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Economics Group

Special Commentary

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Fed Liftoff Plans: The Risks of Doing Nothing

Executive Summary

Following the March Federal Open Market Committee (FOMC) meeting, Treasury market expectations for the first fed funds rate hike moved from June to September amid Fed signals that current economic conditions are still not ripe for a rate increase. We find the delay in Fed action concerning given the incentive effects of searching for higher yield and, in turn, the willingness of market actors to take on additional risk when interest rate expectations are flat. In this report, we outline our argument why the Federal Reserve is behind the curve in terms of lifting the short-term fed funds rate. We begin with a review of previous monetary policy cycles and look at the interaction of Federal Reserve policy and credit markets and their resulting impact on asset price inflation and risk-taking. We then conclude with a review of the current credit environment and explore credit sectors and resulting asset inflation occurring today, in part due to the ongoing low interest rate environment.

We find that there are already signs of risk-taking behavior and attribute at least part of this increase to easy monetary policy that has kept interest rates exceptionally low for a long period of time. In fact, short-term interest rates have been less than the rate of inflation for several years. Increased risk-taking behavior is a natural by-product of global investors looking for higher yielding investments in what is expected to be an exceptionally low rate and low volatility environment. Large run-ups in high yield debt issuance, along with evidence of greater subprime lending activity, particularly in the auto market, show that the increased risk appetite has spread across credit sectors. Our view is that the longer the Fed waits to raise interest rates, the greater the risk that these credit sectors become overheated and result in adverse economic effects.

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Lessons from the Past

There were no doubt a number of imbalances in both the credit sector and the economy that resulted in the financial crisis and Great Recession of 2007-2009. However, there is a large and growing amount of research on the role that the Federal Reserve played in keeping monetary policy too loose for too long.[1] Looking back to the early 2000s, the decade began with the dot-com bubble and resulting recession. The response from the Federal Reserve to counter the effects of the 2001 recession was to cut interest rates. Beginning in January 2001, the FOMC began cutting the federal funds target rate, eventually taking the rate to one percent and kept the low rate in place until June 2003, a full year and a half after the end of the 2001 recession, which itself only lasted eight months.

The by-product of this low rate environment was an increase in risk-taking behavior as investors looked for alternative investments that provided a higher yield. This incentive effect of creating greater demand for riskier assets helped to support the appetite for subprime home mortgage loans, collateralized debt obligations and a host of other credit products. With a greater risk

[1] Taylor, J.B. (2007). Housing and Monetary Policy. National Bureau of Economic Research, Working Paper 13682.
Gordon, Robert J. (2009). *"Is Modern Macro or 1978-Era Macro More Relevant to the Understanding of the Current Economic Crisis?"* September 12, 2009, revision of a paper first presented to International Colloquium on the History of Economic Thought Sao Paulo, Brazil.

appetite came the rapid growth in new residential mortgages (Figure 1) and asset price inflation, in particular home values (Figure 2). The imbalances in the credit system, in part due to the Fed's easy monetary policy, led to the financial crisis and resulting recession.

Figure 1

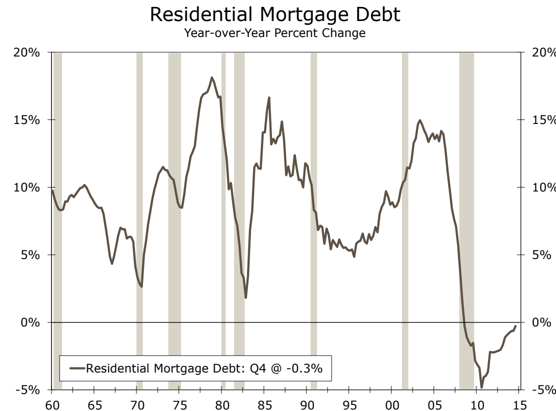
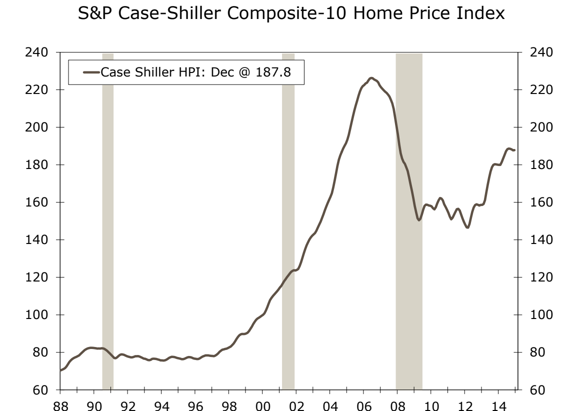


Figure 2



Source: Federal Reserve Board, S&P and Wells Fargo Securities, LLC

Have We Learned Our Lesson?

A look at the U.S. credit sector data suggests we may already be going down the same path as we did in 2003.

Given the experiences of the past, are we set to repeat the same mistakes? A look at the U.S. credit sector data suggests we may already be going down the same path as we did in 2003, but this time the mechanism is focused in corporate credit and consumer auto lending markets as opposed to housing. Among the imbalances that we see currently is the rapid rise of mergers and acquisitions (M&A) activity. Since the trough in 2009, M&A activity has continued to climb higher, more than tripling as of the fourth quarter of 2014 (Figure 3). In addition, stock market prices have been on a steady upward trajectory for quite some time, coinciding with the expansion of the Federal Reserve's balance sheet. One of the more concerning aspects of the recent run-up in M&A activity is that a number of the M&A deals have been funded through the new issuance of riskier high yield debt. As can be seen in Figure 4, there has been a sizable increase in high yield debt issuance since the end of the recession, used for everything from the aforementioned M&A deals to firms refinancing at lower rates.

Figure 3

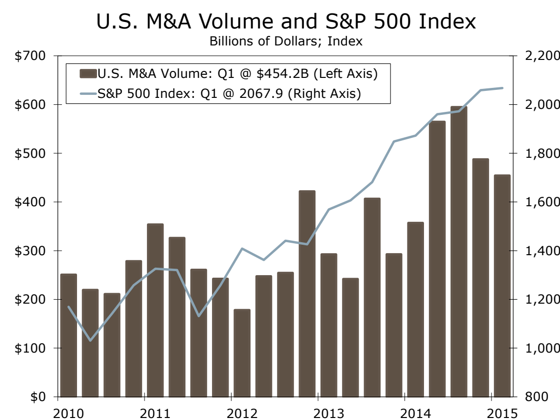
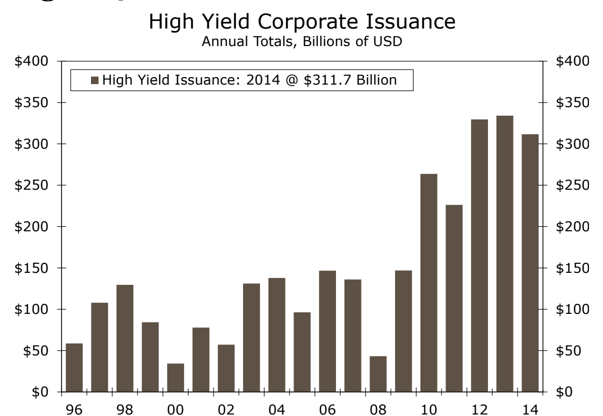


Figure 4



Source: Bloomberg LP, SIFMA and Wells Fargo Securities, LLC

There is evidence to suggest that a great deal of this increased risk-taking is directly related to the stance of monetary policy over the past few years, and that this greater risk-taking to reach for yield is not isolated to the United States. According to a report by the Bank of International Settlements (BIS), global investors have snatched up large volumes of newly issued corporate debt, particularly for lower-rated borrowers, at the same time equity markets reached new highs. The BIS goes on to cite the fact that some asset values appear to be decoupling from fundamentals, one indicator of a potential bubble.[2] Not only does the BIS analysis suggest that the reach for yield is prevalent in the United States, but the trend is also occurring globally.

Figure 5

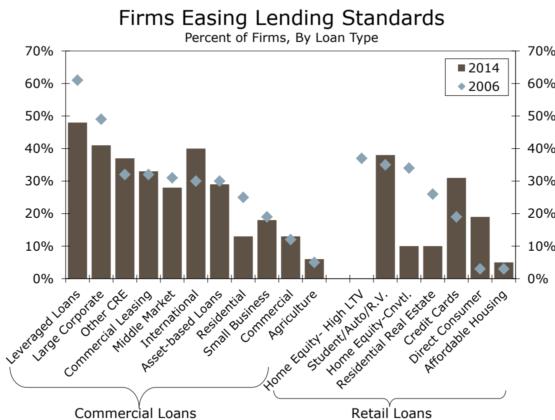
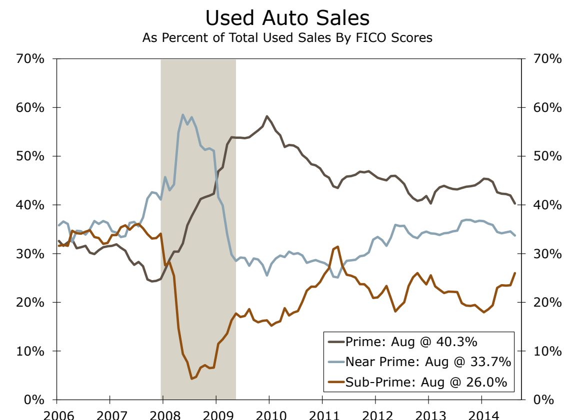


Figure 6



Source: Office of the Comptroller of the Currency, CNW Research and Wells Fargo Securities, LLC

Beside the corporate debt and equity markets, is there other evidence that greater risk-taking is going on in other parts of the economy? Figure 5 presents data on the number firms easing lending standards today (brown bars) compared to the percent of firms easing standards at the height of the bubble in 2006. As can be seen, lending standards for many products have matched the easy lending standards of 2006. In the case of student/auto loans, and asset-based loans, lending standards today are being eased more than they were in 2006.[3]

Another area in which riskier lending, fueled by easy monetary policy, could become a major concern is in the auto market, where a great deal of subprime lending activity has taken place (Figure 6). Furthermore, recent data suggest that delinquencies for auto loans are beginning to rise slightly, which may be the first signs of trouble to come. While large numbers of auto defaults are unlikely to singlehandedly create a financial crisis, there would be adverse impacts on the automobile sector and consumer spending resulting from repossessed cars coming onto the market.

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The Increasing Risks of Doing Nothing

So what are we to conclude about the current stance of monetary policy, keeping interest rates low for so long? First, as we have seen in prior cycles, the strong incentive effects of global investors searching for yield leads to increased risk-taking behavior on both the supply and the demand side of the credit markets. Second, this increased risk appetite then begins to spill over to the credit sectors which we are currently seeing in the form of higher equity values, a surge in high yield debt issuance and easier credit lending standards. The result of this process, in our view, is emerging imbalances in the credit market fueled by the continued low interest rate policy maintained by the FOMC. We have seen this story play out before over the last decade and the story did not end well. We do not feel that the current credit imbalances are enough to cause a

[2] **Bank of International Settlements (2014). 84th BIS Annual Report 2013/2014.**
[3] **For more on the changes in the lending landscape see Silvia, J.E. and Miller, M. (2015). "*Risks in the Lending Market.*" Wells Fargo Economics Group.**

global financial crisis as was the case with the housing boom and bust. However, should delinquencies begin to rise for subprime consumer credit products, this signal would likely be enough to result in anticipated future disruptions to credit markets. The risks of the Fed doing nothing are indeed real, and we look to be poised to repeat the same mistakes of the past.

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