Discussion of “Policy Uncertainty and Asset Markets”

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My Comments

1. Brief discussion of idea

2. Another take on “Asset Prices and Political Uncertainty”
   - Kelly, Pastor, Veronesi (2014)
The Idea

- Construct measure of policy uncertainty at the country level
- Use this measure as signal in a market timing strategy
The Idea
Measuring Policy Uncertainty

- Broker research reports from Thomson Reuters
- Construct Policy Uncertainty measure for country $i$ in period $t$:

$$PU_{i,t} \equiv \frac{\#\text{Reports tagged Country}_i \& \text{"policy" \& "uncertainty"}}{\#\text{Reports tagged Country}_i}$$

- Australia
- Canada
- Euro zone
- UK
- US
The Idea
External Validation?

- Compare against BBD – highly correlated
- Why not just *use* BBD?
- Associated with equity volatility, realized changes in target rates, recession indicators (sometimes predictive)
  - Broker reports are like expectations. They (like prices) should be predictive of outcomes (e.g. Fama 1981)
  - Doesn’t tell us about incremental predictive content – need an alternative to test against
The Idea

Trading Strategy

- Use $PU_{i,t}$ as market timing signal for trading money market securities
- Rationale: Early (private) indicator of future uncertainty may presage “flight-to-safety”
Why this asset class?

- Short sales constraints?
- Liquidity?
The Idea
Trading Strategy

Why not this asset class?

- Among the least informationally sensitive securities
  - Equity vs. risky debt vs. risk-free debt
- Given an oracle, trade the most informationally sensitive securities
  - Leverage (futures, swaps, options)
  - Trade based on first moments or second moments?
- Uncertainty about what?
  - Motivated based on broad notion of policy uncertainty
  - Later, “policy” means “monetary policy”
  - Specificity can help develop more pointed strategy
  - E.g. Interest rate options
Despite salience of political uncertainty, understanding of its effects on financial markets only beginning to emerge.

Among many challenges: Identifying causal effects of political uncertainty.
What We Do
Kelly, Pastor, and Veronesi (2014)

- Analyze whether / how uncertainty associated with political events (national elections, global summits) is priced in options market
  - Why options?
    - Short maturities
    - Different strikes
  - Why elections and summits?
    - Can result in major policy shifts
    - Exogenous variation in political uncertainty
- Guided by *theoretical* model of government policy choice
  - In model, government-related risk cannot be diversified away, so political uncertainty carries a risk premium
  - Premium larger when economy is weaker because that is when policy changes and election upsets are more likely to occur
What We Find
Kelly, Pastor, and Veronesi (2014)

“Treatment-group” options: put options whose lives span political events

- **Price risk:** ATM treatment-group options are more expensive by 5.1% compared to neighboring control-group options, on average

- **Tail risk:** 5% (10%) OTM treatment-group options are more expensive by 9.6% (16.0%)

- **Variance risk:** ATM treatment-group options are 48.1% more expensive relative to the Black-Scholes model, on average; control-group options are 36.5% more expensive

The role of **economic conditions**:

- Treatment-group options 8% (1%) more expensive compared to control-group options when the economy is weak (strong)
What We Find
Kelly, Pastor, and Veronesi (2014)

- Our results indeed suggest a sizable risk premium for political uncertainty, with larger magnitudes in weaker economic conditions
- Trading strategies earn high returns by bearing political risk
Summary Remarks

- Understanding of financial pricing effect of political uncertainty is nascent

- Practical questions include
  - Market efficiency w.r.t. policy uncertainty
  - Which assets most useful for exploiting signal

- Text based approaches intriguing with much room for development