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Economics Group

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Special Commentary

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Economic Outlook and the Banking Sector*

In the latest *Region Focus*, published by the Federal Reserve Bank of Richmond, Renee Haltom provides an introduction to our topic today when she states that "When the Fed injects money into the economy, the effects are not spread evenly."[1] Indeed, monetary policy does impact households and businesses—big and small—differently, reflecting their debt/creditor position and their sensitivity to inflation and labor market developments. Uneven fluctuations among the various components of the economy are the norm for the U.S. economy. For an introduction to this issue see Romer (2006).[2]

Even low, moderate inflation will negatively impact savers in a world of even lower interest rates.

One surprising development for many households has been that even low, moderate inflation will negatively impact savers in a world of even lower interest rates. This is an era of financial repression. Moreover, policy that holds interest rates below the market-clearing equilibrium rate for an extended period provides little incentive for lenders to extend credit.

What are the financial motivating factors behind the current economic recovery given the easy monetary policy at the Federal Reserve? What can the current economic data tell us about the state of financial repair since the Great Recession? Recent economic data appear contradictory to financial developments. In the latest GDP release we witnessed negative economic growth reported for the fourth quarter of 2012 and yet the equity market indices of the Dow Jones and S&P 500 are near previous high-water marks.

Recently, President Esther George of the Kanas City Fed indicated that "the low-interest-rate-policy may be creating incentives that lead to future financial imbalances."[3] Our view is that we have moved beyond *may be* to the reality that the Fed is actually already creating incentives in the market that are generating financial imbalances.

Our framework for the outlook always follows the five pillars of economic factors that drive good decision making: growth, inflation, interest rates, corporate profits and the dollar (Figure 1).

Growth: Sustained Gains, but Subpar Compared to Prior Recoveries

Our outlook is for sustained economic growth despite the recently reported negative GDP for the fourth quarter (Figure 2). We believe that the negative GDP number reflected a correction to the overstated strength in the third quarter. The underlying strength in the economy is better judged by real final sales, which continues to reside in the 1.5 percent to 2.0 percent range and suggests a steady, if subpar, economic recovery.

*** This paper is based on a presentation given at the Federal Reserve Bank of Richmond during the 2013 Roundtable Summit on February 7, 2013. Special thanks to Kaylyn Swankoski for her research support.**

[1] Haltom, Renee. (2012, Second/Third Quarter) Winners and Losers from Monetary Policy. *Region Focus*. Federal Reserve Bank of Richmond.

[2] Romer, David. (2006). Chapter 4: Real Business Cycle Theory. *Advanced Macroeconomics*. McGraw-Hill.

[3] Hilsenrath, Jon. (Jan. 27, 2013). Fed Seems to Keep the Money Spigot Open. *Wall Street Journal*.

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Figure 1

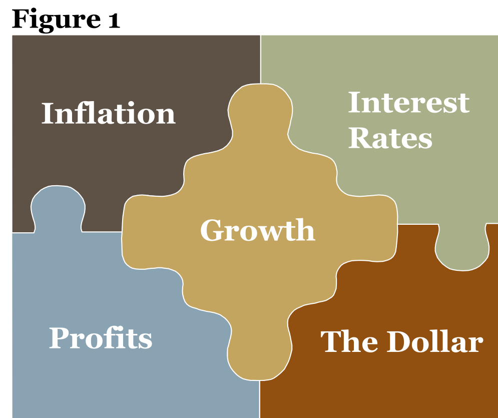
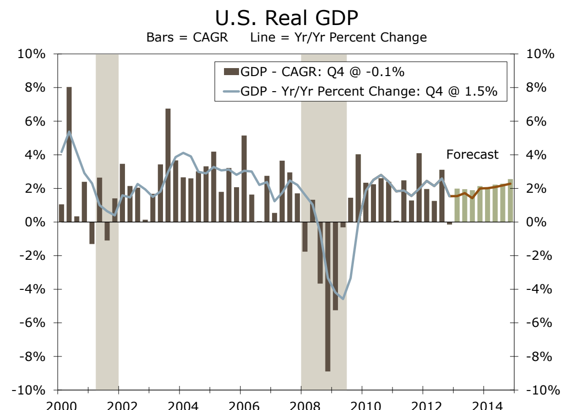


Figure 2



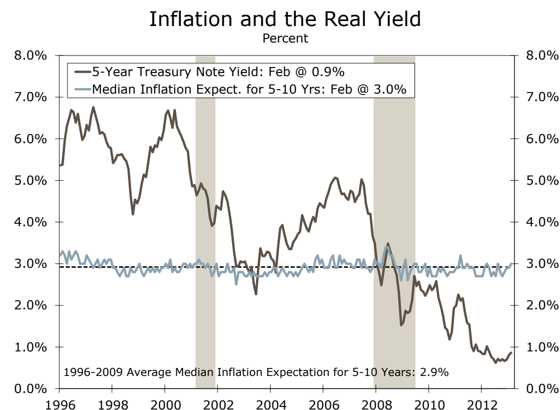
Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

Inflation and Real Yields: A Signal of Financial Imbalances

Yields are far below inflation expectations and have been for some time.

From our viewpoint, one sign of financial imbalances in the economy is the extent to which inflation expectations are not reflected in current 5-year Treasury yields (Figure 3). In the early years of an economic recovery, it is not surprising for Treasury yields to decline in line with monetary policy ease as evidenced in 2002-2004. However, the current period indicates that yields are far below inflation expectations and have been there for some time. This suggests that the extent of Fed buying of Treasury debt, along with that of the Japanese and Chinese central banks, has distorted pricing in the Treasury market.

Figure 3

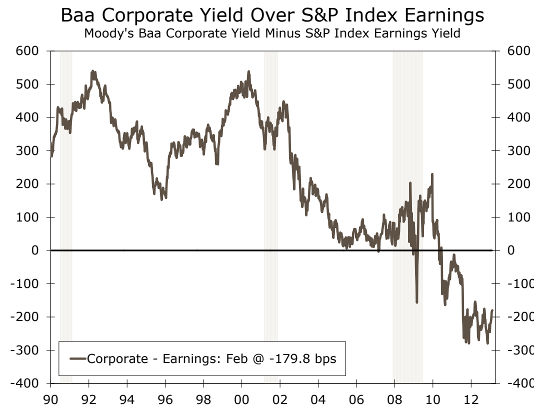


Source: Federal Reserve Board, University of Michigan and Wells Fargo Securities, LLC

Imbalances Between Bond Yields and Equity Earnings

Another signal of the unusual circumstances in today's capital markets is the inversion in the ratio between Baa corporate bond yields and S&P earnings as illustrated in Figure 4. Bond yields appear low relative to equity earnings even though general equities have historically yielded more (1990-2007) and are considered riskier investments.

Figure 4



Source: Moody's Analytics, S&P and Wells Fargo Securities, LLC

Risk Measures: No Crisis Signals

The VIX index suggests little reason to pursue a crisis policy.

Although monetary policy of near-zero interest rates, as described by President Esther George, are associated with financial crisis periods, the available financial market evidence does not signal crisis. The VIX index illustrated in Figure 5, has returned to pre-Great Recession levels and suggests little reason to pursue a crisis policy. In addition, the 3-month LIBOR-OIS spread (Figure 6) also is at pre-euro crisis levels and, thereby suggests, a no-crisis atmosphere.

Figure 5

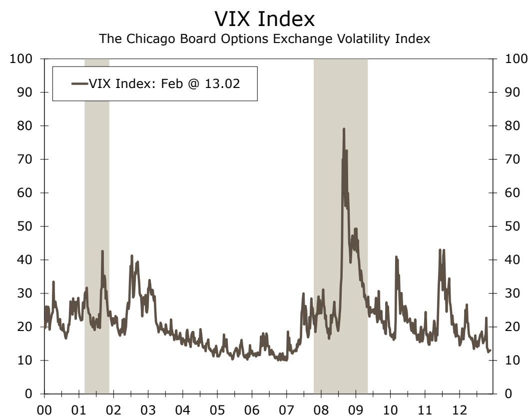
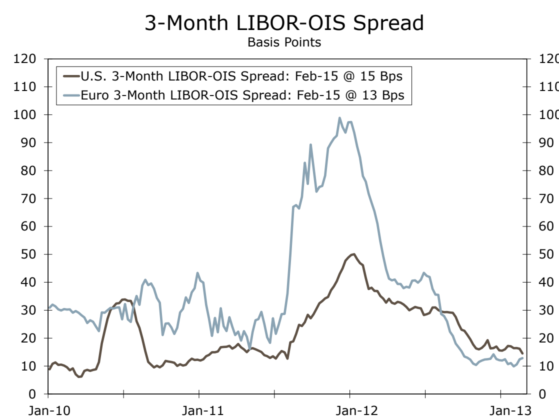


Figure 6



Source: Bloomberg LP and Wells Fargo Securities, LLC

Credit Quality at the Banks

More banks are actually easing credit standards.

Bank charge-off rates (Figure 7) have dramatically improved since the Great Recession ended and while the rates remain higher than prior to the recession, our view is that the workout of the housing boom will take time and there is a long-tail of delinquencies and charge-offs that will take additional time to work through. Meanwhile, the net percent of banks tightening standards on credit cards has actually dropped into negative territory (Figure 8) thereby suggesting that more banks are actually easing credit. In this way, our view is that credit has indeed normalized and the period of crisis near-zero interest rates is no longer appropriate.

Figure 7

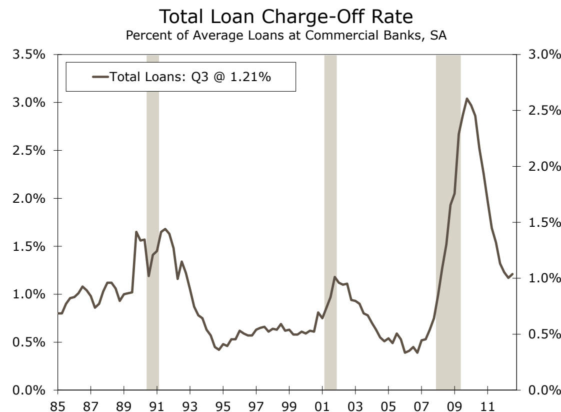
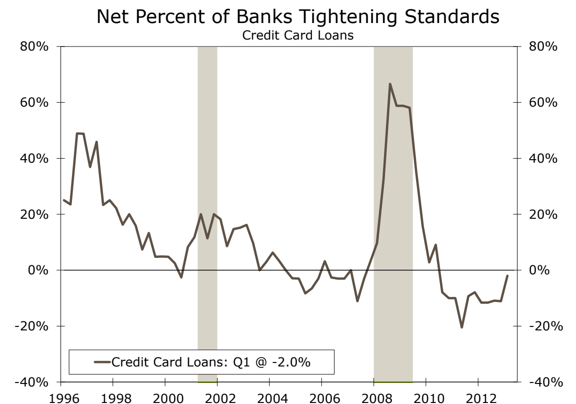


Figure 8



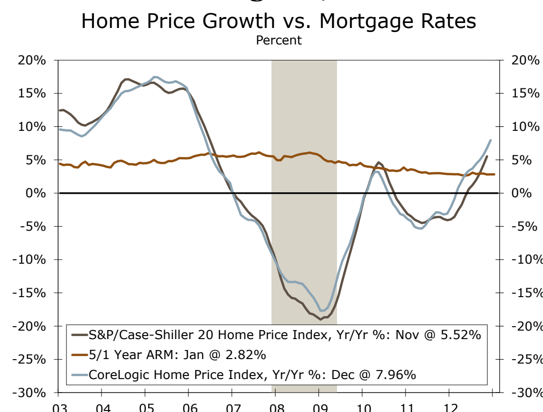
Source: Federal Reserve Board and Wells Fargo Securities, LLC

Home Prices and the Mortgage Rate: Repeating the Mistakes of the Past?

Rising demand and limited floating inventory will lead to rapid price increases.

As illustrated in Figure 9, home price appreciation rates now exceed the mortgage rate in a manner similar to the housing boom period of 2003-2006. Moreover, the acceleration of home prices suggests that this excess of home price appreciation over the mortgage rate is likely to persist for a sustained period of time. In addition, there are other signs of excess in the housing market now as well. First, the inventory of unsold existing homes remains at a very low level relative to the existing housing stock, and this suggests that incremental housing demand with limited inventory will tend to drive up prices faster than otherwise. As for any other good, rising demand and the limited floating inventory will lead to rapid price increases. Secondly, housing vacancy rates are back to 2005 levels suggesting that there is not a lot of excess inventory of homes to rent, and hence there is likely to be upward price pressures for buyers. Finally, new foreclosures are dropping rapidly thereby suggesting very limited new supply coming on the market anytime soon to relieve price pressures.

Figure 9



Source: S&P/Case-Shiller, Bloomberg LP, CoreLogic, Inc. and Wells Fargo Securities, LLC

Non-Financial Corporate Financial Positions: Very Strong

Finances for the non-financial corporate sector appear solid right now. S&P revenue and earnings growth have slowed recently, but that is in line with the experience of prior economic expansions (Figure 10). Moreover, the burden of interest expense is very low relative to prior economic expansions (Figure 11). Finally, the globalization of corporate profits (Figure 12) provides evidence that many U.S. corporations have a broad base of operations and thereby are less

sensitive to the growth expectations of any one economy—including the U.S. economy. In line with the growth in profits and low interest expense ratios we would expect, and we do see that, credit risk premiums for investment grade debt, as measured by the CDS index in Figure 13, appears to be reliably down from the crisis period of 2008-2009.

Figure 10

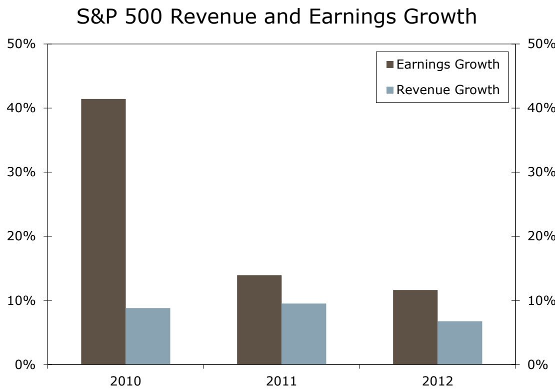
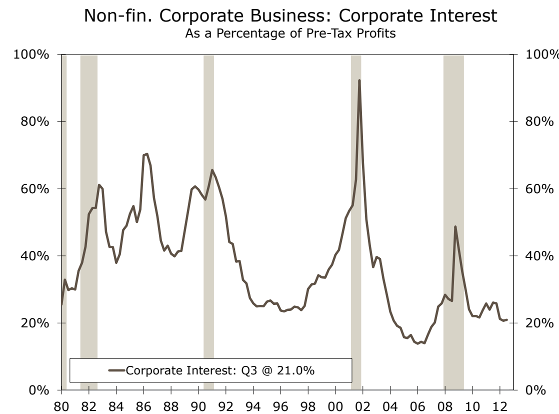


Figure 11



Source: Bloomberg LP, U.S. Department of Commerce and Wells Fargo Securities, LLC

Yet corporate cash is being redirected by the impact of the Fed's policy of sustained low interest rates. Low rates force companies to pour cash into pensions since a decline in rates will raise the present value of the future pension liabilities discount rate.[4] This impact helps explain the high level of cash held by corporations and the weakness of corporate investment in structures during the current economic expansion

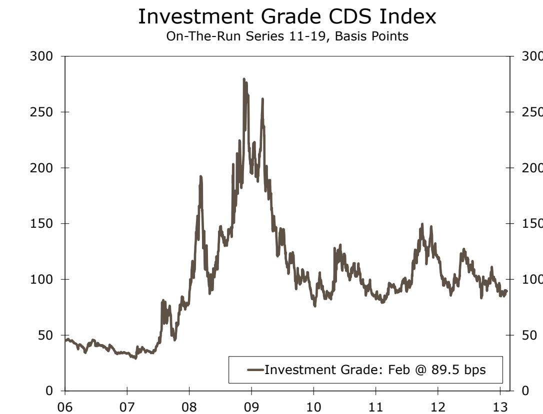
Corporate cash is being redirected by the impact of the Fed's low-interest-rate-policy.

Figure 12

Globalization and Corporate Profits

Sector	Percentage of Total Sales Earned Abroad (07-09 Average)
Information Technology	56.9%
Energy	48.1%
Materials	44.9%
Industrials	36.7%
Consumer Staples	27.5%
Consumer Discretionary	24.0%
Financials	18.0%
Health Care	17.4%
Telecommunications	0.6%

Figure 13



Source: Mark-It Partners, Bloomberg LP and Wells Fargo Securities, LLC

Healthy Bond Issuance Consistent with Functioning Credit Market Expansion

Bond issuance in 2012 has been a strong signal that credit markets are functioning normally. As illustrated in Figure 14, investment grade bond issuance has been at a consistent and solid pace for several years now. In addition, high yield issuance (Figure 15) has accelerated in recent years as the recovery/expansion matures. These developments support our view that credit markets are functioning normally as far as the corporate bond market is concerned.

Credit markets are functioning normally.

[4] **Ramsey, Mike and Monga, Vipal. (Feb. 3, 2013). Low Rates Force Companies to Pour Cash into Pensions. *Wall Street Journal.***

The risk of leveraging activity, however, has increased.

Unfortunately, there are now new worries for bondholders.[5] With low interest rates and more optimistic views of the economy, compounded by an accommodating bond market as illustrated by the strength of issuance, some investors are taking this opportunity to pursue leverage buy-outs. These buy-outs, financed by debt-issuance, could possibly lead to downgrades of corporate debt and investor losses. At present, the risk of leveraging activity has increased and thereby the issue surfaces on whether the current low-interest-rate policy has stayed too long and thereby is encouraging a more aggressive risk-taking appetite than perhaps the Federal Reserve anticipated.

Figure 14

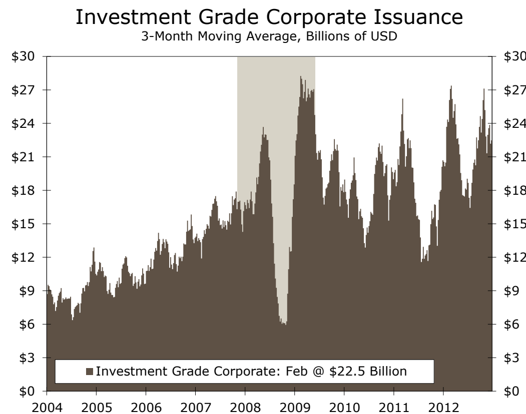
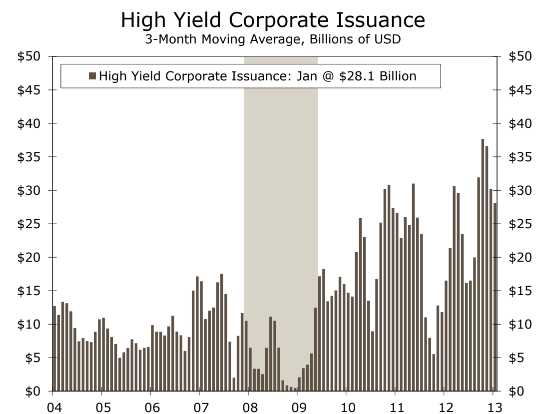


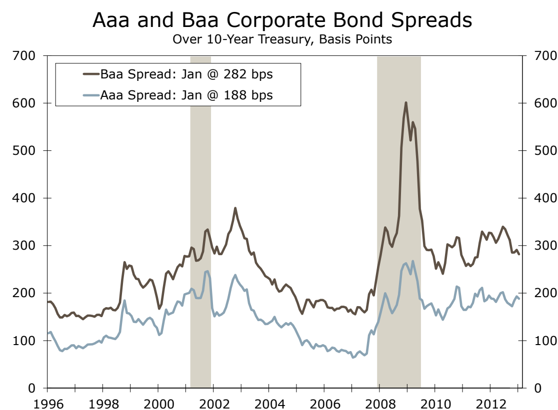
Figure 15



Source: IFR Markets and Wells Fargo Securities, LLC

Finally, current Aaa and Baa corporate bond spreads have travelled in a range slightly higher than during the boom period of 2005-2006, suggesting that there is a risk premium in the market today that provides a better risk/return balance than during the boom period. It is reassuring that the market is pricing risk in a better way than it did in the last decade.

Figure 16



Source: IHS Global Insight and Wells Fargo Securities, LLC

Bank Lending: Patterns of Normal Activity

Contrary to popular commentary, bank lending is rising.

Contrary to popular commentary, bank lending is rising across many subgroups of banks and is in line with traditional patterns of inventory finance. As illustrated in Figure 17, commercial and industrial loans by bank type have exhibited a steady rise in lending since 2010. This lending gain reflects the behavior of foreign banks, as well as large and small domestic banks. The gains in lending are consistent with the rebound of inventories (Figure 18) indicating that the interaction

[5] **McGee, Patrick and Matt Wirz. (Feb. 3, 2013). New Worry for Bondholders: LBOs. *Wall Street Journal*.**

of bank lending and real economic activity is in a normal relationship and no longer in crisis mode.

Figure 17

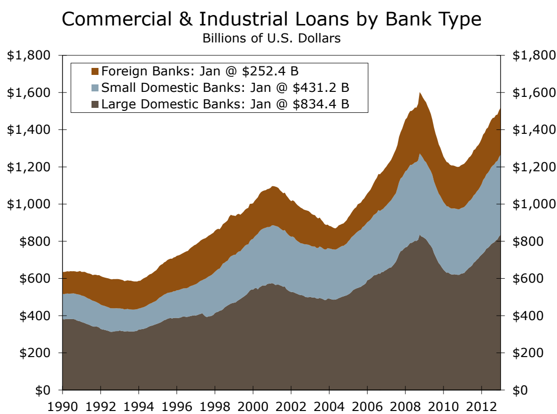
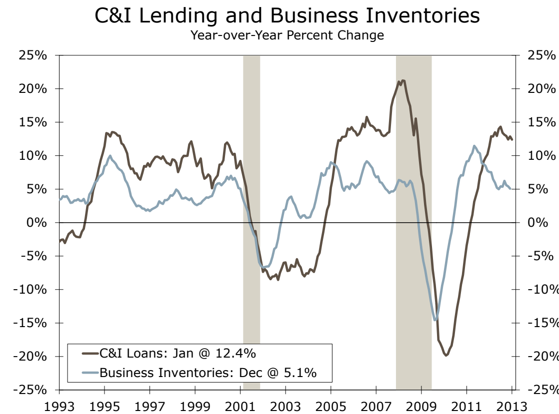


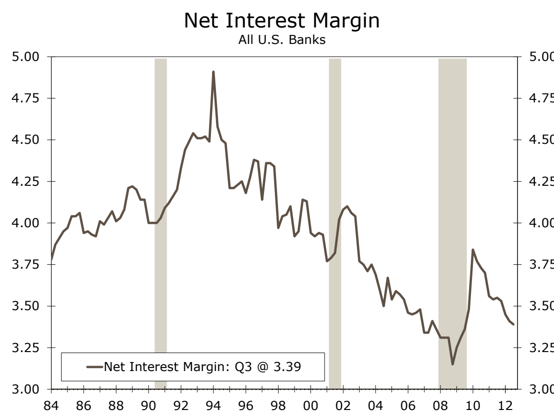
Figure 18



Source: Federal Reserve Board and Wells Fargo Securities, LLC

One challenge for the credit markets and the Federal Reserve is the longer-term decline in the net interest margin at all U.S. banks (Figure 19). The zero-interest-rate policy of the Federal Reserve is, in part, one factor behind the decline in the net interest margin. However, the longer-term pattern of the net interest margin suggests that there is rising competition in the banking sector since the early 1990s.

Figure 19



Source: Federal Financial Institutions Examination Council and Wells Fargo Securities, LLC

Real Estate Lending: Credit Allocation Improving

Credit standards and credit demand in the residential loan market has shown evident improvement in the past six months. As illustrated in Figure 20, banks are reporting stronger demand for residential loans while the percentage of banks tightening loan standards has been relatively unchanged for more than a year. As a result, market dynamics appear to be improving. Meanwhile, actual lending has turned positive as illustrated in Figure 21, and thus indicating a turnaround in the market for real estate lending. The net result suggests that the credit market for residential investment is functioning in a way to support continued home buying.

The credit market for residential investment is functioning in a way to support continued home buying.

Figure 20

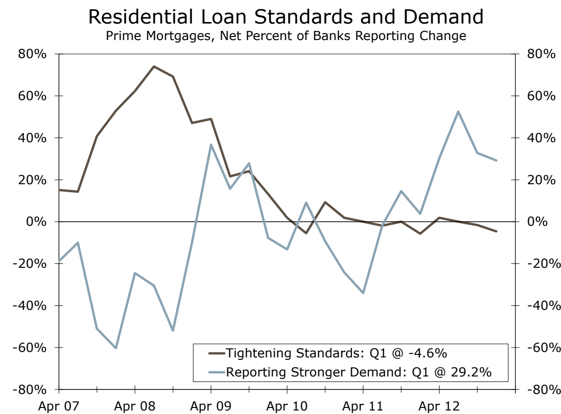
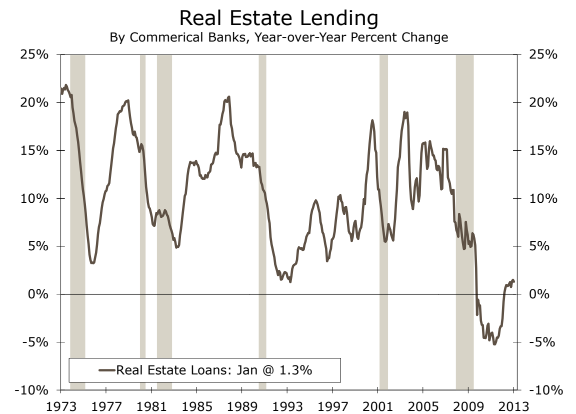


Figure 21



Source: Federal Reserve Board and Wells Fargo Securities, LLC

Inflation: A (Small) Bias to the Upside

There are a few market signals that suggest inflation pressures are rising.

Current modest inflation, measured by the consumer price index and illustrated in Figure 22, provides time for credit markets to continue to improve and also allows the Federal Reserve to continue current policy. There are a few market signals that suggest inflation pressures are rising, although still not at a pace that would prompt us to expect the Federal Open Market Committee would alter its current policy. As illustrated in Figure 23, one measure of inflation expectations, TIPS, demonstrates that since 2010 there is a steady, but very modest, rise in inflation expectations. The five-year measure of inflation expectations is at 2.29 percent, and the five-year forward rate is 2.85 percent. As suggested earlier, inflation expectations are rising but not at the pace that would likely prompt any change in monetary policy soon.

Figure 22

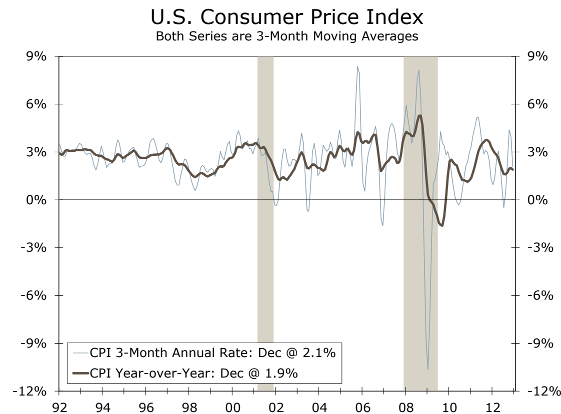
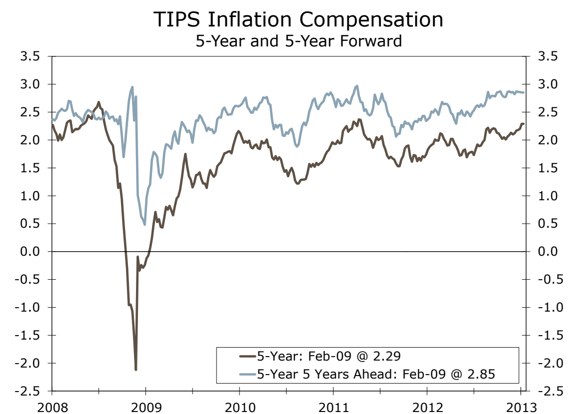


Figure 23



Source: U.S. Department of Labor, Federal Reserve Board and Wells Fargo Securities, LLC

A longer-term perspective of inflation expectations is illustrated in Figure 24. Ten-year inflation expectations have trended upward since 2010 and currently have returned to the levels that existed prior to the 2007-2009 recession. Similar to the 5-year measure of inflation expectations, the current level of inflation expectations is not high enough to move the Federal Open Market Committee to alter current policy. Finally, gold prices have risen steadily since the recovery began in 2009, yet over the past year, prices have leveled off. Gold prices, like many other prices, respond to several factors so that inflation expectations are not the only factor. But, many analysts do use gold prices as an inflation proxy and the message from gold prices now is that inflation expectations do not appear to be accelerating.

Figure 24

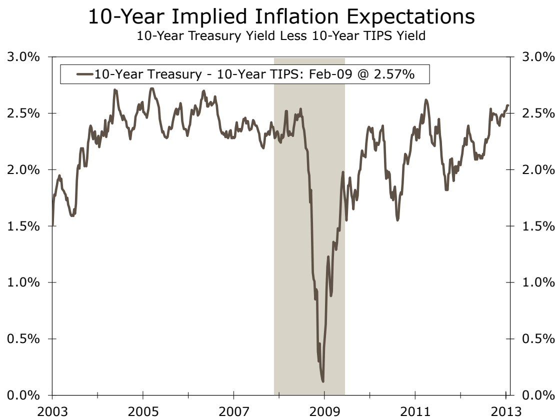


Figure 25

Source: Federal Reserve Board, Bloomberg LP and Wells Fargo Securities, LLC

Credit Imbalance: The U.S. Treasury Market

Policy can change the demand for U.S. Treasury debt at a moment's notice.

Persistent, large future federal deficits as illustrated in Figure 26, create significant uncertainties in the financial markets. Will continued large federal deficits find sufficient demand at current interest rates, dollar exchange rate and level of inflation? How much will large federal financing squeeze out private sector investment? Something has to give. This is especially true given the dominant role played by central bank Treasury-buying policies in Japan, China and, ultimately, by the Federal Reserve in the United States. Since these institutions are not motivated by profits but rather by concerns about exchange rate stability and/or unemployment, policy can change the demand for U.S. Treasury debt at a moment's notice and for no market-related factors.

Figure 26

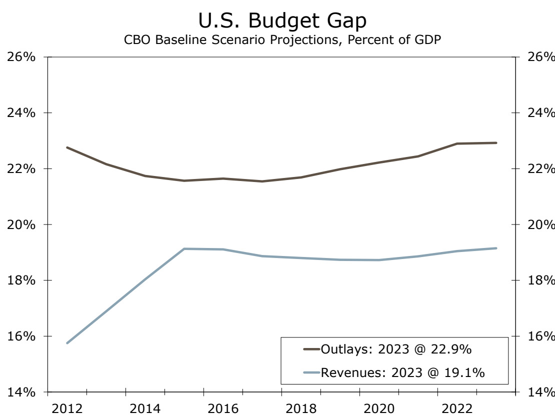
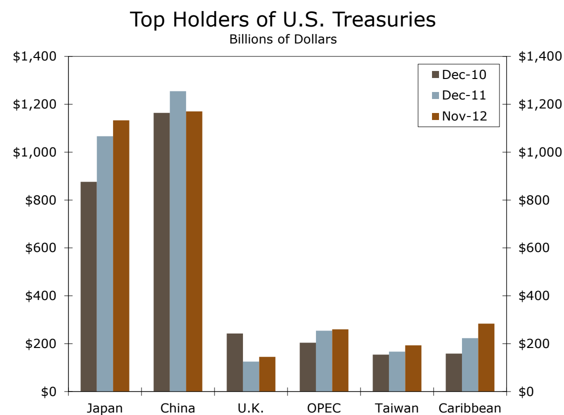


Figure 27



Source: Congressional Budget Office, U.S. Department of the Treasury and Wells Fargo Securities, LLC

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