The Impact of Federal Reserve's Monetary Policy on the Stock, Foreign Exchange and Bond Markets in UK

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Abstract. As the virus invaded and policies such as home isolation and remote work were implemented, the global outbreak of the COVID-19 pandemic in 2020 led to severe economic recession worldwide. The high uncertainty in economic development caused by the virus sparked a "cash rush," with people desiring assets with high liquidity, such as cash. This led to turbulence in global financial markets. Different countries' economic development speeds and social conditions, guided by different national policies, also greatly influenced foreign exchange and bond markets. This paper focuses on analyzing the impact of the Federal Reserve's monetary policy during different periods on the three major markets in the UK: the stock market, foreign exchange market, and bond market. This includes an analysis and interpretation of the performance of the UK's three major markets in response to the Federal Reserve's monetary policy, particularly focusing on the most closely watched policies of interest rate hikes and cuts. These analyses provide valuable reference for subsequent market development and how markets should perform prior to anticipating the Federal Reserve's predicted monetary policies.

Keywords: Federal reserve, monetary policy, UK.

1. Introduction

The UK is a crucial financial center globally, serving as a hub for banking with tight connections to partners worldwide, offering financial services. In 2023, London, UK, ranked jointly first with New York, USA, in financial center rankings. Additionally, the UK leads in international debt issuance, commercial insurance, and foreign exchange trading. Analyzing the UK's stock, foreign exchange, and bond markets provides a comprehensive understanding of the current state of the UK economy. Furthermore, these markets are influenced to a certain extent by international developments and decisions and situations in other economies, making them valuable for research and discussion in this study.

The United States, with its vast domestic market and robust international trade, has established the global circulation and reserve currency status of the US dollar. Therefore, as the central bank of the United States, the Federal Reserve's monetary policy inherently impacts the global economy, depriving countries of monetary policy autonomy. While the Federal Reserve's monetary policy aims to restore and improve the US economy, it inevitably affects policy decisions in the UK. Therefore, this paper selects the UK's stock, foreign exchange, and bond markets for analysis to comprehensively assess the UK's market performance under the influence of the Federal Reserve's monetary policy.

2. Stock Market

The Federal Reserve cut the federal funds rate target by a total of 1.5 percentage points at its meetings on March 3, 2020, and March 15, 2020. These reductions lowered the federal funds rate and kept it within the range of 0% to 0.25%. Beginning February 16, 2020, the stock prices of the UK's FTSE100 experienced an unprecedented and sustained decline, falling by 31.11% by May 15, 2020. The stock prices of FTSE250 also began a significant decline on February 16, reaching their lowest point at the same time, with a total decrease of 28.81%.

As the most influential financial institution globally, the Federal Reserve's reduction of the federal funds rates undoubtedly provided a strong positive signal to the turbulent global economy [1]. The

impact of changes in the federal funds rate on financial markets is the most direct and intuitive. According to research by Ben S. Bernanke and Kenneth N. Kuttner, an average expected reduction of 25 basis points in the federal funds rate target is associated with approximately a 1% increase in composite stock indices [2].

Low interest rates not only stimulate consumption and investment in the United States but also increase confidence in the economic future globally. As the economy slowly recovers, US investors seek higher return opportunities, leading to more assets flowing into overseas stock markets, including those in the UK. After May 15, 2020, both the UK stock indices, FTSE100 and FTSE250, began to rise consistently, and stock prices gradually began to recover.

The rebound of the UK stock market in 2020 may be attributed to positive control of the global pandemic and improved global market sentiment. It may also be due to the UK government's implementation of a series of fiscal stimulus policies, such as providing financial assistance to businesses, funding support, and tax relief. These policies aim to stabilize the economy, protect employment, support businesses, and promote economic recovery and growth [2]. Therefore, the sustained development of the UK stock market also includes the Federal Reserve's ongoing rate reduction plan. Loose monetary policy releases positive economic signals [3]. Coupled with various stimulus policies from the Bank of England, abundant liquidity support, and the low-interest-rate environment, investors are significantly encouraged to reallocate assets to risk markets, with high expectations for stock market growth.

The Federal Reserve's rate cut policy has lowered the yield of traditional fixed-income investments, especially rates close to 0%. Consequently, the stock market has become the best venue for investors seeking high returns [4]. By guiding investors to shift funds from low-yield bonds and similar investments to the stock market, the rise in the UK stock market is propelled. The rising UK stock indices also indicate that investors are gradually regaining confidence in the UK economy and stock market.

3. Foreign Exchange Market

Following the concentrated outbreak of the 2008 financial crisis, the Federal Reserve, after rapidly reducing the traditional space for interest rate cuts, implemented a large-scale asset purchase program, including MBS and long-term treasuries. Financial markets and asset market prices experienced bubbles. After experiencing the financial crisis and economic recession, the US economy slowly recovered. The labor market gradually improved, the unemployment rate declined, and employment growth stabilized. Between 2014 and 2019, to prevent inflationary pressures and excessive liquidity injection issues, the Federal Reserve began to consider gradually restoring interest rates to normal levels and announced and implemented a monetary policy normalization plan [5].

During this period, the UK foreign exchange market experienced significant turbulence under the combined influence of Federal Reserve policy and international factors. On June 23, 2016, the UK held a referendum on Brexit. Although the decision to leave the EU was a democratic result with the majority prevailing, nearly half of UK citizens expressed dissatisfaction with the decision [6]. The uncertainty about the future development of the UK economy and trade relations with EU countries, etc., led to a sharp decline in demand for the pound sterling. The pound sterling to US dollar exchange rate plummeted to its lowest level in decades [7-8].

Apart from the Brexit factor, the long-term tightening monetary policy in the United States has sharply reduced the circulation of US dollars in the market, leading to a strong US dollar and causing the pound sterling to depreciate against it. Investors are more willing to invest in US assets as the high-interest-rate environment makes US assets more attractive, which could lead to a devaluation of the pound sterling in the UK foreign exchange market.

The Federal Reserve's federal funds rate is the benchmark for US monetary policy. The US's policy of continuously restraining economic development by affecting the supply of dollars has led to the appreciation of the US dollar due to reduced supply [9]. This greatly increases the cost of importing

US goods for Britain. As the US dollar is an important currency in international trade, the inevitable sharp decline in the pound sterling to US dollar exchange rate impacts the UK's ability to trade with other countries [9]. Faced with the social factors of just ending the financial crisis and Brexit, stable and efficient economic development is the UK government's primary concern. The appreciation of the US dollar not only significantly increases the cost of importing raw materials or goods for Britain but also leads to continuous losses in subsequent UK trade with other countries. This contradicts the attitude of the UK government encouraging economic growth. This forces a challenge to monetary policy to maintain the stability of the domestic currency and international competitiveness, considering the direction of US monetary policy. During the period of the US's adoption of tight monetary policy, the Bank of England also took similar measures to prevent capital outflows and currency depreciation. After experiencing the Federal Reserve's monetary normalization plan and slow interest rate hikes, although the inflation rate has long remained below 2%, the unemployment rate has gradually declined, the Federal Reserve confirmed at the end of 2013 that potential output has been difficult to return to pre-financial crisis levels.

The slowdown in the US economy will also have a considerable limiting effect on US foreign trade. UK exports to the US will be affected, and UK economic growth will be impacted, further affecting the performance of the UK foreign exchange market.

4. Bond Market

Bonds, as traditional investment products offering fixed returns, are directly tied to interest rates. Previously, it was mentioned in discussions about the UK stock market that a rate cut by the Federal Reserve would prompt US investors to seek high-return investment opportunities overseas, including the bond market in the UK. This includes the UK's bond market. Without considering other social and political factors such as Brexit, the demand brought to the UK market by the Fed's rate cut would drive up prices in the UK bond market.

Over the past two years, various policies from the Bank of England and prolonged stabilization have slowly led the UK out of the economic downturn caused by Brexit. The Federal Reserve's large-scale quantitative easing and continued rate cuts during the COVID-19 pandemic.

In 2023, as investors continued to speculate on the prospect of a rate cut by the Federal Reserve, which boosted the US dollar, the pound outperformed many currencies of developed countries and became one of the few bright spots in the foreign exchange market. And maintained a high exchange rate until July. Signs of economic recovery are evident in various aspects of the UK economy. Althea Spinozzi, an interest rate strategist at Saxo Bank, stated that high levels of government borrowing, coupled with active selling of bonds by the Bank of England, may continue to put upward pressure on UK government bond yields. "If inflation remains sticky or even rebounds, selling of UK bonds may accelerate. In addition, we will face active quantitative tightening measures by the Bank of England, and the UK government may increase the issuance of UK government bonds." She spoke. The yield on UK 10-year government bonds rose from 3.4499% on December 27, 2023, to 4.1170% as of March 15, 2024. Many investors have strong confidence in the pound and bet that the Bank of England's rate cut will be later than that of the Federal Reserve and the European Central Bank. It can be seen indirectly that if the Bank of England's rate cut is relatively later than that of the Federal Reserve, the yield on UK bonds will be affected [10]. There is an inverse relationship between UK bond prices and interest rates. Therefore, investing in UK bonds can yield relatively high returns before a rate cut. If investors can time the rate cuts in the UK and the US Federal Reserve well, they can maximize their returns.

5. Conclusion

This paper analyzes the impacts of Federal Reserve's monetary policy on the UK's stock market, foreign exchange market, and bond market, indicating that the monetary policy formulated by the UK

government should consider the policies of the Federal Reserve and make corresponding policy adjustments. Although this article considers the monetary policies of the Federal Reserve at different times and the performance of corresponding markets, however, deficiencies exist, alternative factors should be considered to analyze these impacts.

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