Institutional Trading around FOMC Meetings: Evidence of Fed Leaks

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Motivation

- Big amount of circumstantial evidence of Fed leaks to financial institutions.
  - Medley Global Advisors scandal in 2012.
  - Several newspaper articles, newsletters and FOMC minutes mentioning leaks.
  - Other direct and indirect evidence from the academic literature:
    - Pre-FOMC announcement drift on the stock market (Lucca et al, 2015)
    - Taxi rides between NY Fed and commercial banks (Finer, 2018)
    - Stock Returns over the FOMC Cycle (Cieslak et al, 2019)
    - Volume dynamics around FOMC dates (Zhu, 2021)
- Informal central bank communication is not necessarily bad, unless leaked information is actively exploited to front-run monetary policy decisions.
  - I test this hypothesis on the stock market using data from Ancerno.
  - 1999-2014: daily trades of US mutual funds, hedge funds, and pension funds.
  - Stock sensitivity to interest rates surprises is based on CAPM β and on the monetary policy exposure measure of (Ozdagli et al, 2020).

Research question

- *Do financial institutions exploit leaked information to execute profitable trades on the stock market before FOMC meeting dates?*
- Short answer is Yes.
  - For a 25*bp* surprise rate increase, on the 3 days before the FOMC announcement, the trading imbalance is 11% higher for high-exposed stocks (stocks that are expected to perform well after a monetary tightening).
  - The characteristics of the trades and of the institutions that front-run monetary surprises are consistent with an information-leakage story.
- The effect is stronger:
  - Before easing monetary surprises, when market reaction is positive.
  - For the hedge funds that are headquartered close to regional reserve banks.
  - For the institutions represented in the FOMC by an alternate member.

Contribution

- These findings:
  - Show that institutions receive and exploit Fed leaks.
  - Contribute to an information-based explanation of the pre-FOMC drift.
  - Provide an additional channel through which institutions make abnormal profits from their intra-quarter trades.
- Policy implications
  - Concerns about unequal access to Fed information, with some investors gaining a persistent and unfair advantage.
  - Hedge funds have reportedly made a practice of hiring former central bankers as their funds grow in size and scope[1].

[1] Svea Herbst-Bayliss, Reuters Financial, March 24, 2015.

The paper is available in SSRN.

I very much look forward to hearing your feedback!
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