Chapter 31
FED's Unconventional Monetary Policy and Correlation Dynamics Among Conventional and Alternative Investments

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ABSTRACT

This chapter investigates the correlations between conventional and alternative investments during the quantitative easing (QE) programs launched by the U.S. Federal Reserve. Authors focus on different asset classes to examine the dynamics on their correlations and to highlight alternative investment options for rational investors and policy makers. Their analysis covers the period from January 3, 2005 to March 16, 2018. Research has significant policy implications and the empirical findings indicate a ripple effect of QE across conventional and alternative investments and suggest that their correlations differ by QE periods. Researchers also confirm the effectiveness of the portfolio rebalance channel pictured on specific assets' correlation sign, as well as the existence of specific patterns. UMP programs create portfolio rebalance since investors followed the required path set by the Fed.

INTRODUCTION

Global economic environment is changing rapidly and recent developments require more flexible investment strategies as well as different monetary policies. Firms tend to operate and trade internationally while investors are more keen to fund firms and governments in new markets. The main reason, besides their will to increase their earnings, is portfolio diversification to minimize the market risk. On the other hand, governments try to secure a sustain economic environment by adjusting money supply as well as

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changing basic interest rate. In other words, governments invoke the appropriate monetary policy under the current circumstances.

There is a large body of literature focusing on monetary policy as well as the Central Banks' means by which they manipulate the economic activity, production, financial markets and investment strategies. Investors mainly aim to maximize their profit and receive positive returns. Even though markets seem to act independently, there are many different parameters which impact above economic aspects. However, markets' correlation differs during the economic cycle. When markets' volatility is rising and firms' fundamental economic ratios become weaker, stability is more vulnerable and recession needs to be treated centralized, by Central Banks and Governments.

Governments may employ lower tax policies, create a better economic environment for investors and try to attract foreign investors to rekindle economy. However, those actions' results may not be seen as soon as they expected and further actions need to be taken. These actions refer to monetary instruments which have a direct impact on economic decisions. Central Banks first lower the interest rates to motivate investors change their strategy, but this is not effective always. When interest rates reach almost zero levels, the basic monetary instrument - the interest rate - becomes inefficient to fire the economy. Thus, unconventional monetary policies are employed to minimize the impact of recession and sustain markets to recent high levels.

The most common unconventional monetary policy is the quantitative easing (QE) which was first applied in Japan in the end of 20th century when Japanese market stagnated after continuous interest rate decreases. Japan's unique monetary decision was also applied by Fed in United States during the recent global financial crisis. Even though quantitative easing had significant impact on economy's rebound, markets' development continued till the beginning of 2019. After a decade of QE policy, Fed rose interest rate increase in December 2018, but market reaction was not that optimistic. In contrary with Japan in the late '90s, U.S. economy may need more time to be characterized sustainable. Thus, another UMP period needs to be implemented to sustain economy. In line with the Fed UMP, European Central Bank (ECB) and Bank of England (BoE) also applied a similar monetary policy in order to force investors rebalance their portfolios.

Generally, Joyce et al. (2012) concluded that there are a number of channels through which QE might be expected to affect the behavior of investment community, including policy signaling, portfolio rebalancing, and liquidity effects, authors attempt to quantify the effects of these QE programs by focusing on the changes on conventional and alternative investments' correlations.

These effects are well described by Kryzanowski et al. (2017) and Steeley (2017). In this chapter, authors provide new insights into the impact of Fed's UMP regimes on the cross-assets correlation dynamics of alternative financial assets by applying the dynamic conditional correlation model to investigate the correlation dynamics across QE and unconventional periods of programs across a range of assets. Furthermore, they examine whether cross-assets correlations differ across the implementation periods of Fed UMP, as well as the effectiveness of the portfolio rebalance channel and the existence of a ripple effect among specific asset classes. Results provide evidence regarding the ripple effect across conventional and alternative investments which is pictured on specific assets' correlation sign. They also highlight the portfolio rebalance among different assets.

The motivation of this research is to study the effectiveness of the UMP followed by Fed and the existence of the portfolio rebalance channel. Should the portfolio rebalance channel works effectively, the UMP followed by Fed succeeded to shift investors behavior.