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The end of an era

Dr Robert Gay | Fenwick Advisers | 24 March 2015 |

For the first time in more than six years, the Federal Reserve no longer promises to keep its policy rate at or near zero. The era of the Fed's version of ZIRP (zero interest rate policy) will come to a close probably sometime this (northern hemisphere) summer or early fall depending on the strength of the US labor market. Contrary to prognostications of doomsayers and carry traders, both equities and bonds rallied and the dollar sold off. Even the beleaguered euro staged a rebound. Instead of promises, the Fed now is conveying its intentions via forecasts. By revising the outlook for growth, inflation and interest rates downward, FOMC members have opted for a strategy of "sooner and slower" rather than "later and faster" on normalising rates. Although markets interpreted the revised forecasts to mean short-term interest rates will normalise more slowly than was feared, the issue still remains on how far rates ultimately will rise. The consensus of FOMC participants now expects the "long term" policy rate to stabilise at 3.5% sometime after 2017 - distinctly lower than they projected in the past. The debate on the so-called neutral rate has barely begun[1], though, and I suspect reality is even lower as long as the specter of stagnation and deflation is lurking around the world.

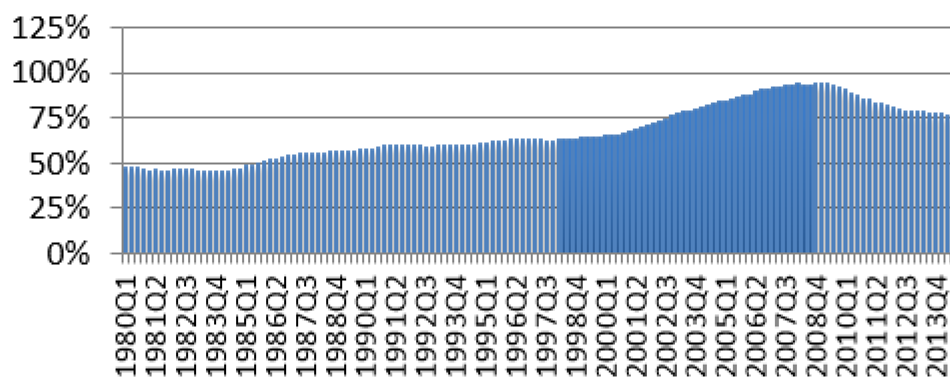
WHY IS QE ENDING?

The simple answer is that the US economy has improved a lot over the past few years, even if it has taken more time than usual recoveries. Financial crises always make recessions worse and more protracted than simple business cycle downturns because the damage to balance sheets, notably those of financial institutions, impairs lending and the normal flow of credit. Banks restrict lending to their best customers, raise lending standards to everyone else and hoard liquidity. Bad debts shrink their assets so they are forced to reduce their liabilities. Rebuilding balance sheets of banks and the rest of the private sector takes time.

Indeed, that is why the first priority of the Federal Reserve, which is embodied in its founding legislation, is safety and soundness of the financial system. That priority in effect supersedes the other operational priorities of low inflation and full employment during financial crisis and allows the Fed to undertake extraordinary measures including ZIRP and large scale asset purchases of US Treasuries and mortgages as it has done during the past six years. By lowering the fed funds rate to zero, the Fed in essence allows banks unlimited free funding with the intent of resuscitating their health by bolstering operating profits. In that context, it is not surprising that the Fed is viewed as favoring Wall Street over Main Street. That is what it is supposed to do during crises or everyone will be worse off.

Unfortunately, the Fed cannot do the same for households and companies because they cannot control long term interest rates. Hence, QE targets long-term securities in the hopes of lowering those rates, which it did by about 115 basis points according to most studies[2]. The rationale is similar, though – by lowering long-term rates, households could refinance mortgages and repay debt (or save) from the extra after-mortgage take home pay. It is not perfect but households have managed to reduce their indebtedness from a peak of 94% of GDP in late 2008 to 76%, the lowest level since 2002 (see Figure 1).

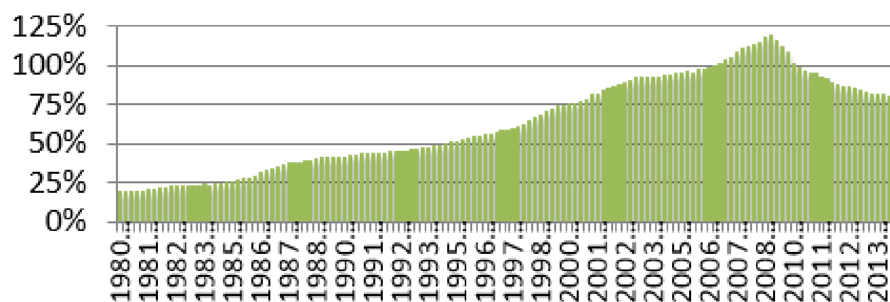
Figure 1: Credit Market Debt Outstanding of U.S. Households (% of GDP)



Source: Federal Reserve

Since the advent of stress tests, the Fed has been able to assess better the impact on bank balance sheets of large changes in interest rates, exchange rates and securities prices in the event of another recession. By that standard, the health and resilience of American banks has improved dramatically[3]. Indeed, the US financial institutions have reduced leverage substantially during the crisis and far more than those in other countries. Gross indebtedness of the financial system has declined from a peak of 118% of GDP at the end of 2008 to 80% in 2014 (see Figure 2). In short, the US financial system no longer needs life support from the Fed and FOMC members can feel more comfortable in making policy decisions based on the usual objectives of low inflation and full employment.

Figure 2: Credit Market Debt Outstanding of U.S. Financial Sector (% of GDP)



Source: Federal Reserve

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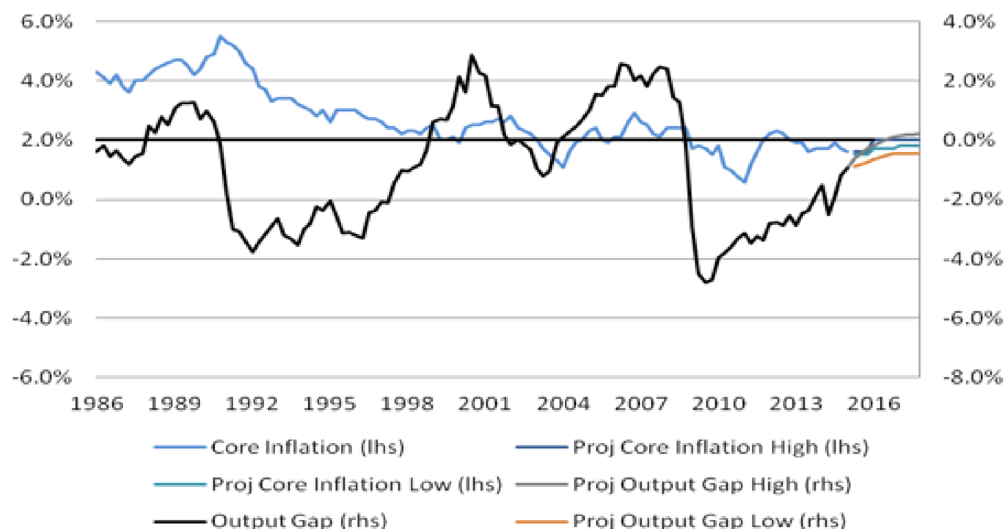
Those two goals are intertwined, however, as shown in Figure 3. The output gap, measured as the difference between actual and potential GDP (in percentage points on the right-hand scale), is a powerful empirical construct used the Fed's staff to gauge inflationary pressures. An output gap of zero is akin to the concept of full employment. Note that whenever real GDP rises above its inflation-stable potential (i.e. the black line is above zero), core inflation - shown as the blue line and measured by the left-hand scale - tends to rise, albeit with some delay. Likewise, when output falls below potential, inflation subsides. Although the whole history is not shown here, the relationship has held over every business cycle for the past six decades[4].

Figure 3: US Output Gap and Inflation



Sources: BLS, Bureau of Economic Analysis and Fenwick Advisers estimates.

There are several key conclusions to be drawn. First, the output gap at about 1% of GDP is quite small. This estimate is consistent with the staff estimate of the NAIRU at 5% to 5.25% as well as the central tendency of FOMC members' current long-run projections. Granted, nothing in Figure 3 implies that the US economy will experience a nasty surge in inflation anytime soon. The lags and the strong US dollar will postpone inflation for several years. Moreover, economic activity would have to be considerably stronger than FOMC members expect to raise real GDP significantly above its potential.

So why not wait and see how events unfold?

In my opinion, and apparently that of the majority of FOMC members, waiting is a riskier option than procrastinating. A zero nominal policy rate, or a negative real rate, simply is not the correct value when the economy is closing in on full employment. A 1% output gap leaves precious little wiggle room if the economy strengthens and the hurdle for

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outperformance is quite low. Indeed, FOMC members continue to revise down their estimates of potential growth, which the Fed staff and the projection materials now put around 2% annually – just a few years ago, that number was 2.5% and a decade ago many analysts fantasised that it was well north of 3%. A brief growth spurt would erase what little slack is left in the economy and put the Fed behind the curve in guarding against future inflation.

A second consideration is that a zero funds rate promotes the kind of behavior that the Fed would like to avoid. Credit risk becomes mispriced and leverage creeps back into structured products that securitise whatever cash flows are available. In the US, investment banks are using auto and student loans as the underlying assets, and in Europe the pooling peer-to-peer loans brings back memories and US subprime – an unregulated and opaque products with a potential for unscrupulous behavior. Investors regularly are presented with new products offering high yields because they are levered threefold – all made possible by the negligible cost of funds, negative deposit rates and grossly mispriced sovereign debt that is part of the ECB's huge new QE program. When central banks stay too long or arrive too late with negative real interest rates, they set the stage for a whiplash selloff when they belatedly normalise policy. The Fed has some history of staying too long and that is why an early adjustment and a slow trajectory likely would be much less disruptive to financial markets and debtors[6].

On a less technical level, mending balance sheets, while therapeutic, is not an engine of growth. Main Street, not Wall Street, must be the source for a sustained expansion. Households spend only four cents of every extra dollar in their wealth, and even less in asset price bubbles. By contrast, about 90 cents of each dollar extra income is spent and that prospective sales are the reason businesses invest. Hence, income generation is the key to a sustained US expansion. In that context, zero interest rates represent financial repression for average savers, whereas normal interest rates will translate into some positive income flow on households almost $2 trillion in cash holdings. Now that the Fed has opened the door to normalising interest, the remaining issue is what constitutes "normal" in a world awash with excess savings and with too few compelling investments. In this era of transition to a new normal, it behooves us to take care in stretching for yield since the Fed no longer is making promises.

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ENDNOTES

1. See for example BCA Research, Global Investment Strategy, “Seven Structural Reasons for a Lower Neutral Rate in the US”, March 13, 2015.

2. See for example Tao Wu, “Unconventional Monetary Policy and Long term Interest Rates”, IMF Working Paper 14-189, September 2014.

3. The US subsidiaries of two foreign banks, Deutsche Bank and Santander, did fail the latest stress test released on March 5, 2015 and will need to raise more capital.

4. Federal Reserve staff has published their empirical model of the output gap. See Dave Reifscheider, William Wascher and David Wilcox, “Aggregate Supply in the United States: Recent Developments and the Implications for the Conduct of Monetary Policy”, presented at the 14th Jacques Polak Annual Research Conference hosted by the IMF, November 7-8, 2013. Figure 4, while not nearly so elegant as the staff work, does show the same relationship to core inflation over time.

5. See footnote 4 and the FOMC projection materials from the meeting on March 17-18, 2015 on the Fed’s website.

6. Recent media articles have highlighted comments from Ray Dalio, a highly successful hedge fund manager who likened the Fed’s prospective exit from QE to their premature tightening of policy in 1937, and those of Christine Lagarde of the IMF who has warned of the vulnerability of emerging countries that have borrowed heavily in US dollars to higher US rates. Mr. Dalio’s admission that it was not a good time for ‘concentrated bets” suggests that is a good time for an initial rate adjustment since leveraged carry traders are not a feature of the financial landscape now as they were prior to the ‘taper tantrum’ of May 2013. At least debtors with dollar liabilities will have more time to alleviate their predicament if the Fed gives them an early heads up and normalizing rates gradually.

Dr Robert Gay is managing partner of Fenwick Advisers, a financial consultancy serving global investment banks, hedge funds, and other fund managers and financial institutions including fixed income manager, Stratton Street Capital. Prior to forming Fenwick Advisers, Dr Gay served as international economist and global strategist Morgan Stanley, Bankers Trust and Commerzbank AG. He spent eight years as Senior Economist with the Board of Governors of the Federal Reserve System in Washington, DC, primarily during the chairmanship of Paul Volcker.

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