Discussion: Pre-FOMC Information Asymmetry

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This Paper: Two Empirical Evidence

- Predictability of conventional measures of *monetary policy surprises*
  - by pre-FOMC corporate bond market returns
  - by pre-FOMC corporate bond trade imbalances
  - interpret as evidence for informed trading
- Predictability of *stock return* 24 hours ahead of FOMC announcement
  - by pre-FOMC corporate bond market returns
  - by pre-FOMC corporate bond trade imbalances
  - interpret as evidence of insider information flows from corporate bond to stock market

Two Main Comments

- Extremely interesting set of empirical evidence
- Comment 1: An alternative interpretation of predictability of monetary policy surprises
    - Fed's response to publicly available information (Bauer-Swanson, 2022)
- Comment 2: An alternative interpretation of pre-FOMC return predictability
    - risk premium

Comment 1: Predictability of Monetary Policy Surprises

- How to interpret predictability of monetary policy surprises (MPS)?
- This paper: insider information
  - Traders with private info about contents of future Fed policy choose to trade in the corporate bonds market
  - Insider information is materialized in MPS

Literature on Monetary Policy Surprises

- High-frequency monetary policy "surprises" are predictable
  - Cieslak (2018), Karnaukh (2020), Miranda-Agrippino-Ricco (2021), Sastry (2021), Bauer-Chernov (2021)
- Bauer-Swanson (2021, 2022): "Fed response to news" channel
  - Public information predicts surprises with an R^2 of 10-40%.
- Does Fed have insider information?
  - Nakamura-Steinson (2018): Yes
  - Bauer-Swanson (2021): No
- Both corporate bond market and monetary policy respond to the same publicly available information?

Comment 1: Which Interpretation?

- Insider information or "Fed response to news"?
- This paper's evidences seem to suggest the latter
  - Why insiders trade in corporate bond market, but not *treasury market*?
  - Why corporate bond yield changes are *3 times* sensitive to MPS?
  - Why returns on *high-yield* corporate bonds have more explanatory power for trade imbalances?

Suggestion 1: Which Interpretation?

- Distinguish between insider information and "Fed response to news"
- Control for omitted predictors
  - macro forecasts
  - nonfarm payrolls surprise
  - economic growth
  - stock returns
  - yield curve slope
  - commodity prices
  - treasury skewness
  - ...

Comment 2: Pre-FOMC Return Predictability

- How to interpret predictability of pre-FOMC stock return?

$$\text{Realized return} = \underbrace{\text{Risk premium}}_{\text{publicly available info}} + \underbrace{\text{Surprises}}_{\text{insider info}}$$

- This paper: insider information $\rightarrow$ surprises
  - Informed trading gives rise to predictable movements in stock returns
- Alternative interpretation: risk premium
  - Ai-Bansal (2018): information requires risk premium
  - Ai-Bansal-Han (2022): investors acquire publicly available information

Comment 2: Pre-FOMC Return Predictability

- Evidence for announcement return predictability:
  - Liu-Tang-Zhou (2022): option price based measure of risk premium
  - Ai-Han-Xu (2022): informativeness based measure
- Alternative interpretation: risk premium
  - Variations in macro conditions affect the risk premium in both corporate bond and stock market?

Suggestion 2: Insider Information or Risk Premium?

- Disentangle insider information from risk premium
    - Compare with other known measures that predict pre-FOMC returns
    - Can corporate bond market return be explained by other measures?

Summary: An Equilibrium Perspective

- Common prediction of equilibrium models of information asymmetry
  - Price is a martingale $\rightarrow$ returns are *not* predictable
  - Kyle (1985), Glosten-Milgrom (1985), Grossman-Stiglitz (1988)
- Issues with return predictability without risk premium
  - informed traders leave money on the table
  - uninformed traders should quote prices more aggressively
- Alternative interpretations are rationalized in equilibrium
  - "Fed response to news": investors are uncertain about Fed true policy
  - Time-varying risk premium
- This paper:
  - price is not a martingale $\rightarrow$ market inefficiency?
  - Why corporate bond market is so special pre-FOMC announcement?

Conclusion

- Extremely interesting set of empirical evidence
- Important in understanding monetary policy surprises
  - relate to known macro variables that predict "surprises"
- Important in understanding mechanism for pre-FOMC drift
  - relate to existing measures that predicts FOMC returns