February 1, 2021

As the Economy Slows, New Questions Arise About Financial Stability

Transcript

Bill Emmons: Hi, I'm Bill Emmons. Today is February 1, and I'd like to talk about the FOMC meeting that took place January 26 and 27. There were not very many changes in the policy stance so, what I'd like to do, is take a little bit of a step back and think about the context. The economy is slowing, and there are some new questions that are arising about financial stability and the Fed's potential role in that discussion.

But, first, the takeaways from this meeting included an unchanged interest-rate policy, that is, the Fed funds target range is to remain between zero and a quarter percent; and the interest rate on reserves will remain at 10 basis points. The Asset Purchase Program will continue. That means Treasury securities will be purchased monthly, at least $80 billion, and GSE mortgaged-backed securities will be purchased in the amount of at least $40 billion per month. In terms of economic outlook, the FOMC believes that the recovery will continue into 2021, but they stress that there are significant risks and a great deal of uncertainty remaining, not least around the course of the pandemic and the vaccination campaign. As for monetary policy, there's every intention on the part of the FOMC to remain supportive until the economy has substantially recovered and, by that, they mean getting back to those very low unemployment rates we saw before the pandemic and getting close to that 2% inflation objective.

So, the financial stability concerns that I mentioned, really go back to the crisis period of March 2020. So, I'll take this in three steps. First, there's more discussion, and the Chairman talked about this in his press conference; he was asked about it. Really, the robustness of some of the nonbank financial institutions and critical financial markets; we saw those infrastructure components really start to buckle last March, and there are some unresolved issues that people, and the Fed, are somewhat concerned about. Second is the level of asset prices, that actually measures, the potential for corrections; and third, closely related to that, are levels of volatility that we're seeing in markets.

So, first, the financial-market infrastructure components that I'm thinking about primarily are these major asset markets like equities, corporate bonds, but also the Treasury market; and that was very surprising last March that we saw breakdowns, almost a loss of functioning, even in the Treasury market. It was only extraordinary actions by the Fed back at that time, initiating the large asset purchase programs, for example, that allowed those markets to recover. So, there's a lot of concern, that if there is to be another, a period of turmoil, that we may have those problems again.

The second issue is evaluations, and, as the Chairman stressed, the Fed doesn't have a particular concern about any particular level of asset prices, except for its implications for financial stability. The historical pattern, that when asset markets are very highly valued, there seems to be a higher likelihood of large corrections, and those can be pretty disruptive. So, for example, in the stock market, one common measure is a price earnings ratio, and a version of that is the cyclically adjusted price to earnings ratio, or CAPE. This is the current level of the S&P 500 Index divided by a 10-year moving average of inflation-adjusted earnings. And, looking back over 100 years, the current level is very high. It's exceeded only by the levels in the late 1990s and around 2000 and, of course, as we know, that period was followed by a very large correction in stock prices. So, this is a concern, somewhat a concern in corporate bond markets, somewhat, although less so I'd say, in commercial real estate, and even in particular housing markets.

The third concern with financial stability is volatility, and this is a picture that shows the VIX Index, the Market Volatility Index. And, looking back over a 15-year period, the average was about 17.6%, and just in the January 27 period, the close was more than twice that high. And, notably, since March of 2020, this level of volatility has remained consistently above the longer-term historical average. This really indicates that investors in financial markets do believe there's the potential for some pretty significant asset price movements. And, that, as I say, can be disruptive. So, that's something the Fed is keeping an eye on.

So, what are the implications for banks? I think the low interest-rate environment will continue for the foreseeable future. The economy is slowing and, with that, likely lower demand for loans. So, I think this is the significant question mark that banks need to think about going into this year. And, as for credit quality, we've had substantial support from fiscal policy in 2020; even at the very end of 2020, there was discussion of more fiscal support coming. Even if it's not very well targeted, it does seem to have been fairly helpful in avoiding large credit losses, because we know a lot of households and businesses would have had a lot more difficulty maintaining or avoiding defaults if it had not been for that support.

And, as for what we should expect, the Fed will maintain a very accommodative policy stance until the recovery is substantially complete and, by all accounts, that is not likely to occur until well into next year or even the year after that. Inflation may pick up briefly, but the FOMC view is that inflation expectations are going to remain anchored around that 2% level. And, so, it's unlikely that the Fed would react, even if we do see a few isolated readings of elevated inflation. As for financial-market volatility, there's every reason to believe that it's going to continue. I think the Fed would prefer not to react to that, but we'll be keeping an eye on it.

Thanks for listening, and we'll see you next time.

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