ECONOMIC NEWS

United States: A Fake Tightening?

The Federal Reserve (Fed) has recently increased the pace of monetary normalization by performing two rate hikes at 3-month intervals and signalling further increases later this year. However, ultimately, it is the financial conditions that matter, not just the level of policy rates. As New York Fed President William Dudley commented on March 30, very little economic and financial activity is directly dependent on the federal funds rate, which is an overnight rate. For example, in the United States, most households take out mortgages over a period of thirty years. The federal funds rate, however, usually influences a host of other variables, such as corporate bond rates, mortgage rates, currency levels, and stock market indices. Hence why it remains the Fed's preferred tool.

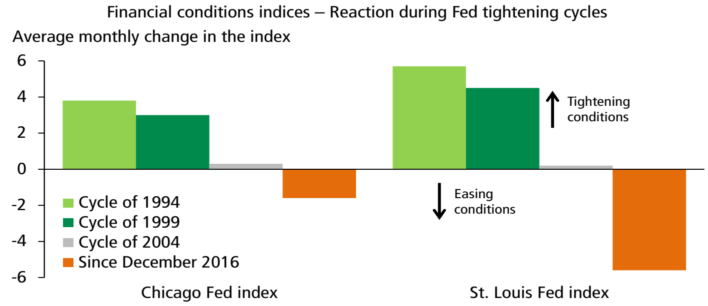
There are several indices that bring together a range of variables, which evolution gives an idea of the tightening or easing that is actually taking place in the economy. These variables commonly include short and long-term government bond yields, swap yields, corporate spreads, the S&P 500 index, and volatility indicators among several others.

Currently, these indices paint a rather perplexing picture of the transmission of U.S. monetary policy. Despite the fact that the Fed has made two rate hikes since last December, the St. Louis Fed's financial conditions index, just like the one from the Chicago Fed, rather indicate an easing of conditions. This contrasts with the reaction of these same indices during the preceding cycles.

Stock market performance explains a good part of this situation. The S&P 500 has gained more than 7% since the beginning of December, boosted by optimism surrounding the possibility of tax reforms favouring corporate profits. On an annualized basis, this represents a gain of almost 25%. In contrast, the average annualized gain in the previous three cycles was only 6.5%.

Market interest rates also have a share of responsibility. For example, since December, the 30-year yield has declined by 0.8 basis points per month on average. In the previous three cycles, it increased by an average of 3.9 basis points per month.

GRAPH
Recent Fed rate hikes have not translated into more restrictive financial conditions



Fed : Federal Reserve
Sources: Chicago Fed, St. Louis Fed and Desjardins, Economic Studies

It must be said that the Fed is proceeding much more gradually than before. An equilibrium rate estimated to be significantly lower than in the past implies fewer cumulative increases than otherwise for policy rates. More immediately, the global quest for returns may also be part of the elements that restrict the spreading of monetary tightening to the entire curve.

IMPLICATIONS

Thus far, U.S. financial conditions have not reflected the tightening of policy rates. Officials are aware of this situation, which may in fact reinforce their stated intention to move forward with additional rate hikes. As long as there is no evidence of overheating, they will not seek to accelerate tightening or use drastic measures such as outright sales of assets on the Fed's balance sheet. The issue may well indeed normalize on its own. A stock market correction, for example, could easily cause a reversal of the financial condition indices.

Jimmy Jean, CFA, Senior Economist

François Dupuis, Vice-President and Chief Economist • Mathieu D'Anjou, Senior Economist
Benoit P. Durocher, Senior Economist • Francis Généreux, Senior Economist • Jimmy Jean, Senior Economist • Hendrix Vachon, Senior Economist
Desjardins, Economic Studies: 514-281-2336 or 1 866-866-7000, ext. 5552336 • desjardins.economics@desjardins.com • desjardins.com/economics