Monetary Policy Drivers of Bond and Equity Risks

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Abstract
The exposure of US Treasury bonds to the stock market has moved considerably over time. While it was slightly positive on average in the period 1960-2011, it was unusually high in the 1980s and negative in the 2000s, a period during which Treasury bonds enabled investors to hedge macroeconomic risks. This paper explores the effects of monetary policy rules, monetary policy uncertainty, and macroeconomic shocks on nominal bond risks, using a New Keynesian model with habit formation and discrete regime shifts in 1977 and 2000. The increase in bond risks after 1977 is attributed primarily to a shift in monetary policy towards a more anti-inflationary stance, while the more recent decrease in bond risks after 2000 is attributed to a renewed focus on output stabilization combined with decreased volatility of supply shocks and increased volatility of the Fed’s long-run inflation target. Endogenous responses of bond risk premia amplify these effects of monetary policy on bond risks.