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SHORT THOUGHTS

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The Fed's Financial Conditions Dilemma

Did The Fed Undermine Itself On Financial Conditions?

Most off-the-shelf financial conditions indices (FCIs) are much looser today than they were just a few weeks ago. This sets up a policy and communications dilemma for the Federal Reserve. Before the Oct. 31-Nov. 1 FOMC, Fed officials suggested that tighter financial conditions at the time were doing some of the Fed's work for it, helping to obviate the need for higher policy rates. Higher bond yields (on the 10y note reaching 5% intraday on Oct. 23), lower equity markets and stronger dollar – among other financial variables – were seen contributing to a tightening of financial conditions. This would help to slow the economy, relieving some pressure on policy. Chair Powell highlighted these tighter financial conditions at this Nov. 1 press conference: "In this case, the tighter financial conditions we're seeing—[coming] from higher long-term rates, but also from other sources, like the stronger dollar and lower equity prices—could matter for future rate decisions…"

The implication, also repeated in the minutes from that FOMC meeting, was that tighter financial conditions meant the Fed could hold off on subsequent hikes and, as we have been arguing, the tightening cycle had likely peaked. This, ironically, set up the dilemma. Between softer data, a less-bad-than-feared quarterly refunding announcement from the Treasury (also on Nov. 1), and the perception that the Fed is indeed finished hiking, financial conditions loosened significantly. By celebrating tighter financial conditions as one of the main reasons not to keep raising rates, the Fed ironically created looser financial conditions!

Indeed, if we read further in Powell's press conference transcript, he goes on to say that the tighter financial conditions at the time would matter for future policy decisions as long as two conditions were satisfied. Again, quoting the Chair: "The first is that the tighter conditions would need to be persistent…. we're looking for persistent changes that are material. The

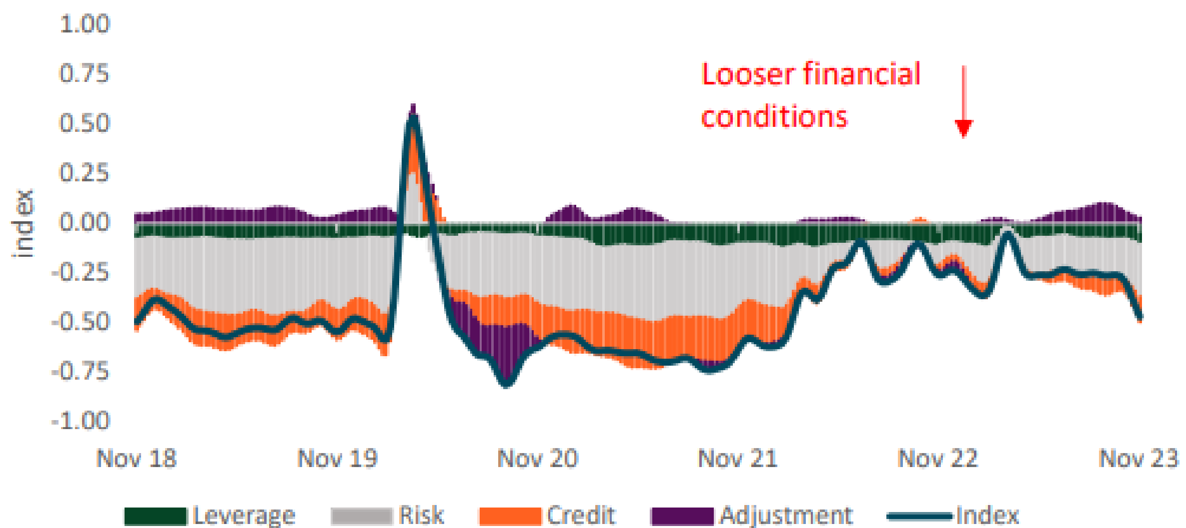
second thing is that the longer-term rates that have moved up… if we didn't follow through on [rate hikes] then the rates would come back down." In other words, tighter financial conditions would have to endure for some time, and the risk that no more rate hikes would be coming could drive conditions to be looser, which could swing the rates pendulum back the other way. Hence the dilemma that has arisen in recent weeks since the FOMC.

Take a look at the chart below. We present the Chicago Fed's Adjusted National Financial Conditions Index, a combination of over 100 financial variables. We prefer this measure to other off-the-shelf FCIs because the large number of inputs doesn't allow for any single market, price, or spread to dominate the index – it is quite broad in its construction. See here for more information on this index. Furthermore, the Chicago Fed classifies these many variables into three main components: "risk", "leverage", and "credit", according to the role they play in the financial system. There is also an adjustment factor which moves with the overall stance of the macroeconomy. We present the decomposition of the overall index into these four factors, as well as the index itself.

Note the clear drop, -19% between Oct. 20 and Nov. 17, the latest date for which we have data, implying much looser financial conditions than previously. This FCI is now as loose as it was in the beginning of 2022, before the Fed started raising rates! This cannot be what the Fed had in mind just a few weeks at the FOMC meeting. Obviously, the first condition set out by Powell, cited above, has not been fulfilled. The second – that the end of rate hikes should not mean an end to tighter financial conditions – also looks to have been violated. If one leans on FCIs to make policy, one risks moving them in the opposite direction than desired.

All that said, we don't think this means further policy moves are likely – at least in the short term. What it does mean, we think, is that Fed rhetoric and its overt bias will be hawkish. We already think the market has gotten ahead of itself by pricing rate cuts starting next May. We have argued (see here) that although the economy will likely slow in 2024 and inflation continue to decelerate, both of these phenomena will be drawn out and stubborn. We don't see the first rate cut until July 2024, or maybe even September (after being teed up in August at the Jackson Hole confab). We expect the Fed to push back against the notion of rate cuts so early, in part as an effort to reestablish tighter financial conditions.

Looser Than Before Fed Started Tightening!



Source: BNY Mellon, Federal Reserve Bank of Chicago

However, Lending Conditions Are Tightening

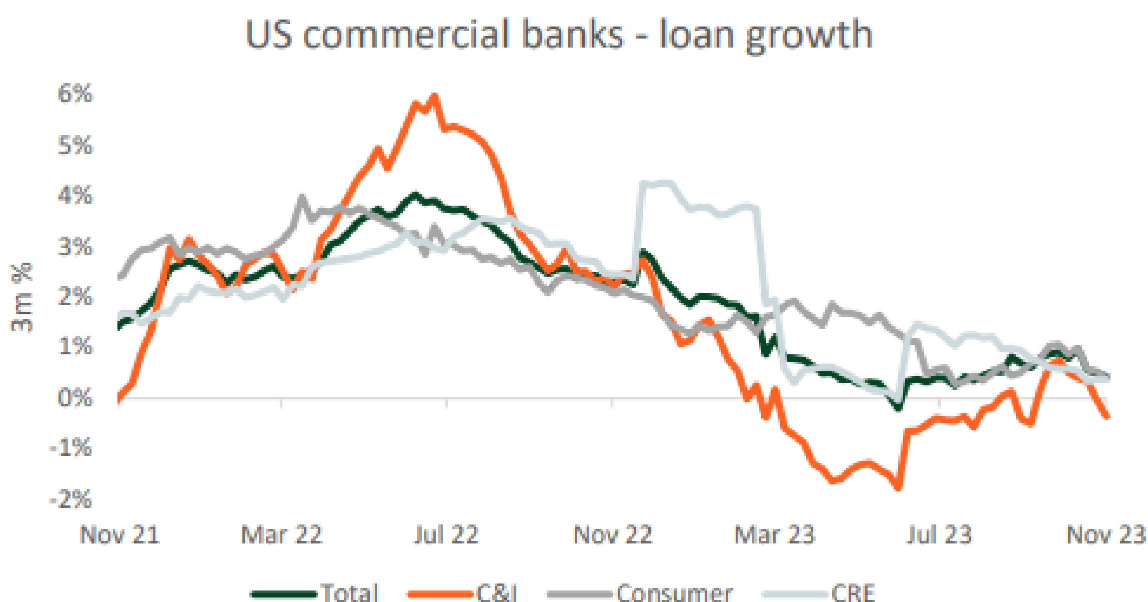
We are also keeping an eye on the provision of credit in the economy. One of the ways that monetary policy works is to tighten credit conditions – higher funding costs, expectations of a slowing economy, and higher interest rates curb lending, slowing demand, hence the economy, relieving pressure on inflation.

While we note in the Chicago Fed data cited above that the credit conditions sub-index has loosened along with the other components, it is less responsible for the overall loosening of the FCI than the “risk” sub-index. The former contains variables like credit spreads as well as surveys on credit availability – things that reflect the perceived availability and pricing of credit. The latter includes variables that reflect risk appetite in financial markets, like short-term money market spreads and volatility measures.

However, and as can be seen in the chart below, actual lending by commercial banks has slowed to a crawl after being pretty hot just a few months ago.. The pace of lending dropped significantly back in March/April, during the regional bank stresses, but then picked up again during the summer and a period of surprisingly strong macroeconomic conditions.

Now, all four series are converging on – or in the case of commercial and industrial lending, already below – zero growth. The three-month increase in overall lending (just 0.4%), as well as consumer loans (also 0.4%), commercial real estate (0.4%) and commercial and industrial lending (-0.4%) are the slowest since at least 2021. With bank balance sheets shrinking and lending drying up, we expect this to exert a braking influence on the economy, slowing growth to below trend in Q1-Q2 2024, in line with the Fed’s preference.

Lending Squeeze?



Source: BNY Mellon Markets, Federal Reserve Board of Governors

iFlow: Bill Bonanza Continues

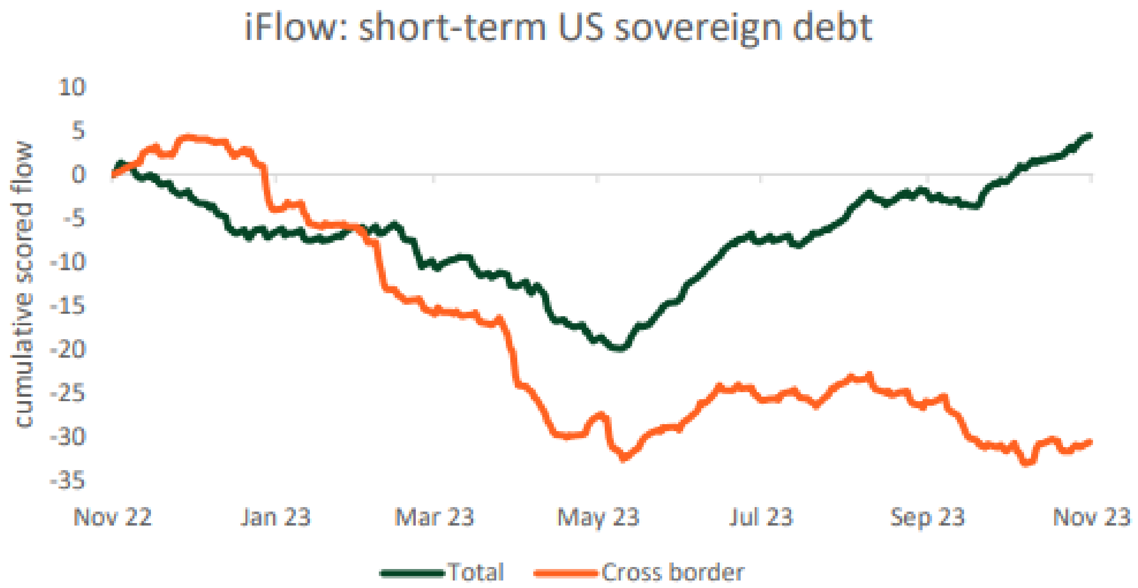
We now take a look at what iFlow says about take-up of the ongoing surge in T-bill issuance. We have reported (for example, here) that more than $1.6trn in T-bill issuance since June 1 has gone smoothly for the most part, with money market mutual funds content to move assets out of the Fed's reverse repo facility (RRP) and into the bills market.

Real money institutional investors are following suit. In the chart below, we show cumulative flows into the 0-1y part of the US sovereign curve – both total flows and just those from cross-border investors, setting Nov. 18, 2022 to zero and adding each day's flows thereafter. This allows us to see trends in the data over the past year. Since June 1, the day the debt ceiling impasse was averted and T-bill issuance resumed, there has been an impressive pickup in total flows into short duration Treasuries. Note that this 0-1y maturity bucket isn't comprised of only bills; it also includes any US paper that is less than one-year away from maturing. Nevertheless, the trend is clear: real money institutional investors are buying the front of the curve and snapping paper up consistently and almost relentlessly, except for a few brief lulls in July and September.

Also note that foreign buyers have been much more restrained in their purchases, depicted by the orange line. This is presumably because yields overseas on short-term paper are similarly attractive, obviating the need for overseas investors to come to the US to get attractive returns on short duration instruments. The difference between the blue and orange lines suggests that onshore money is ravenous in its desire to pocket significant yield at 0-1y

maturities. We don't expect this trend to relent. It also further illustrates that the refunding is meeting with adequate demand at the short end of the curve.

Snapping Up Short-Term Paper



Source: BNY Mellon Markets, iFlow

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