TAKE FIVE with Bill Emmons

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FOMC Support for the Economy Continues

Transcript

Bill Emmons: Hi. I'm Bill Emmons. I'd like to talk to you about the FOMC meeting that took place April 27 and 28. The FOMC is committed to supporting the economy for quite some time. That's the main takeaway from the meeting. More particularly, interest rates will remain unchanged, the fed funds rate between 0% and ¼%; the interest on reserves at 10 basis points. Large-scale asset purchases will continue at a pace of at least $120 billion per month. The FOMC statement made clear that FOMC members believe the economy is strengthening and that the Fed will remain patient. In particular, they stressed those hard-hit, face-to-face service sectors—like restaurants and travel—are picking up. Bottom line for the economy: The vaccine progress we're seeing, continuing policy support, plus improving confidence throughout the economy are going to result in strong spending growth this year.

I think it's notable that there was discussion at the post FOMC press conference of the Fed's monetary policy exit strategy and possible concerns about financial stability. In particular, people want to know: When will the Fed begin tapering bond purchases? When will the fed funds rate lift off of zero? There were only qualitative indicators provided by the chairman, nothing really specific. And in terms of financial stability, are fiscal and monetary policies excessive? Will they stoke inflation or financial instability?

So, just to set the stage for those policy considerations, the FOMC statement continues to stress at the very top the role of COVID in determining how quickly the recovery can proceed. COVID-19 is down but not out. Case of new infections and deaths nationwide is down 80% from their January peaks, but they are still at considerable levels. The share of the population now fully vaccinated is 29%. We'd like, of course, to get that much, much higher. As the chairman said, we need people to be comfortable re-engaging in the economy.

The massive policy support we've seen will continue. One way to think about that is that the Treasury has borrowed $11 billion per day since March 30 of last year. Meanwhile, the Fed's balance sheet has been growing at $9 billion a day since late February of last year. So, with all of that support, all of that improved outlook, banks' balance sheets are growing. They will continue to grow this year with the economy. Deposits and securities are up 30% in just two years, and they're still rising very rapidly. Bank loans are increasing after a flat spot last year led by Commercial and Industrial (C&I) and consumer loans.

So, a little bit more detail on a couple of those points. In terms of the COVID-19 impact, we have now lost more than 573,000 Americans to COVID. In comparison with other G7 countries—the major industrialized nations—adjusted for population, the United States stands in the middle, but actually a little bit on the high side relative to some of our peer nations. If you take the seven states of our district, put those in comparison, again, adjusted for population, you can see that our district has been hit very, very hard by COVID. Five of our seven states have death rates above the U.S. average, which itself is somewhat high in the G7 comparison.

So looking at that spending recovery, we can think about GDP, gross domestic product, as a measure of spending. This is what consumers, businesses, governments are spending as we recover. After that huge hit last year, we had a strong bounce back in the third quarter, some flattening in the fourth, and then a renewed surge in the first quarter of this year. But jobs have not recovered as quickly. How are we able to spend more rapidly than the job market is improving? Well, of course, that's the role of that income support coming from government policies.

As for bank balance sheets, deposits and securities have gone up by more than 30% in just two years. Loans grew rapidly early in 2020 but then flattened out. And only early in 2021 are we starting to see a little bit of an increase again. This is for banks outside the top 25 by assets or under about $160 billion. Looking at the loans by category, C&I loans, which surged early last year—part of that is PPP lending, part of that is businesses taking down their credit lines—that flattened out. But only in early 2021 are we starting to see some growth in C&I loans again. Also, consumer lending, which shrank last year, has started to grow. Meanwhile, residential and commercial real estate loans are about flat.

So, the challenge, of course, facing banks with this huge inflow of deposits and liquidity is finding good loans. Here's a measure of the loan-to-deposit ratio at banks outside the top 25, and you can see, that's been a real challenge in recent quarters. As recently as February of 2019, that loan-to-deposit ratio was 89%. Now it's only 77%. So, that pressure is going to continue as deposits continue to surge.

Finally, let me point to an echo, really, that Chairman Powell made at the press conference that brought us back to 2005. Both Chairman Alan Greenspan and Chairman Powell used the word "froth" when they were asked about what's happening in asset markets. So, let's go back to June of 2005. Fed Chairman Greenspan said, "although a 'bubble' in home prices for the nation as a whole does not appear likely, there do appear to be, at a minimum, signs of froth in some local markets where home prices seem to have risen to unsustainable levels.… Although we certainly cannot rule out home price declines, especially in some local markets, these declines, were they to occur, likely would not have substantial macroeconomic implications."

And, of course, we know that home prices did decline, not just locally, but across the nation as a whole. And, in fact, there were very substantial negative macroeconomic implications. So, it's a little bit interesting that Chairman Powell used the same terminology and came to the same conclusion. This was pointed out by a number of press reports after the press conference. Chairman Powell said, "Some of the things that are going on do reflect froth in the equity markets. You are seeing things in capital markets that are a bit frothy. That's a fact." He concluded, "On balance, [the overall financial stability picture] is manageable, I would say."

What are the implications for banks? The economy is going to grow rapidly, spending should increase loan demand, while government income support could limit credit losses. The rising vaccination rate and continued policy support will reduce the downside risks to growth in the near term, in my view. Meanwhile, inflation pressures later this year could push up long-term interest rates, improving net interest margins but also possibly unsettling asset markets. So, I think we should expect rising inflation readings this year along with very rapid GDP growth and falling unemployment, possibly down even into the 4% range by the end of the year—or 4% to 5%.

The Fed is committed to maintaining very accommodative monetary policy, as we heard again, until the economic recovery is substantially complete. That means getting that unemployment rate down, getting inflation up actually a little bit above 2%. That could mean the Fed will not lift off zero until 2024 or later. That's the current guidance from the Fed. But markets are expecting the Fed to move sooner than that. We'll wait and see how that is resolved. At the moment, financial markets appear calm and orderly, but as indicated by that discussion at the press conference, there are concerns about future financial instability that could emerge.

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

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