

Transcript

Bill Emmons: Hi, I'm Bill Emmons. Today's Friday, December 18th. I'd like to talk about the FOMC meeting that took place this week on the 15th and 16th. I characterized the main message from this meeting, that the Fed communicated that bond purchases will continue much longer than we probably expected—that is, until the economy is substantially recovered. So the main takeaways from the meeting included: no significant changes in the Fed's main monetary or financial policy settings, and that includes the fed funds target range between zero and a quarter percent; interest rate on required and excess reserves remains at 10 basis points; and the large-scale asset purchases of at least \$120 billion a month will continue.

As I said, the FOMC clarified their plans for bond buying. They will continue these very large purchases, at least until the economy is nearly back to normal. So that could well be a couple of years. The same time, the Fed continued the dollar swap lines and international repo facilities to March 31. And as you probably heard in the news, the Treasury has ended five of the emergency credit market facilities operated by the Fed, so they will end at the year-end of this year.

The FOMC also released its quarterly summary of economic projections. The main differences in December, from the September release of this set of projections, is that the unemployment rate now is expected to be only 6.7% at the end of this year, down from their September projection of 7.6%. Real GDP is now expected to decline "only" 2.3% this year rather than 3.7%, and over the course of the year, the expectations have improved quite a bit. Inflation is expected to run a bit closer to 2% but still below that 2% target through at least 2022.

And the Fed also released its longer-run projections of where these important variables are likely to be. Very little change there. Real GDP growth is still expected to be about 1.8% annually in the long run; unemployment about 4.1%; inflation, that 2% target; and a normalized fed funds rate around 2.5%. As I said, the FOMC is much more optimistic than even earlier this year about where the unemployment rate will be over the next few years.

If you remember, back in June, the expectation was unemployment would still be over 9 percent in this fourth quarter. Well, that came down to 7.6% in their September forecasts, and most recently—this week—that was dropped even further, to 6.7%. And as you can see, over the next few years, the FOMC is expecting a gradual return back to these very, very low levels of unemployment, 4% or even below, by 2023.

I want to highlight two other important Fed reports that came out in November. First is the Senior Loan Officer Opinion Survey on Bank Lending Practices. This is a quarterly report that goes back to about 1990, and it has proven to be very effective in identifying changes in the demand for loans that banks are facing, as well as the standards that banks apply to those loans. So, in broad terms, this report was pretty clear that banks are reporting weak loan demand for all types of loans except residential mortgages; and conversely, banks generally are tightening their lending terms, and this includes rates, spreads, and collateral. And these have significantly tightened across all loan types.

So first for market loan demand, most banks—that is, the majority of banks that are changing their assessment of demand—are reporting that this loan demand is weaker for all loan types. This is the entire series that goes back, as I said, to the early 1990s. Recessions are indicated by those gray vertical slashes, and it's pretty clear that when the economy is weak in those recessionary periods, loan demand tends to go down for all loan types. But as we can see—you look a little bit more closely—residential mortgage demand is actually strengthened. Banks are reporting much stronger demand for residential mortgages with—that's the only exception.

Looking at loan standards—that is, the terms that banks are asking for lending—across all these major loan types, most banks have reported tightening standards throughout the recessionary period. And again, going back in history, it's during recessions that banks tend to tighten up those terms. And the combination of weaker loan demand, tighter loan supply, of course, results in much less lending during these periods. Looking closer at the most recent period and comparing back to the Great Recession of 2008 and '9, that very, very sharp tightening of loan standards took place across all loan types and peaked in the third quarter—at least that's the most recent numbers. In the fourth quarter, the share of banks tightening standards has come back just a little bit.

The other Fed report that I wanted to highlight is the twice-a-year Financial Stability Report, and that came out in November. One of the very clear conclusions that the Fed drew from looking back over this period, is that banks were in much better shape going into this recession than the last one. And that's going to pay big dividends in terms of making our economy much more resilient even as we get hit by this big shock. At the same time, of course, there are risks to financial stability, and those include asset valuations, business leverage, nonbank financial firms, and fragile money markets. I'll say just a little bit about each of those.

In terms of elevated asset valuation pressures, a phrase that appeared in this report, was that the Fed saw increased willingness of investors to take on risk. It does appear to be a period in which there is extended asset valuation because of this risk-taking preference for—by investors. It also appears—and this was flagged even before the recession—that there's been a large increase in leverage borrowing by many businesses. And so now some of them appear to be vulnerable to distress if incomes fall or asset values decline. The third vulnerability identified in this report was excessive leverage within the nonbank financial sector. This includes firms like hedge funds and trading firms of various types. And with respect to this group, the Fed have noted that some of these financial institutions may not be able to absorb even modest losses. And we saw something like that in March in the market turmoil, that some of these nonbank financial institutions were fairly fragile.

The final risk, which has more to do with those banks and financial firms involved in short-term money markets, that there still appear to be some risks, some dollar funding risks. Some of these intermediaries—and again, the nonbank financial institutions in particular—their liquidity and maturity transformation can create an incentive for investors to withdraw funds quickly in adverse situations. Another example here is the money market mutual funds, which have once again in this episode, as well as in the Great Recession, proven to be very fragile and very disruptive.

Those are the kinds of risks that the Fed is particularly concerned about. Notable is the absence of concern about banks in contrast to the 2008 recession. The implications for banks, I think, include the assessment that the economy is growing but it is slowing. There's definitely a slowdown occurring in the latter half of 2020—some risk of a double-dip recession even as we go into 2021. Loan demand is weak, except for residential mortgages. And as for the interest rate outlook, it's now pretty clear that they're going to remain very low for a very long time, putting some pressure on net interest margins.



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Fed Rate Outlook Unchanged While Financial Markets Predict Otherwise

So what should we expect? In my assessment, the economy is not out of the woods yet. With surging COVID cases and deaths, it is definitely slowing down the recovery. The Fed may increase the pace of bond purchases in coming quarters, but other actions are unlikely, because the short-term interest rate of course is already around zero. And I think another round of fiscal relief is likely and it may prevent a double-dip recession and more severe problems for banks that otherwise might have occurred in 2021. Thanks for listening, and we'll see you next time.

(END OF RECORDING)