

Optimistic language from the Fed reduces market uncertainty and risk aversion

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Optimistic language used by the Federal Reserve (Fed) in their communication can reduce market uncertainty and risk aversion in the US, UK and Eurozone equity markets, according to new research by Durham University Business School.

The study also found that the Fed's language became even more influential during recessions and times of high policy uncertainty, such as elections.

The research, conducted by Frankie Chau and Rataporn Deesomsak, both Associate Professors of Finance at Durham University Business School, alongside Raja Shaikh, from Sukkur IBA University, Pakistan, sought to understand the impact of Fed's communication and language when it came to equity markets.

To do so, the researchers used a linguistic tool to measure the tone and sentiment of the Fed's communication through Federal Open Market Committee (FOMC) meeting minutes – which are often highly reported in the press.

Then to measure market volatility and risk aversion, the researchers employed an option-implied volatility index on the S&P500 index (VIX), FTSE-100 index (VFTSE), and STOXX-50 index (VSTOXX). In doing so, they were able to link the tone of communication in the Fed's meeting minutes with changes in volatility of the equity market in the US, UK and Eurozone.

The study revealed that positive and optimistic communication in the Fed's meeting notes led to much less volatility in the market. More specifically, uncertainty decreases by 0.42 percentage points in response to one percentage point increase in the Fed's optimistic tone. In addition, one percentage point increase in Fed's optimistic tone also decreases the investor's risk aversion (increases the risk-bearing capacity) by 0.38 percentage points.

This, the researchers say clearly shows the Fed is a trusted and authoritative voice in the sector, which has the power to affect the market even with the smallest of actions.

The findings also show that in states of greater market uncertainty – such as upcoming elections, recessions or market crashes – the Fed's voice becomes even more authoritative and important, signalling towards investors on what to do next, and where the market is heading.

"With the US election round the corner, the US' future monetary policy is uncertain, and the stock market will act as a key barometer of confidence in the next incoming leader.", says Professor Chau. "The transition of power brings uncertainty and volatility to the markets, and our research clearly shows that the Federal Reserve's steady, independent voice is more crucial than ever in maintaining economic stability and guiding investors through unpredictable times."

These findings, Professor Chau states, highlight the importance of the Central Bank's communication when it comes to affecting the market, and policy makers must carefully design a transparent

communication strategy to ensure market stabilisation and effective implementation of monetary policy.

With this in mind institutions such as the Central Bank, they stress, should always be mindful of using pessimistic language as financial markets tend to overreact to negative news, especially during recessions and economic downturns.

Whilst for investors, these findings showcase just how impactful the Fed can be when it comes to shaping and impacting the market – their authoritative voice is clearly trustworthy and should not be ignored.

This research was published in the Review of Quantitative Finance and Accounting.

If you would be interested in speaking with the researchers, or receiving the full research paper, please contact Peter Remon at BlueSky Education – peter@bluesky-pr.com +44 (0) 77 235 228 30.