

# MEASURING THE RELATIONSHIP BETWEEN MONETARY POLICY AND STOCK RETURNS

A new model offers evidence that monetary policy impacts stock returns, but not vice-versa. What does this model offer that past research did not?

Researchers have been studying the relationship between monetary policy and stock returns for years. Even so, their research methods on this topic are still changing, yielding new insights.

Cheng Jiang applies the Markov-switching dynamic bi-factor model, a new econometric model to answer this classic research question. While past researchers have used models that abstract one factor at a time, the bi-factor model simultaneously abstracts two factors: one representing monetary policy, the other representing stock market return.

Jiang finds that expansionary monetary policies (such as a decrease in the federal funds rate) follow economic recessions, but bear stock markets occur before economic recessions.

In addition, he finds that expansionary monetary policies will raise the stock return, but the stock return does not directly influence monetary policy.

These findings can help stock market investors and federal reserve officers to predict the impact of monetary policy on the stock market. Furthermore, future researchers studying this topic, or any dynamic relationship between two variables, can use the Markov-switching dynamic bi-factor model.

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## MAJOR TAKEAWAYS:

- The Markov-switching dynamic bi-factor model simultaneously abstracts two factors: one representing monetary policy, and the other representing stock market return.
- Expansionary monetary policies (such as a decrease in the federal funds rate) follow economic recessions, but bear stock markets occur before economic recessions.
- Expansionary monetary policies will raise the stock return, but the stock return does not directly influence monetary policy.

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## WHO NEEDS TO KNOW:

- Stock market investors
- Monetary policymakers
- Researchers of monetary policy and stock returns

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## CONTACT US:

- Cheng Jiang, associate professor of instruction, [cheng.jiang@temple.edu](mailto:cheng.jiang@temple.edu)
- Nonlinear relationship between monetary policy and stock returns: Evidence from the U.S. <https://doi.org/10.1016/j.gfj.2022.100796>