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Monetary Policy and Asset Valuation

(co-authored with Martin Lettau and Sydney C. Ludvigson)

Abstract

This paper presents evidence of infrequent shifts, or "breaks", in the mean of the consumption-wealth variable cay_t that are strongly associated with fluctuations in the long-run expected value of the Federal Reserve's primary policy rate, with low policy rates associated with high asset valuations, and vice versa. By contrast, there is no evidence that infrequent shifts to high asset valuations and low policy rates are associated with higher expected economic growth or lower economic uncertainty; indeed the opposite is true. Additional evidence supports a "reaching for yield" channel, wherein low interest rate regimes coincide with low equity market risk premia.