinpoint the source of explanatory power from the regression, I estimate additional regressions that contain a subset of variables that are based on a specific group characteristic, such as a particular variable type, forecast type or specific horizons. Table [4](#) displays these results. The sample period is from November, 2008-December, 2017 since this is the last data vintage available from the Philadelphia Federal Reserve. The parentheses below coefficients contain the Newey-West heteroskedasticity and autocorrelation corrected standard errors with a possible autocorrelation structure of up to one lag.

Starting with column (1) that includes forecasts and revisions only related to GDP growth as regressors, the GDP block’s null of no significance is rejected at 1% level. Column (2) contains results from the inflation block and it is significant at 5% level. Column (3) suggests that news about unemployment rate does not have

Table 4: Information effects in the LSAP factor

Column	1	2	3	4	5	6	7	8	9	10	11
GDP growth <sub>t-1</sub>	-0.01 (-0.19)			-0.01 (-0.15)		0.07 (0.71)					0.05 (0.45)
GDP growth <sub>t</sub>	0.17 (1.22)			0.23* (1.70)			0.21* (1.94)				0.16 (0.79)
GDP growth <sub>t+1</sub>	-0.02 (-0.06)			-0.35 (-1.63)				0.14 (0.76)			0.21 (0.51)
GDP growth <sub>t+2</sub>	-0.25 (-0.70)			0.08 (0.22)					0.31 (1.52)		-0.09 (-0.21)
GDP growth <sub>t+3</sub>	0.38** (2.14)			1.04** (2.56)						0.48*** (2.73)	-0.06 (-0.19)
ΔGDP growth <sub>t-1</sub>	-0.03 (-0.18)				-0.00 (-0.01)	0.05 (0.30)					-0.04 (-0.20)
ΔGDP growth <sub>t</sub>	-0.31 (-1.53)				-0.11 (-0.69)		-0.04 (-0.27)				-0.12 (-0.40)
ΔGDP growth <sub>t+1</sub>	0.03 (0.06)				0.18 (0.89)			0.19 (0.73)			0.09 (0.19)
ΔGDP growth <sub>t+2</sub>	0.52 (1.22)				0.24 (0.81)				1.13*** (3.25)		0.42 (0.84)
ΔGDP growth <sub>t+3</sub>	0.90** (2.40)				1.12** (2.49)					1.33*** (4.72)	1.16** (2.56)
Deflator <sub>t-1</sub>		0.07 (0.72)		0.14 (1.02)		0.16 (1.04)					0.11 (1.12)
Deflator <sub>t</sub>		-0.12 (-0.81)		-0.14 (-0.97)			-0.00 (-0.01)				0.13 (0.85)
Deflator <sub>t+1</sub>		-0.06 (-0.17)		0.25 (1.35)				0.02 (0.08)			0.09 (0.31)
Deflator <sub>t+2</sub>		-0.21 (-0.92)		0.34 (1.14)					0.43 (1.57)		-0.18 (-0.53)
Deflator <sub>t+3</sub>		0.22 (0.48)		0.14 (0.55)						0.21 (0.71)	-0.52 (-1.32)
Δ Deflator <sub>t-1</sub>		0.54 (1.25)			0.21 (0.71)	0.41 (0.96)					-0.10 (-0.34)
Δ Deflator <sub>t</sub>		-0.43 (-1.54)			-0.22 (-1.35)		-0.66* (-1.82)				-0.41 (-1.61)
Δ Deflator <sub>t+1</sub>		0.00 (0.00)			-0.00 (-0.02)			0.39 (0.51)			-0.17 (-0.53)
Δ Deflator <sub>t+2</sub>		0.67 (1.26)			0.03 (0.08)				-0.37 (-1.00)		-0.19 (-0.44)
Δ Deflator <sub>t+3</sub>		0.73* (1.81)			0.42 (0.98)					-0.01 (-0.04)	0.09 (0.17)
Unemp <sub>t-1</sub>			0.62 (0.68)	-0.66 (-1.45)		0.05 (1.35)					
Unemp <sub>t</sub>			1.45 (0.75)	1.77 (1.37)			0.02 (0.56)				-0.02 (-0.26)
Unemp <sub>t+1</sub>			-3.77 (-1.58)	-3.49** (-2.01)				-0.02 (-0.24)			
Unemp <sub>t+2</sub>			2.73 (0.98)	0.79 (0.33)					0.03 (0.89)		
Unemp <sub>t+3</sub>			-0.94 (-0.67)	1.52 (0.84)						-0.02 (-0.38)	
Δ Unemp <sub>t-1</sub>			1.20 (0.90)		0.68 (0.54)	2.44 (1.28)					1.70 (1.33)
Δ Unemp <sub>t</sub>			-1.49 (-0.75)		0.14 (0.15)		0.62 (1.19)				-0.47 (-0.50)
Δ Unemp <sub>t+1</sub>			6.80 (1.57)		-0.85 (-0.56)			0.48 (0.93)			0.85 (0.50)
Δ Unemp <sub>t+2</sub>			-1.37 (-0.52)		-1.46 (-0.67)				0.96** (2.10)		-0.73 (-0.37)
Δ Unemp <sub>t+3</sub>			-3.24 (-1.63)		2.00 (1.10)					0.58* (1.93)	1.23 (0.75)
Constant	-0.68** (-2.22)	0.16 (0.38)	-0.70 (-1.56)	-3.00** (-2.13)	0.00 (0.03)	-0.68 (-1.34)	-0.52 (-1.29)	-0.25 (-0.54)	-1.66* (-1.74)	-1.51 (-1.57)	0.25 (0.19)
Observations	73	73	73	73	73	73	73	73	73	73	73
F-test	4.69	2.11	0.99	0.96	3.50	0.51	1.00	0.96	3.03	6.67	3.99
Prob>F	0	0.04	0.46	0.51	0	0.80	0.43	0.46	0.01	0	0

**Note:** This table reports results for regression of LSAP factor in (Swanson, 2021) on Greenbook forecasts and revisions. Each column represents a different specification of regressors. Sample length is Nov, 2008-Dec, 2017. \*p<0.1, \*\*p<0.05, \*\*\*p<0.01. Standard errors in parentheses.

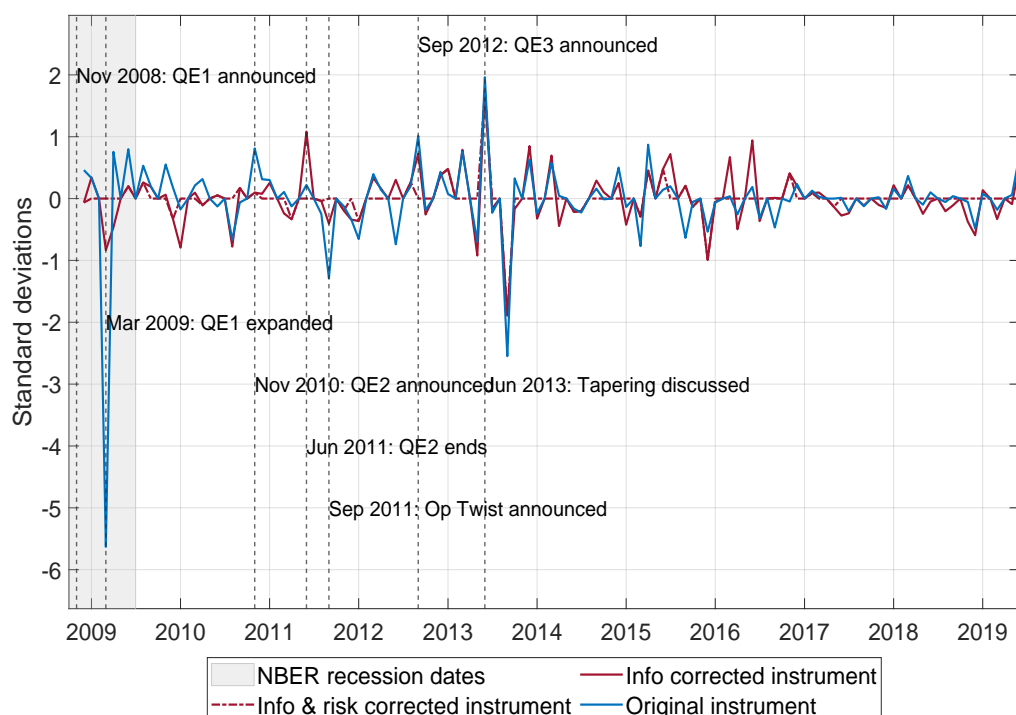
any significant impact on the factor. Columns (4) shows that projections of GDP and unemployment are significant predictors of the LSAP factor but they are not jointly significant even at 10% level. The specification on revisions in column (5) displays joint significance at 1% level and largely driven by GDP revisions in the 3 quarters ahead forecast. Turning to specifications at different horizons, variables at longer horizons from  $h = 2$  and  $h = 3$  are jointly significant at 5% level and 1% level respectively. Finally, the last column contains all variables in the regression and the F-test is rejected at 1% level of significance. These results confirm the presence of information effects around FOMC announcements in the medium and long term maturity of the yield curve.

Based on these regressions, I conclude that the market's reaction to Fed announcements contains inference about future economic fundamentals, in particular on the central bank's assessment of future economic growth and to a lesser extent, the inflation rate. In contrast, forecasts and revisions in price level seem to have little significance in the above results. A potential reason behind this might be that inflation was benign during most of this period and was not of much concern to the market. Instead, it focussed more on receiving a signal about the state of economic growth in the coming quarters. To control for these effects, I utilize the regression specification of column (11) to obtain the residual or the information corrected instrument. This is the first step in constructing the external instrument. Although the regression is at meeting frequency, converting it to monthly frequency has no consequence since each month has a single meeting only. I replace the missing values with a zero for any months during which no meeting took place.

Figure 2 shows the impact of this step by comparing the time series plots of the LSAP factor along with the information corrected instrument. Some of the dates coincide with announcements about QE. For example, March, 2009 had the biggest impact on long term bond yields. It is plausible that the FOMC announcement of a \$1.15tn expansion of the QE1 program led to this decline. It committed to additional purchases of GSE and MBS and added treasury securities to the purchase program. However, it also painted a grim picture of the economic outlook in its [statement](#). The lower value of the residual relative to the LSAP factor suggests



Figure 2: Time series plot of informationally robust LSAP factor



**Note:** This figure plots the time series of the LSAP factor (in orange) along with it's informationally robust variant (in yellow), obtained as the residual from estimating regression equation (12).

that this may have also played a role in the big decline in the factor and this is corrected by the regression. A similar story may have played out in September 2011, when the Federal reserve [announced](#) details of Operation Twist alongside concerns about “elevated” unemployment rate and slow pace of economic recovery. Another interesting episode is from November 2010, when the FOMC [announced](#) expansion of securities holdings and the LSAP factor registered a positive value. Since the average duration of additional purchases was about 5-6 years and only 6% of new purchases were in treasuries with maturities equal or greater than 10 years, treasuries at the longer end of the yield curve witnessed a sell-off. But the value of the residual declines to near zero since Greenbook data shows an improvement in real GDP growth in the coming year. The regression removes this positive information effect from the LSAP factor. Finally, in June 2011, the FOMC [announced](#) the end of QE2. Despite noting a slower than anticipated pace of economic recovery, the FOMC did not commit to any further stimulus. This may have led to a rise in yields at the long end of the yield curve. The negative sentiment about pace of growth in the statement was matched with downward revisions of growth projections in the

greenbook forecasts. The regression removes this effect and leads to an even higher positive magnitude for the residual than the LSAP factor. Figure 2 also contains the information and risk-corrected instrument which is used as an external instrument in the VAR exercise. It mirrors the information corrected instrument except for dates where the co-movement between the information corrected instrument and information corrected risk premium surprises suggests that financial markets reacted to shifts in risk sentiment. As described in section 4.1, this may have been the case on several announcement dates such as March 2009, June 2009, etc.

Following Forni and Gambetti (2014), I also test for information sufficiency of the instrument using 7 factors estimated from the FRED-MD database. These factors represent state variables in the economy and are interpreted on the basis of the incremental explanatory power of the factors for various time series in the database (McCracken and Ng, 2016). The results are presented in Table 5 and show that none of the factors granger cause the information and risk corrected instrument.<sup>11</sup>

Table 5: Granger causality test of information and risk corrected instrument

Excluded	$\chi^2$ statistic	DF	p-value
Factor 1	0.08	2	0.95
Factor 2	0.44	2	0.80
Factor 3	2.89	2	0.24
Factor 4	0.84	2	0.65
Factor 5	3.78	2	0.15
Factor 6	1.64	2	0.44
Factor 7	0.69	2	0.71
All	6.78	14	0.94

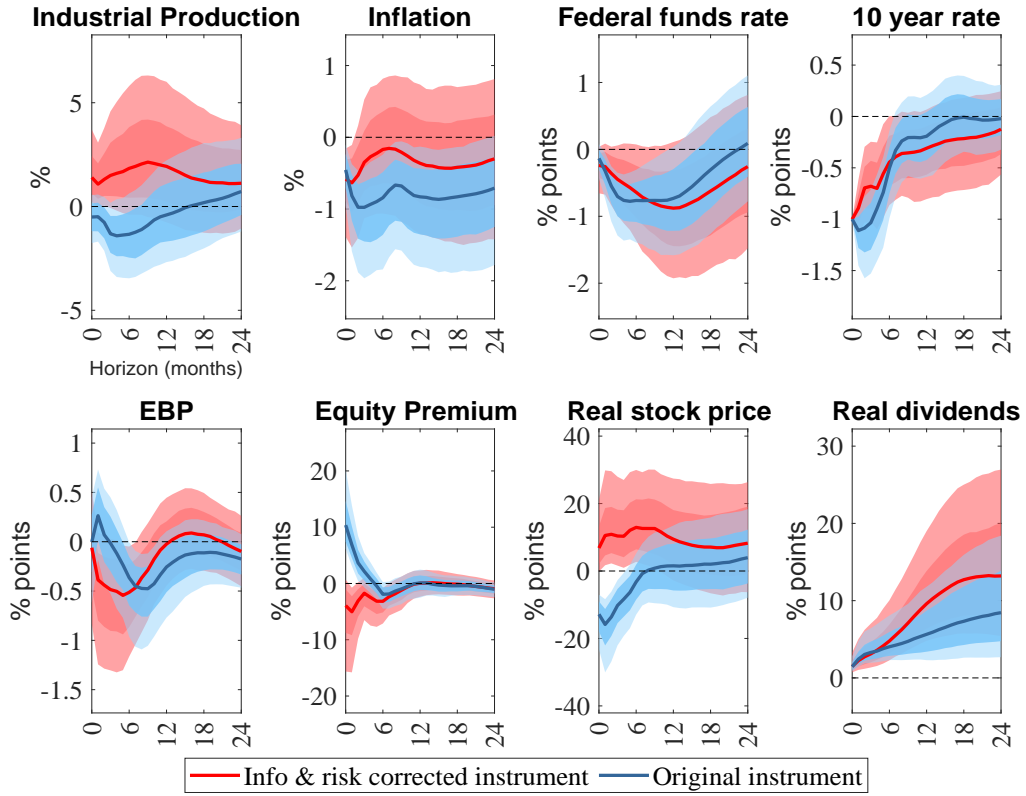
**Note:** Each row reports the  $\chi^2$  statistic, degrees of freedom and p-value of a hypothesis test that the variable in the first column does not granger cause the information and risk corrected instrument.

<sup>11</sup>In contrast, some factors do granger cause the original LSAP factor. Results available on request.

## 5.2 VAR results with information and risk-corrected instrument

The estimation sample length is from Jan. 1996 to Dec, 2019, ending just prior to the start of the pandemic. The median responses are plotted along with confidence bands where dark shaded bands indicate 68% bands while light shaded bands indicate 90% bands. I begin with results for variables included in the VAR and show the importance of disentangling monetary policy shocks from non-monetary shocks in the instrument series. I then discuss results for responses of the decomposed stock price components.

Figure 3: IRFs for Quantitative Easing policy shock



**Note:** Impulse responses to a Quantitative easing policy shock using information and risk-corrected instrument (solid red), and LSAP factor (solid blue). Responses of real stock price and real dividends are in terms of growth. The shock is normalised to induce a 1% decrease in the 10 year rate. Sample: 1996:1-2019:12. Dark and light shaded areas represent 68% and 90% posterior coverage bands respectively.

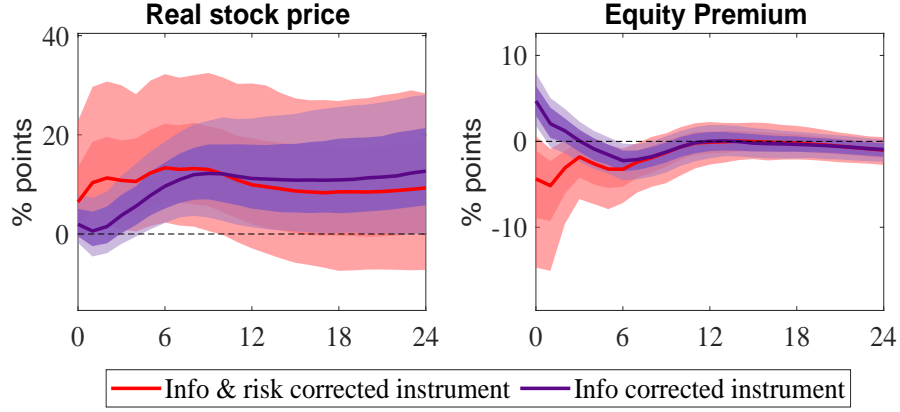
The response of variables in the VAR to a 100 bps expansionary QE shock are in Figure 3. Each sub-plot includes structural impulse responses estimated by using

the information and risk corrected instrument (in red) along with those estimated using the original instrument (in blue). The IRFs from using the original instrument contain several empirical puzzles for industrial production, inflation, stock index, excess bond premium and equity premium. In contrast, results with the information and risk-corrected instrument are largely free from these puzzles. In particular, responses of industrial production, stock index, excess bond premium and equity premium are *in the expected direction after the information and risk correction* in the instrument. Focussing only on responses with this instrument now, output response increases by 1% on impact and is weakly significant for roughly six months. The risk-free rate response is near-zero on impact and the hump shaped dynamic response probably reflects dynamics from the period prior to the global financial crisis. The excess bond premium decreases in the short run suggesting some easing of financial conditions in the bond market. The equity premium decreases by about 4% points (annualized) on impact and declines over 12 months. Real stock index growth increases by about 6% points with a peak effect of about 12% points in the first six months. Real dividends also register a persistent increase with a peak of roughly 13% points at the end of eighteen months.

My findings on the importance of information and risk correction in the IV for obtaining causal effects of QE policy shocks complements recent work on using the LSAP factor as an external instrument. [Miranda-Agrippino and Ricco \(2023\)](#) suggest that the correlation of the instrument with contemporaneous shocks may have lead to confounding estimates for impact responses of macro variables. [Swanson \(2023\)](#) finds that a correction in the factor for publicly available economic and financial news improves identification for financial variables but there are still puzzles in output and prices. I show the importance of controlling for risk premium shocks in eliminating empirical puzzles in estimated effects of QE policy shocks. [Figure 4](#) highlights this by plotting the IRFs for the stock index and equity premium using two different instruments: the information and risk corrected instrument (in red), i.e., the instrument that uses both steps and an instrument that *only* corrects for information shocks (in purple). The impact response and subsequent dynamics for equity premium are positive in response to an expansionary shock when the instrument is corrected for only information effects. In addition, the response of

stock price is stronger after risk correction. Hence, the use of both steps is crucial to correctly quantify the impact of QE policy shock of stock index and equity premium. This becomes relevant while quantifying the decomposition of the stock index.

Figure 4: Importance of risk correction in constructing the instrument

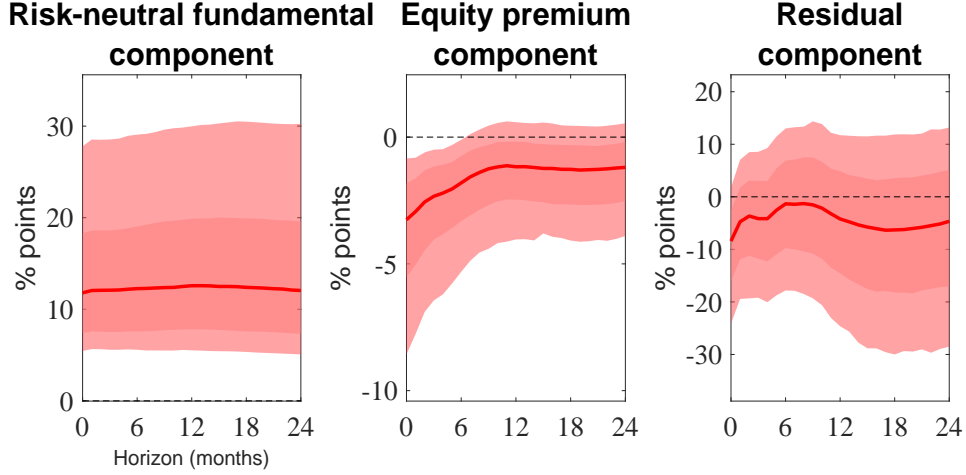


**Note:** Impulse responses to a Quantitative easing policy shock using information and risk-corrected instrument (solid red), and information corrected instrument (solid purple). Horizontal axis indicates horizon (months). Responses of real stock price are in terms of growth. The shock is normalised to induce a 1% decrease in the 10 year rate. Sample: 1996:1-2019:12. Dark and light shaded areas represent 68% and 90% posterior coverage bands respectively.

I now turn to the dynamic response of the two components based on equation 5. The sub-plot on the left side in Figure 5 shows that the risk-neutral fundamental value increases by about 12% points and is persistent for more than 2 years. The sub-plot in the center shows that the equity premium component decreases by about 3.2% points (monthly) on impact and declines gradually towards 1% point within one year. Hence, throughout the two year period, the risk-neutral fundamental component remains the dominant mechanism through which QE policy impacted the S&P500 index. Finally, the sub-plot on the right side shows the response of the difference between stock price and its fundamental value, i.e., the sum of responses of the risk-neutral fundamental component and the equity premium component. One explanation for this residual may be that it captures mis-pricing of the stock index, potentially due to presence of heterogeneity in market participants' beliefs about stocks in financial markets. Based on estimates of the two components, I find that the dynamic response of the median residual component is negative but insignificant.

The above results provide three important takeaways: first, the importance of information and risk correction in the original instrument to identify the causal effect

Figure 5: Results from decomposition of stock index



**Note:** Impulse response of components of stock index to a Quantitative easing policy shock using information and risk-corrected instrument. The left hand sub-plot shows the response of risk-neutral fundamental component. The central sub-plot shows the response of the EP component. The right hand side sub-plot shows the difference between the response of stock index and the sum of responses of risk-neutral fundamental and EP component. The shock is normalised to induce a 1% decrease in the 10 year rate. Sample: 1996:1-2019:12. Dark and light shaded areas represent 68% and 90% posterior coverage bands respectively.

of QE policy shocks on the stock index and its components; *without the two-step correction*, an expansionary QE policy shock results in a negative response in the stock price and a positive response of equity premium to an expansionary shock. Further, the second step of risk correction in the instrument is crucial to obtain the causal effect of equity premium and stock index in response to QE policy shocks. Second, both components are important for transmission of monetary policy but the risk-neutral fundamental component plays a larger role in response of the stock index. It moves the stock market four times more relative to the risk-neutral fundamental component. Third, both components have persistent effects over a period of two years with the relative importance of equity premium declining gradually over time.

### 5.3 Heterogeneous effects of monetary policy shocks

This subsection presents evidence for the effect of QE policy shock on risk-neutral fundamental of industry specific Fama-French portfolios. Industry specific data on stock price and dividends replace the aggregate stock index and corresponding dividends in the VAR model to obtain industry specific impulse responses to the QE

policy shock.

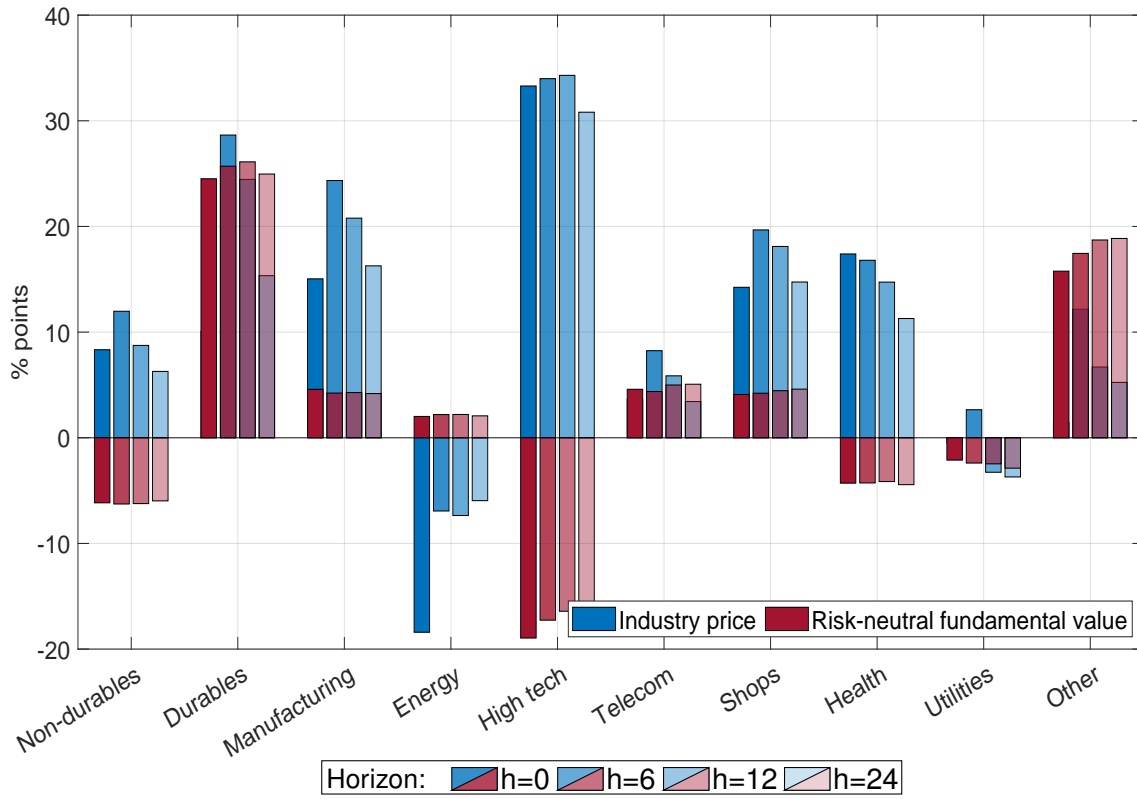
Results for response of the industry level stock index and the risk-neutral fundamental value are in Figure 6. It contains responses from impact to two years for a select number of horizons. Greater fading intensity reflects more distant horizons. I begin with responses of the industry level stock index, given in blue. QE policy shocks exerted a large effect on stock prices in seven out of ten industry groups. The high tech and health sector have the largest effect followed by manufacturing, durables and retail. Non-durables, energy and utilities either have a small effect or they are insignificant. On impact, the increase among industries is in a wide range of 0-15%. In addition, industries also differ in persistence of the effect, although the responses are within a narrower range as horizons increase. Next, I discuss the risk-neutral fundamental component response in red. The response of this component is large only for durables and others. Note that the others grouping includes finance, so this result might be due to the interest sensitive nature of durables and finance industries. In terms of persistence, the effects on all industries are relatively more persistent than the effect on the aggregate. The smaller effect of QE policy shocks on risk-neutral fundamental component of other industries indicates that, perhaps, tech dominated sectors such as high tech, health and telecom are impacted more by the risk premium mechanism than cash flows.

There are two key takeaways from these results. First, there is a high degree of heterogeneity in the response of industry groups to monetary policy shocks. Second, heterogeneity exists not only at the aggregate level but also at the component level. In particular, only durables and others' industries report a big increase in risk-neutral fundamental value. This opens the possibility that equity premium plays a key role in movement of majority of industries. In addition, all industries differ in persistence of the effects of QE policy shocks.

## 5.4 Robustness checks

I verify the robustness of results on several fronts. The results are in appendix H. First, I verify that dynamic responses are qualitatively similar if I use the 5 year and

Figure 6: Industry level IRFs for Quantitative Easing policy shocks



**Note:** Industry level impulse responses of industry level stock index (in blue) and its corresponding risk-neutral fundamental value (in red) to a Quantitative easing policy shock using information and risk-corrected instrument at select horizons ( $h = 0, 6, 12, 24$  months). Increased fading intensity reflects more distant horizons. The shock is normalised to induce a 1% decrease in the 10 year rate. Sample: 1996:1-2019:12.

10 year rate surprises as instruments instead of the LSAP factor. Figure 8 shows that dynamic responses with the 5 year and 10 year surprises as instruments are affected by the same empirical puzzles. This suggests that this issue is more general than with a single instrument. Second, I verify that IRFs are qualitatively similar to an alternate construction of the two step procedure for correction. In particular, I use the market-based approach in place of the survey based approach for the first step, as followed by [Miranda-Agrippino and Nenova \(2022\)](#) for analysing the international transmission of US QE policy. In the first step, I zero out all those dates where the surprises in stocks and yields co-move negatively ([Jarociński and Karadi, 2020](#)). The second step is the same, i.e., I zero out dates where the co-movement between LSAP factor and surprises in risk premium is negative. I find that results are similar to the main result in Figure 3. Second, I check if results are sensitive to alternative monetary policy indicators. This is because it might be possible that monetary policy



may not be an important factor at a maturity as long as 10 years. The alternative is to use the 5 year treasury yield. Again, the VAR results from using the 5 year rate are similar to those from the 10 year rate. Third, I verify that the results are qualitatively similar for a sample starting after the dot-com bubble, i.e., November, 2001-December, 2019. Fourth, I verify my results using an alternate methodology as the F-statistic of the instrument is low. This was also reported in the literature by [Miranda-Agrippino and Ricco \(2023\)](#); [Swanson \(2023\)](#). Hence, I re-estimate my results by using sign restrictions approach for identification. The two restrictions are first, a QE policy shock should lead to negative co-movement in stock index surprises and LSAP factor, and second, a non-monetary shock should lead to positive co-movement in stock index surprises and LSAP factor. The results in [Figure 12](#) of the appendix shows that sieving out non-monetary shocks from the LSAP factor is important for correctly estimating the causal effect of monetary policy shock on equity premium.

## 6 Conclusion

Quantitative easing (QE) played a pivotal role for central banks during the global financial crisis, serving as a means to transmit monetary policy when the economy was stuck at the zero lower bound. Empirical evidence supports its effectiveness on the stock market, but it is unclear which mechanism is more relevant for the transmission of monetary policy. This paper fills this gap in the literature by examining the relevance of both mechanisms within the same framework.

I utilize the standard asset pricing equation to break down the fundamental value of the S&P500 index into two components: the risk-neutral fundamental component and the equity premium component. The former represents discounted dividends at the risk-free rate, while the latter signifies the extra return required for riskier assets. This decomposition allows for an evaluation of the share of the stock market response attributed to these two components.

Empirical analysis employs a VAR model encompassing macroeconomic aggregates

and stock price components. For the identification of a QE policy shock, I use a two step procedure to construct an information and risk-corrected external instrument. This ensures separation of monetary policy shocks from non-monetary shocks, which is an important assumption for the use of external instruments.

The results indicate that QE policy shocks increase the risk-neutral fundamental component although this impact is heterogeneous across industries. The response of the equity premium component is negative and its share in the stock price response declines gradually over 12 months. The response of the risk-neutral fundamental component is approximately four times larger than the response of the equity premium component. Both components exhibit persistence and highlights the role of both components in transmitting monetary policy through the equity market.

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## A Appendix

## B Tables

Table 6: Data Sources of variables included in the VAR model

Variable	Series	Symbol	Logs	Random Walk	Source
Output	Index of industrial production	$ip_t$	•	•	FRED
Prices	PCE price index	$p_t$	•	•	FRED
Risk-free rate	Fed Funds Rate	$r_t^f$			FRED
Long-term rate	End-of-month GS10	$r_t^L$		•	FRED
Credit risk	Excess bond premium	$ebp_t$			<a href="#">Favara et al. (2016)</a>
Stock index <sup>1</sup>	S&P 500 stock index	$q_t$	•	•	Robert Shiller
Dividends <sup>1</sup>	S&P 500 index dividends	$d_t$	•	•	Robert Shiller
Equity premium	Equity premium lower bound <sup>2</sup>	$ep_t$			OptionMetrics, FRED
Industry portfolios					
Stock index	Author <sup>3</sup>	$q_t^i$	•	•	Kenneth French
Dividends	Author <sup>3</sup>	$d_t^i$	•	•	Kenneth French

<sup>1</sup> Stock price and dividends are log-differenced after deflating by the PCE price index.

<sup>2</sup> Construction follows Martin (2017)

<sup>3</sup> Construction follows Hodrick (1992)

Table 7: Details of asset purchases under different QE phases

Name	Duration	Asset class	Purchases (in \$bn)
QE1	11:2008-03:2010	Agency	175
		MBS	1250
		Long-term treasury	300
QE2	11:2010-06:2011	Long-term treasury	600
Operation Twist <sup>1</sup>	09:2011-12:2012	Long-term treasury	667
		Short-term treasury	-667
QE3	09:2012-10:2014	Long-term treasury	770
		Agency	823

Source: FRB of New York

<sup>1</sup> The aim of this programme was to change the composition of the Fed balance sheet towards long-term assets, hence the name operation twist.

## C Asset pricing equation in the Present Value Model

This section provides detailed steps for various equations described in [section 3](#).

Let  $R_t$  denote gross returns (equivalent to gross returns on the risk-free bond ( $R_t^f$ ) under the assumption of risk neutrality) and  $D_t$  be dividends at time  $t$ . Start with the identity:

$$\begin{aligned}
 1 &= R_{t+1}^{-1} R_{t+1} \\
 \implies 1 &= R_{t+1}^{-1} \left[ \frac{Q_{t+1} + D_{t+1}}{Q_t} \right] \\
 \implies Q_t &= R_{t+1}^{-1} [Q_{t+1} + D_{t+1}] \\
 \implies Q_t &= \sum_{k=1}^{\infty} \left( \prod_{j=1}^k \left( \frac{1}{R_{t+j}} \right) \right) D_{t+k} + \lim_{k \rightarrow \infty} \frac{Q_{t+k}}{\prod_{j=1}^k \left( \frac{1}{R_{t+j}} \right)} \\
 \implies Q_t^F &= \sum_{k=1}^{\infty} \left( \prod_{j=1}^k \left( \frac{1}{R_{t+j}} \right) \right) D_{t+k} \tag{13}
 \end{aligned}$$

The above equation is non-linear and has a long history of it being linearised to allow use of linear time series methods. Starting again from the identity, [Campbell and Shiller \(1988\)](#) shows how to derive this:

$$\begin{aligned}
 \frac{Q_t}{D_t} &= R_{t+1}^{-1} \left[ 1 + \frac{Q_{t+1}}{D_{t+1}} \right] \frac{D_{t+1}}{D_t} \\
 \implies q_t - d_t &= -r_{t+1} + \Delta d_{t+1} + \ln(1 + e^{q_{t+1} - d_{t+1}})
 \end{aligned}$$

where the lower-case letters denote the variable in log terms. Using Taylor expansion around a constant  $\frac{Q}{D} = e^{q-d}$ ,

$$\begin{aligned}
q_t - d_t &= -r_{t+1} + \Delta d_{t+1} + k + \rho(q_{t+1} - d_{t+1}) \\
\implies q_t &= (1 - \rho)d_{t+1} - r_{t+1} + k + \rho(q_{t+1}) \\
\implies q_t &= c + \lim_{n \rightarrow \infty} \rho^n q_{t+n} + \sum_{k=1}^{\infty} \rho^{k-1} [(1 - \rho)d_{t+k} - r_{t+k}]
\end{aligned} \tag{14}$$

$$\text{where } c = \ln\left(1 + \frac{Q}{D}\right) - \rho(q - d) \text{ and } \rho = \frac{Q}{Q+D}$$

Note that  $\rho$  can also be written in terms of the price-dividend ratio of the asset. According to [Cochrane \(2005\)](#), this ratio averages about 25. Hence,  $\rho$  should be close to 1. Under the standard assumption of no bubbles ( $\lim_{n \rightarrow \infty} \rho^n(q_{t+n}) = 0$ ), the above can be written as:

$$\begin{aligned}
q_t &= const + \sum_{k=1}^{\infty} \rho^{k-1} [(1 - \rho)E_t d_{t+k} - E_t r_{t+k}] \\
\implies q_t &= const + \sum_{k=1}^{\infty} \rho^{k-1} [(1 - \rho)E_t d_{t+k} - E_t(r_{t+k}^f + ep_{t+k})] \\
\implies q_t &= const + q_t^{F,RN} - \sum_{k=1}^{\infty} \rho^{k-1} ep_{t+k} \\
\implies q_t &= const + q_t^{F,RN} - q_t^{EP}
\end{aligned}$$

The above equation shows that any fluctuation in the asset price is driven by its risk-neutral fundamental value and equity premium.

## D Construction of equity premium lower bound using options data

The lower bound on equity premium is constructed using options contracts on the S&P500 index. Options contracts are akin to futures contracts but with the difference that it gives a right to the holder whether to proceed with the transaction at the agreed date. There are two types of contracts - a call option and a put option. The call option gives the right to the holder to buy the underlying asset at an agreed date and at an agreed price, also commonly known as strike price ( $K$ ). The put option has the same features but gives the holder the right to sell the asset. In exchange for this right, the holder pays a premium ( $P$ ) to the seller.

The equity premium for the stock index can be described by the following relation:

$$E_t R_T - R_{f,t} = \frac{var_t^* R_T}{R_{f,t}} - cov_t(M_T R_T, R_T) \quad (15)$$

where

$R_T$  = stock returns

$R_{f,t}$  = risk-free rate

$M_T$  = SDF

where  $*$  denotes the risk-neutral measure. [Martin \(2017\)](#) provides a couple of insights about equity premium using this equation. The first term on the right hand side is directly observable using options data and the risk-free rate. The second term on the right side is likely to be negative and hence, we can derive a lower bound for the equity premium measure.

The first term can be expanded to see how to obtain the measure using options data:

$$\frac{1}{R_{f,t}} var^* R_T = \frac{1}{S_t^2} \left[ \frac{1}{R_{f,t}} (E_t^* S_T^2) - \frac{1}{R_{f,t}} (E^* S_T)^2 \right] \quad (16)$$

where  $S$  is the stock price. Note that the second term can be found by using the forward price at time  $t$  ( $F_{t,T} = E_t^* S_T$ ). This uses the condition that  $F_{t,T}$  can be found as the  $x^*$  that solves  $call_{t,T}(x) = put_{t,T}(x)$ . Evaluating the first term requires obtaining the price of the squared contract. This can be achieved using prices of call options:

$$\frac{1}{R_{f,t}} E_t^* S_T^2 = 2 \int_0^\infty \frac{1}{R_{f,t}} E_t^* \max\{0, S_T - K\} dK \quad (17)$$

$$= 2 \int_0^\infty call_{t,T}(K) dK \quad (18)$$

Since In the money (ITM) call options are generally illiquid <sup>12</sup>, [Martin \(2017\)](#) uses the put call parity formula <sup>13</sup> to replace a range of call options with Out the Money (OTM) put options,

$$\frac{1}{R_{f,t}} var^* R_T = \frac{2}{S_t^2} \left[ \int_0^{F_{t,T}} put_{t,T}(K) dK + \int_{F_{t,T}}^\infty call_{t,T}(K) dK \right] \quad (19)$$

Now, the expression uses only OTM options to estimate the risk-neutral variance of returns at time  $T$ . Since a continuum of strike prices is not available in the data, a discrete version of this expression is used. Finally, it can be shown that:

$$\frac{1}{R_{f,t}} var^* R_T = (T - t) \times SVIX_{t \rightarrow T}^2 \quad (20)$$

$$\text{where } SVIX_{t \rightarrow T}^2 = \frac{2}{(T - t) R_{f,t} S_T^2} \left[ \int_0^{F_{t,T}} put_{t,T}(K) dK + \int_{F_{t,T}}^\infty call_{t,T}(K) dK \right] \quad (21)$$

$$= \frac{1}{T - t} var^* \left( \frac{R_T}{R_{f,t}} \right) \quad (22)$$

---

<sup>12</sup>If the market price is greater than the strike price, the investor is more likely to hold the option than sell it in the secondary market

<sup>13</sup>This formula suggests that the return from buying a call option is equal to return from a put option and buying the actual asset

where  $SVIX$  is a measure of the annualized risk-neutral variance of the realized excess return from  $t$  to  $T$ . Note that this formula requires fixing of a duration. Dividing LHS by  $(T - t)$  gives the *per period* expected equity premium. In terms of the inequality, we therefore have the following lower bound:

$$\frac{1}{T-t}(E_t R_T - R_{f,t}) \geq R_{f,t} \cdot SVIX_{t \rightarrow T}^2 \quad (23)$$

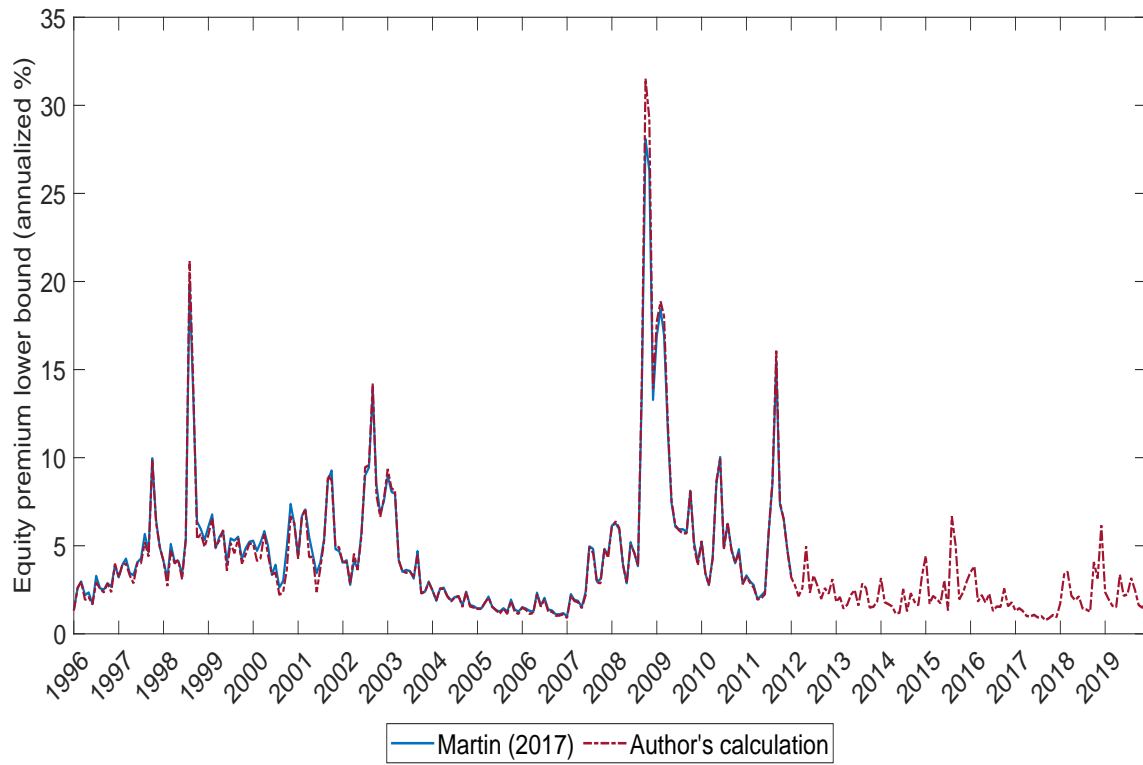
The OptionMetrics dataset includes the type of options contract, its expiration date, its forward price, strike price and closing price of the index. The following steps describe the construction for the period January 4, 1996- December 31, 2019:

1. Delete all options contracts with the following characteristic:
  - (a) Highest closing bid of 0.
  - (b) Quarterly option contracts since they are relatively less liquid.
  - (c) Date to expiry is more than 550 days.
2. For all the options with non-zero value, construct mid price as the average of bid price and ask price.
3. Calculate the sum over discrete strike prices for each date-expiry date-strike price combination:

The above expression provides a value for every date-expiry date combination.
4. Calculate the constant maturity premium for 30 days using linear interpolation.
5. The final numbers are annualized and the unit of measure is percentage points.

I utilized the above listed steps to extend the 30 day constant maturity equity premium lower bound series in [Martin \(2017\)](#) from 2012 up to 2019. I first compute the series for the same sample period (1996m1-2012m1) and visually compare them. Figure 7 shows that the two series are remarkably similar. There is one exception - the peak of the series during the financial crisis from my code is higher. In terms of numbers, the annualized average for both the series is about 5% and the correlation coefficient between them is 0.99.

Figure 7: Time series of lower bound of equity premium at 1 month horizon



**Note:** This figure plots the time-series of the lower bound on expected equity premium constructed using [Martin \(2017\)](#) (in blue) along with the same measure available with the original paper (in maroon) for the period Jan 4, 1996-Jan 1, 2012. The sample length was chosen to match the original paper's dataset. The two time series are remarkably similar, with a correlation coefficient of 0.99.

## E External instrument approach

The identification requires exclusion restrictions on the contemporaneous relationships between variables in the model. The model has an instrumental variable interpretation in the sense that linear combinations of innovations act as an IV for identifying structural parameters (Stock and Watson, 2012). However, contemporaneous restrictions can be considered subjective. In this paper, I instead follow the “external” instruments approach (developed by Stock and Watson, 2008 and [Mertens and Ravn \(2013\)](#)). It utilizes information from outside the VAR model to create instrumental variables. Suppose the relationship between structural shocks ( $\varepsilon_t$ ) and the reduced form innovations ( $u_t$ ) is given by  $\varepsilon_t = A_0 u_t$  where  $A_0$  represents these contemporaneous relationships. Assuming that the shock of interest is ordered first, estimation of the monetary policy shock is done in three steps:-

1. Estimate the VAR model and obtain the residuals ( $\hat{u}_t$ ).
2. In order to obtain elements of the column of the matrix ( $A_0^{-1}$ ), say  $a_1$ , regress  $\hat{u}_t$  on  $z_t$ .
3. Take the ratio of regression coefficients obtained from step 2 with the coefficient  $a_{11}$ .
4. Choose a normalization.

In order to transmit a unit shock in the system, I normalize such that  $a_{11}=1$ . Under these assumptions, the shock can be identified up to a scale by regressing the instrument on each innovation series.



## F Instrument in presence of risk premium shocks

In this section, I discuss the assumptions required to eliminate risk premium shocks using a regression based approach. The idea is to isolate the variation in financial market surprises,  $\Delta f_t$ , that is attributed only to monetary policy shocks. Typically, these changes are measured for futures contracts that capture interest rate expectations. A popular method following (Romer and Romer, 2000; Miranda-Agrippino and Ricco, 2021) is to first isolate the variation in market surprises due to information effects via OLS and then use the residual as the instrument. To follow this approach for eliminating risk premium shocks, suppose I have a daily measure of risk premium. Think of the two market surprises as being generated due to 3 types of exogenous IID shocks  $\varepsilon_t^j \sim \mathcal{N}(0, 1)$ ,  $j$  - monetary policy shock ( $m$ ), growth shock ( $g$ ) and risk premium shock ( $rp$ ):

$$\Delta f_t = \alpha_1^i \varepsilon_t^m + \alpha_2^i \varepsilon_t^g + \alpha_3^i \varepsilon_t^{rp} \quad (24)$$

$$\Delta rp_t = \alpha_1^{rp} \varepsilon_t^m + \alpha_2^{rp} \varepsilon_t^g + \alpha_3^{rp} \varepsilon_t^{rp} \quad (25)$$

where  $\alpha_k^j$  is the impact of shock  $j$  on surprise in  $k$ . If we could isolate the variation in  $\Delta f_t$  which is only due to monetary policy shocks, then it would be a good candidate for use as an external instrument in the VAR. Suppose we estimate the following regression equation:

$$\Delta f_t = b_0 + b_1 \Delta rp_t + \epsilon_t \quad (26)$$

Then, the parameter  $b_1$  captures the variation in  $f_t$  that is explained by risk premium surprises. The OLS estimate can be shown to be a function of the parameters in the equations (24) and (25) above:

$$\begin{aligned}
\hat{b}_1 &= \frac{cov(\Delta f_t, \Delta rp_t)}{var(\Delta rp_t)} \\
&= \frac{\overbrace{\alpha_1^i \alpha_1^{rp}}^+ var(\varepsilon_t^m) + \overbrace{\alpha_2^i \alpha_2^{rp}}^- var(\varepsilon_t^g) + \overbrace{\alpha_3^i \alpha_3^{rp}}^- var(\varepsilon_t^{rp})}{(\alpha_1^{rp})^2 var(\varepsilon_t^m) + (\alpha_2^{rp})^2 var(\varepsilon_t^g) + (\alpha_3^{rp})^2 var(\varepsilon_t^{rp})}
\end{aligned}$$

where the sign on top of the brace is the expected sign of the product of  $\alpha_k^j$ . The denominator is positive, so the sign of the coefficient depends on the numerator's product terms associated with each shock. If we assume that risk premium surprises do not respond to monetary and growth shocks, i.e.,  $\alpha_1^{rp} = \alpha_2^{rp} = 0$ , then we can further obtain:

$$\begin{aligned}
\hat{b}_1 &= \frac{\alpha_3^i \alpha_3^{rp} var(\varepsilon_t^{rp})}{(\alpha_3^{rp})^2 var(\varepsilon_t^{rp})} \\
&= \frac{\alpha_3^i}{\alpha_3^{rp}}
\end{aligned}$$

For the sake of convenience, I normalize it to 1. The coefficient estimate  $\hat{b}_1$  isolates the variation in  $f_t$  due to risk premium shock  $\varepsilon_t^{rp}$ . I expect that a positive risk premium shock (or equivalently, a negative risk appetite shock) will decrease the LSAP factor. A residual  $\hat{\varepsilon}_t$  obtained by estimating equation (26) could be used as an external instrument for identifying the monetary policy shock. However, the assumptions required to obtain such an instrument are extremely strong. For this reason, using a market surprise series for risk premium is unlikely to isolate variation in  $\Delta f_t$  *only* due to risk premium shocks.

## G Loadings on risk premium measure from PCA

The measure of risk premium index is based on nine financial market indicators whose common co-movement captures changes in risk premium (Bauer et al., 2023). All financial indicators enter the PCA in daily changes of their respective units. The common sample length is Jan 03, 2003-May 15, 2020. The loadings of the first principal components used to construct the risk premium measure are presented in Table 8 below.

Table 8: PCA loadings

Variable	Index loading	Unexplained
ICE BofA US high yield OAS index	0.46	0.29
ICE BofA US corporate OAS index	0.44	0.35
Moody's Baa corporate bond spread	0.33	0.62
3 month commercial paper spread	0.20	0.87
J.P. Morgan EMBI diversified sovereign spread	0.43	0.38
Bloomberg OAS for US fixed rate MBS index	0.15	0.92
ICE BofA MOVE index	0.26	0.77
S&P500 volatility index	0.32	0.66
CBOE 10-Year treasury note volatility futures index	0.28	0.72

**Note:** This table reports the loadings from principal components analysis of nine variables that reflect credit spreads and volatilities in financial markets. OAS denotes to Options Adjusted Spread, MBS denotes mortgage backed securities, and MOVE denotes Merrill Lynch Option Volatility Estimate.

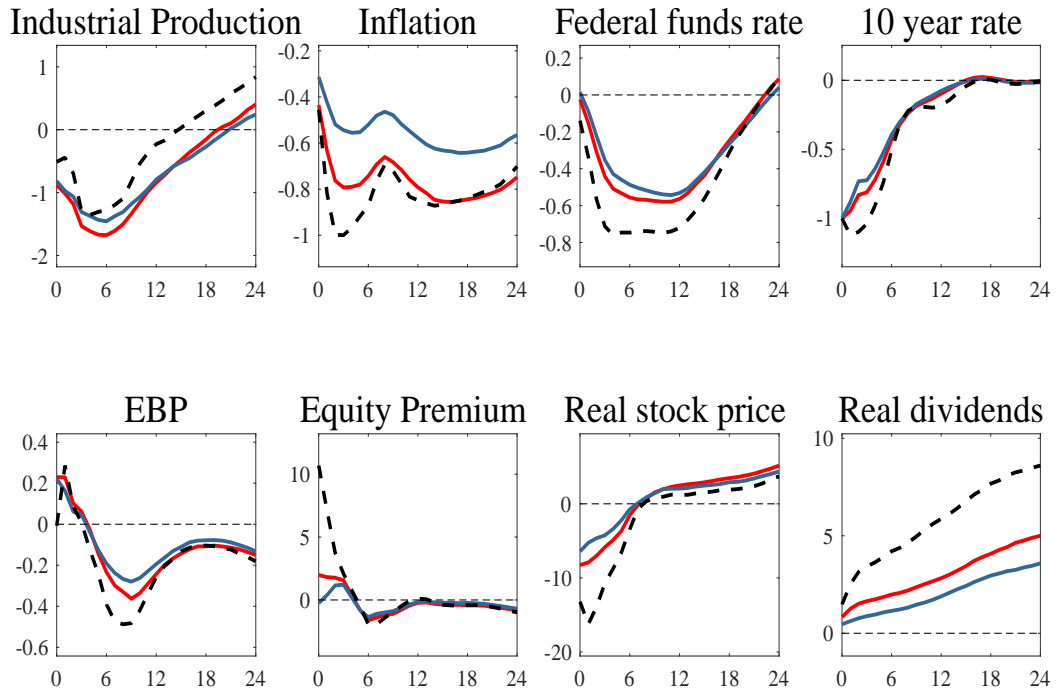
## H Robustness checks

This section contains results to check robustness of IRFs from the VAR exercise.

### H.1 Alternate instruments

I re-estimate the model by replacing the LSAP factor as external instrument with surprises in the 5 year and 10 year rate. These are sourced from the dataset of [Bauer and Swanson \(2023b\)](#). They contain the same qualitative puzzles as we observe when using the LSAP factor as the external instrument.

Figure 8: IRFs for QE policy shock using alternate IVs

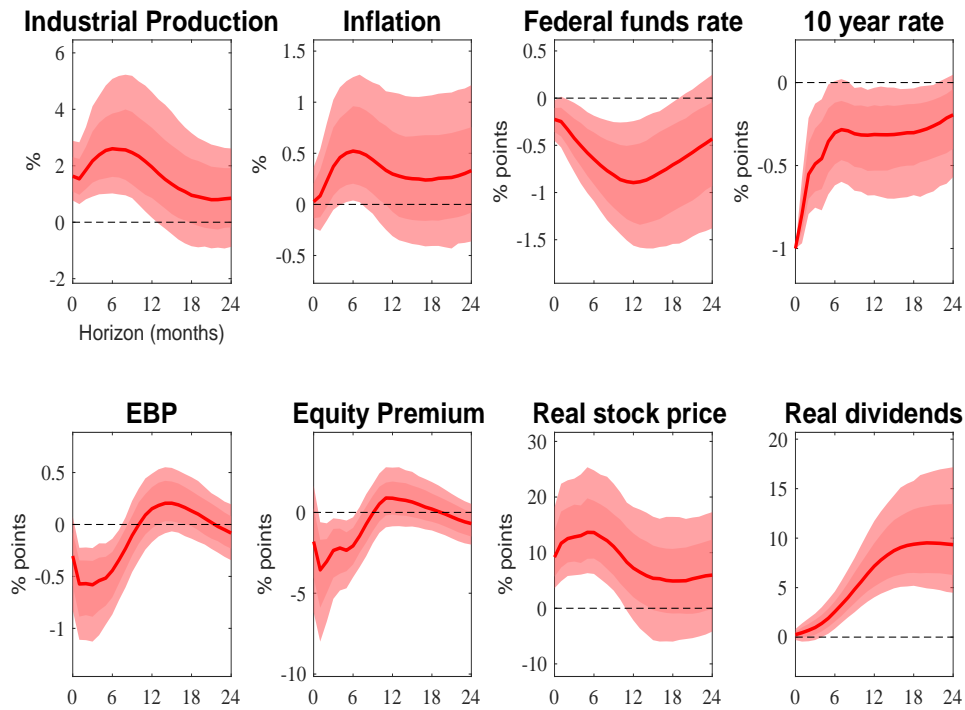


**Note:** Median impulse responses to a Quantitative easing policy shock using different external instruments. Alternate indicators include surprises in the 10 year (in red) and 5 year (in blue) treasury note. Responses of real stock price and real dividends are in terms of growth. The shock is normalised to induce a 1% decrease in the 10 year rate. Sample: 1996:1-2019:12.

## H.2 Construction of IV using market-based approach

I construct an alternate instrument for identifying the QE policy shock using two steps. In the first step, I zero out all dates from the LSAP factor where surprises in stocks and LSAP factor co-move positively (Jarociński and Karadi, 2020). In the second step, I zero out dates where the co-movement between risk premium and the LSAP factor is negative. Hence, only those values of the LSAP factor are used which are consistent with co-movements generated by a monetary policy shock.

Figure 9: IRFs for QE policy shock using alternate identification strategy

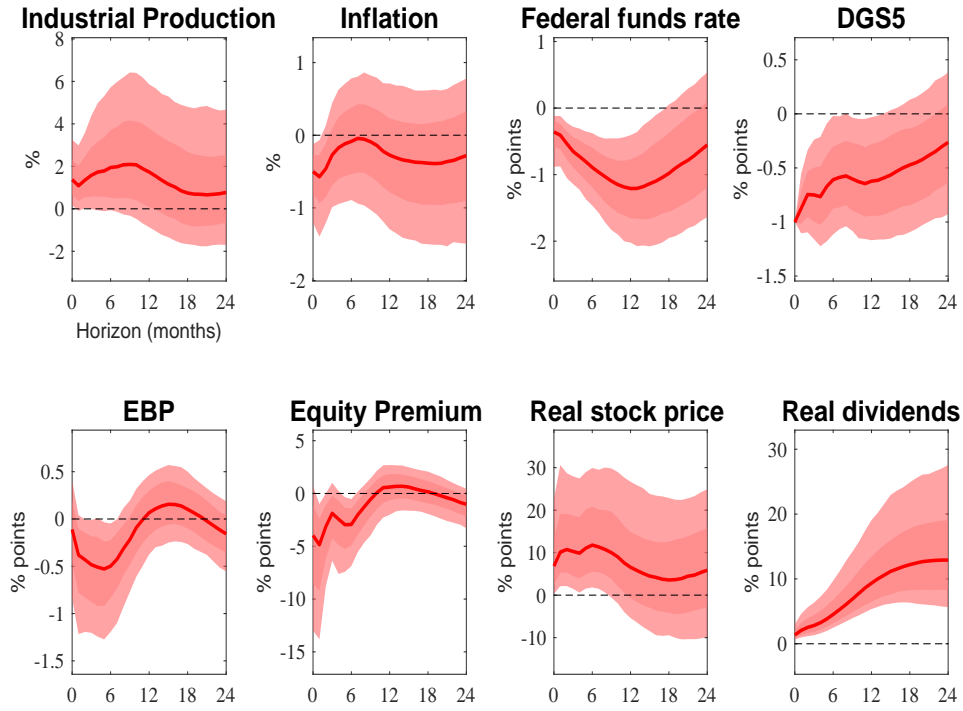


**Note:** Impulse responses to a Quantitative easing policy shock using information and risk-corrected instrument. The external instrument uses only those events where the co-movement between surprises in stocks, risk premium and yields is consistent with a monetary policy shock. Responses of real stock price and real dividends are in terms of growth. The shock is normalised to induce a 1% decrease in the 10 year rate. Sample: 1996:1-2019:12. Dark and light shaded areas represent 68% and 90% posterior coverage bands respectively.

### H.3 Alternate indicator of monetary policy

I use the 5 year treasury yield in place of the 10 year treasury yield as an indicator of monetary policy in the VAR model.

Figure 10: IRFs for QE policy shock using 5 year policy rate

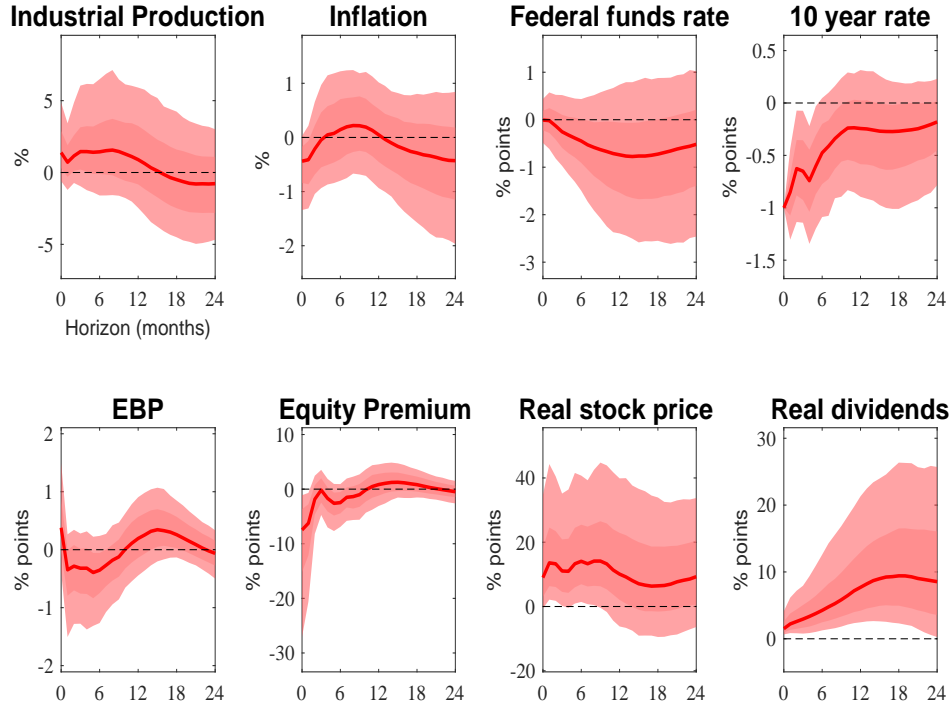


**Note:** Impulse responses to a Quantitative easing policy shock using information and risk-corrected instrument. Responses of real stock price and real dividends are in terms of growth. The shock is normalised to induce a 1% decrease in the 5 year rate. Sample: 1996:1-2019:12. Dark and light shaded areas represent 68% and 90% posterior coverage bands respectively.

## H.4 Alternate sample length

I use an a shorter sample length of November 2001-December 2019 for estimating the VAR model. The start date was chosen keeping in mind the end of recession after the dot com bubble.

Figure 11: IRFs for QE policy shock for the sample Nov 2001-Dec 2019



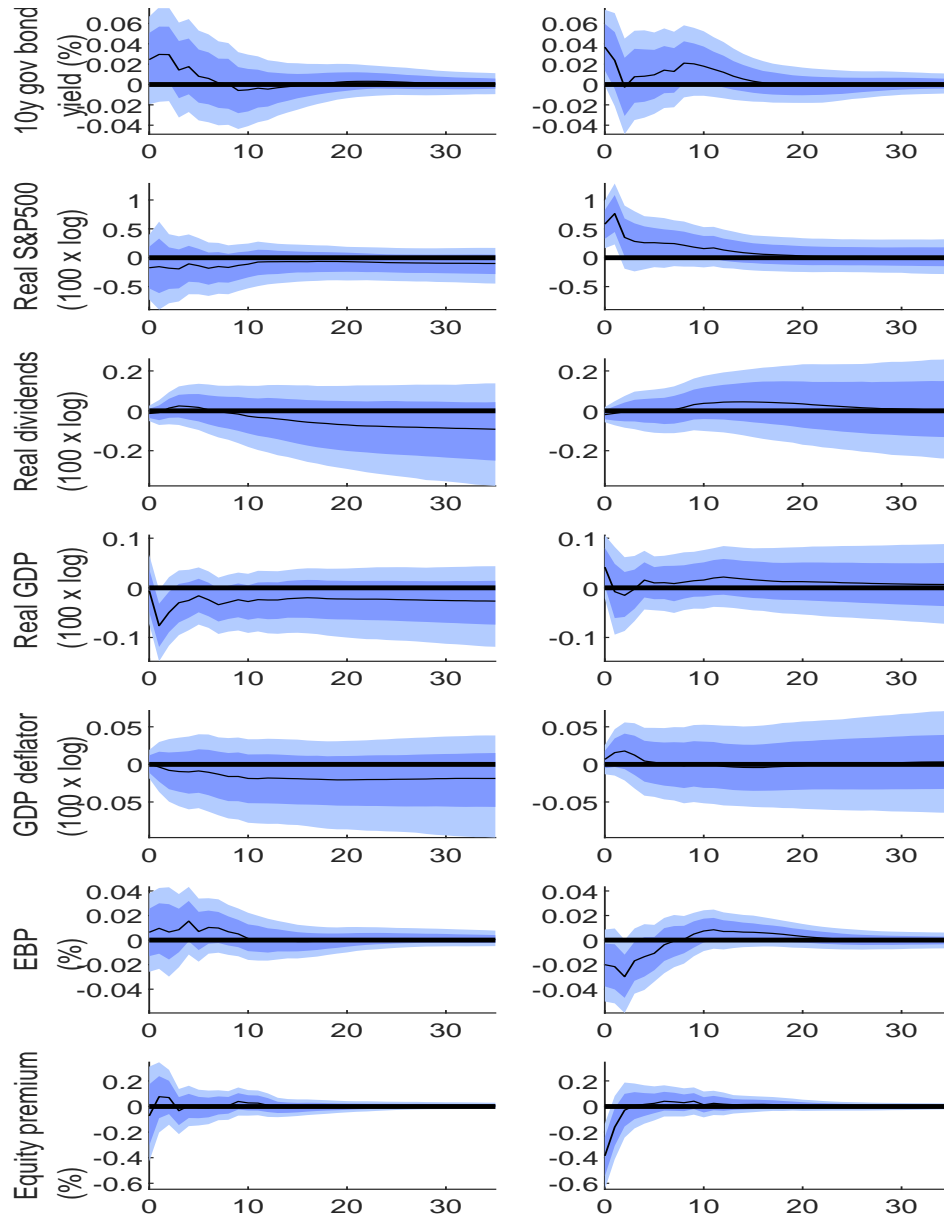
**Note:** Impulse responses to a Quantitative easing policy shock using information and risk-corrected instrument. Responses of real stock price and real dividends are in terms of growth. The shock is normalised to induce a 1% decrease in the 10 year rate. Sample: 2001:11-2019:12. Dark and light shaded areas represent 68% and 90% posterior coverage bands respectively.

## H.5 Alternate identification methodology

I use the sign restrictions identification approach to examine the effect of monetary policy shocks on stock prices and its components. The restrictions are based on [Jarociński and Karadi \(2020\)](#), who disentangle *conventional* monetary policy shocks and information shocks by placing restrictions on high frequency surprises on market data. The two restrictions are first, a QE policy shock should lead to negative co-movement in stock index surprises and LSAP factor, and second, a non-monetary shock should lead to positive co-movement in stock index surprises and LSAP factor. Note that the latter restriction identifies a mix of information and risk premium shocks. The sample length is 2008:11-2019:12 and the shock is normalized to have a 1 standard deviation change in the LSAP factor. The sample has been truncated relative to that in the main exercise since sign restrictions require the high frequency measures of LSAP factor and stock surprises to be included in the VAR. Figure [12](#) presents IRFs from this exercise using the replication code of ([Jarociński and Karadi, 2020](#)) with monetary policy shocks in the left column and non-monetary shocks on the right column. The two columns shows that placing sign restrictions disentangles two shocks with different implications for impact response of S&P500 index, real GDP, excess bond premium and equity premium. This shows that sieving out non-monetary shocks from the LSAP factor is important for correctly estimating the causal effect of monetary policy shock on equity premium.



Figure 12: IRFs for QE policy shock using sign restrictions



**Note:** Impulse responses to one standard deviation (contractionary) shocks using sign restrictions on high frequency surprises in stock index and LSAP factor. Sample: 2008:11-2019:12. Dark and light shaded areas represent 68% and 90% posterior coverage bands respectively.