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Volatility in Equity Markets and Monetary Policy Uncertainty*

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Abstract

Asset pricing models assume the risk-free rate to be a key factor for equity prices. Hence, there should be a strong link between monetary policy rate uncertainty and equity return volatility, both in theory and data. This paper uses regression-based projections for realized variance to examine the relationship between short horizon forecasts of equity variance and proxies for monetary policy uncertainty. By assessing various projection models for UK, US and euro area equity indices, we show that the proxies for monetary policy uncertainty have a significant and positive predictive power for the equity return variance. Adding monetary policy rate uncertainty variables can significantly improve forecasting models for equity variance and volatility at weekly, monthly and even quarterly horizons. The findings imply that market views of short-term interest rate developments may indeed be imbedded in equity prices and their variations.

Keywords: equity indices; monetary policy rate uncertainty; option implied volatility; realized volatility; risk-free interest rates; volatility forecasting

JEL Classification: C22, C52, G12, E52

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