

Yardeni Research, Inc.



I. The Yield Curve Carry Trade

Thanksgiving is tomorrow. I would like to thank the Fed. In response to the financial crisis, the Federal Reserve started to lower the federal funds rate on September 18, 2007 from 5.25% down to a record low of 0-0.25% on December 16, 2008 (Figure 1). This extraordinary easing was certainly necessary to avert a financial meltdown and an economic depression, especially following the collapse of both Lehman Brothers and AIG last year in mid-September. Back then, the Fed doubled its balance sheet first by providing emergency liquidity funding, and subsequently by purchasing lots of Agency and Treasury securities as the liquidity crisis eased (Figure 2). It all worked: The financial crisis has abated and the economy is recovering. Thanks for that!

I don't want to sound ungrateful, but I would like to send another message to the Fed about its current policy: "Thanks for nothing." The Fed's zero-interest-rate policy (ZIRP) may be inadvertently depressing rather than stimulating the economy. I believe that the Federal Reserve should now raise the federal funds rate to 1.0%, and be less predictable in setting this rate, rather than continue to peg it at zero for "an extended period." This phrase first popped up in the statement issued by the Federal Open Market Committee (FOMC) immediately after their meeting on March 17 and 18. It has reappeared in all five FOMC statements since then. Indeed, last week on November 16, at the Economic Club of New York, Fed Chairman Bernanke repeated this promise to do nothing in the closing paragraph of his prepared remarks.

Despite the Fed's generosity, US commercial banks have been very stingy with their borrowers. Bank loans are down \$419.6 billion so far this year, led by a \$230 billion drop in commercial and industrial loans. Over the same period, on the other hand, their holdings of Treasury and Agency securities have increased \$141.9 billion and their cash holdings (i.e., excess reserves) rose \$247.7 billion (Figures 3 and 4).

I believe that banks aren't lending in large measure because it makes more sense for them to buy Treasury and Agency securities so long as they are certain that the Fed won't raise interest rates. Thanks to the Fed, their cost of money has dropped sharply as they have lowered their deposit rates close to zero. Rather than make new loans or renew maturing loans, they can play the ascending yield curve by investing in Treasury notes and bonds. This is a profitable and no-risk trade as long as their funding costs don't rise and as long as the prices of Treasury securities don't fall. Both conditions are met if the bankers believe that the Fed's zero-interest-rate policy will be maintained for an extended period.

Why make risky loans, especially when the jobless rate exceeds 10%, if the Fed is guaranteeing a "carry trade" with deposit rates near zero and the opportunity to buy lots of riskless securities with higher yields that aren't likely to rise given the Fed's do-nothing stance. However, if the Fed started nudging the federal funds rate higher, then banks might have a greater incentive to take some risk and make some loans. In a rising rate environment, fixed-income securities incur capital losses, while loans continue to be priced at par as long as they are performing.

Of course, the weakness in bank loans may be partially attributable to demand. According to the Fed's October survey of senior loan officers, some of the drop in bank loans to businesses may be because corporations have raised lots of cash in the capital markets and haven't needed to use their credit lines. In response to a special question on the reasons for the decline in commercial and industrial lending this year, the two that domestic banks cited most often as being "very" important were (1) decreased originations of term loans and (2) decreased draws on revolving credit lines. Nevertheless, banks have also been reducing their lending to mortgage and consumer borrowers.

An ascending yield curve usually sets the stage for more bank lending and better economic growth (Figure 5). Indeed, the spread between the 10-year Treasury yield and the federal funds rate is one of the components of the Index of Leading Economic Indicators. When the spread is widening, the pace of economic activity tends to quicken roughly 12 months later. However, this relationship may not be as dependable if the Fed is widely expected to keep the federal funds rate at zero.

The Fed has enabled the financing of the Treasury's record budget deficits by lowering the federal funds rate to zero and promising to keep it there for an extended period in each of the last six FOMC statements. Perversely, excessively easy monetary policy may be making fiscal policy less rather than more effective at reviving the economy and employment. "Crowding Out" can occur when the government is borrowing lots of money at the same time that households and businesses are doing the same. This tends to happen during economic expansions if the government is running a deficit and bond yields are rising. The higher rates presumably crowd out private borrowers. While this remains a dubious notion, it isn't usually an issue when the economy is depressed. It is an issue now, in my opinion.

The public sector may be crowding out the private sector right now. This is obviously the case if banks are reducing their loans while increasing their portfolio of Treasuries. If so, then contrary to Keynesian dogma, deficit-financed fiscal spending enabled by the Fed's zero-interest-rate policy may be prolonging the jobs recession rather than reviving self-sustaining economic growth (Figure 6). In this scenario, the fiscal multiplier may very well be less than rather than greater than 1.0. If so, then stimulative fiscal policy may be destroying more jobs than its proponents claim to be saving or creating!

II. Japan's Unhappy Experience with ZIRP

The experience of Japan with zero interest rates is relevant and worth reviewing. The Bank of Japan (BoJ) lowered its official rate to zero on February 16, 1999 and kept it there, with a very brief uptick at the beginning of the decade, until July 14, 2006. On that date, it was raised to 0.25%, and again to 0.50% on February 21, 2007. It was lowered at the end of last year back down to 0.10% (Figure 7). Japanese bank loans fell by 29.5%

for seven and a half years from January 1998 through June 2005 despite the BoJ's zero-interest-rate policy. Since then, bank loans have risen by 7.1% through October, but remain 20.7% below where they were when the BoJ first cut its official rate to zero (Figure 8).

Japanese banks have been investing in government bonds instead of making loans. This explains why the 10-year Japanese government bond yield has been fluctuating around 2.0% since the late 1990s despite huge government deficits and mounting government debt (Figure 7). Indeed, over the past 10 years, the ratio of government debt to nominal GDP has soared from 95% to 180% during the third quarter of this year (Figure 9).

The BoJ's zero-interest-rate policy certainly enabled the government to issue lots of bonds at extremely low yields. However, this didn't do much to revive self-sustaining economic growth in Japan. The United States seems to be heading down the same path. The Fed is certainly enabling the government to borrow lots of money. The ratio of US federal debt held by the public relative to GDP was 51% during the second quarter, and likely to rise sharply over the next ten years given official budget projections of \$10 trillion in deficits.

III. Would Tightening Depress Housing?

But won't raising the federal funds rate push up mortgage rates, depress the housing industry further, and abort the economic recovery? This is certainly possible. However, there is mounting evidence that housing activity is heading south again despite the zero federal funds rate! The 30-year mortgage rate dropped last week to 4.83%, the lowest since late May. Yet, mortgage applications for purchasing homes have dropped over the past six weeks to the lowest pace since November 1997! These applications are highly correlated with the sum of new and existing homes (Figure 10). The tax credit for first-time buyers was set to expire on November 30, until it was renewed and expanded until April 30 on November 6. One would think that there might have been a last minute burst of mortgage applications in early November by those homebuyers perceiving that the credit might not be available after the end of November.

Clearly, home affordability has increased significantly thanks to lower mortgage rates and home prices. However, real estate loans are down \$18.4 billion at the banks so far this year. The housing recovery since the summer has been mostly enabled by the Federal Housing Administration, which has been insuring lots of mortgages this year by lowering its lending standards. The result has been a big increase in the agency's delinquencies and a precipitous drop in its reserves. So it is now tightening its standards. Under the circumstances, it isn't likely that raising the federal funds rate to 1.0% will worsen the availability of mortgage credit. It might boost it by encouraging banks to stop playing the yield curve game and take more risk in their loan portfolios instead.

IV. The Asset Bubble Debate

Raising the federal funds rate would also reduce the risk of inflating more asset bubbles, and should strengthen the dollar. It should reduce speculative inflows into commodity markets, which might bring their prices down somewhat. A drop in oil prices would be especially welcome, and might provide some stimulus to the global economy.

Last week, Fed Vice Chairman Donald Kohn defended the Fed from criticism of its approach to asset bubbles. Kohn dismissed the Fed's critics by claiming that monetary policy is not the appropriate tool for dealing with asset bubbles. He favors "microprudential and macroprudential policies." The former is the regulation and supervision of banks to make sure that they are individually resilient, while the latter focuses on systematic risk in the financial system.

I strongly disagree with Mr. Kohn. When he was the Fed Chairman, Alan Greenspan on several occasions said that the Fed isn't responsible for causing or stopping asset bubbles, but should clean up the mess when they burst. His successor, Ben Bernanke, concurred with this philosophy, and apparently still does.

Mr. Greenspan first started to publicly discuss the role of asset bubbles in the setting of monetary policy on December 5, 1996, when he famously said: "But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade? And how do we factor that assessment into monetary policy? We as central bankers need not be concerned if a collapsing financial asset bubble does not threaten to impair the real economy, its production, jobs, and price stability. Indeed, the sharp stock market break of 1987 had few negative consequences for the economy. But we should not underestimate or become complacent about the complexity of the interactions of asset markets and the economy. Thus, evaluating shifts in balance sheets generally, and in asset prices particularly, must be an integral part of the development of monetary policy."

Initially, market pundits concluded that Mr. Greenspan was stating his concern that the stock market was a bubble. They quickly realized that irrational exuberance was framed as a question rather than as a statement of fact. At the end of 1996, the federal funds rate was 5.25% and the Dow Jones Industrials Average was 6448.27. It rose 81.8%% to a peak of 11,722.98 on January 14, 2000. Along the way, the Fed did raise the federal funds rate to 5.50% on March 25, 1997. It was then lowered in three 25 basis point cuts to 4.75% during the fall of 1998 in reaction to the collapse of LTCM. This was the Fed's original sin with respect to inflating asset bubbles.

When the Tech bubble burst and the economy fell into a recession, the Fed lowered the federal funds rate from 6.50% at the start of 2001 to a low of 1.00% at the June 2003 meeting of the FOMC. It remained that low until the FOMC started a series of "measured" rate hikes of 25 basis points at every single meeting of the FOMC from June 2004 through June 2006, which brought the rate up to 5.25%. By keeping the federal

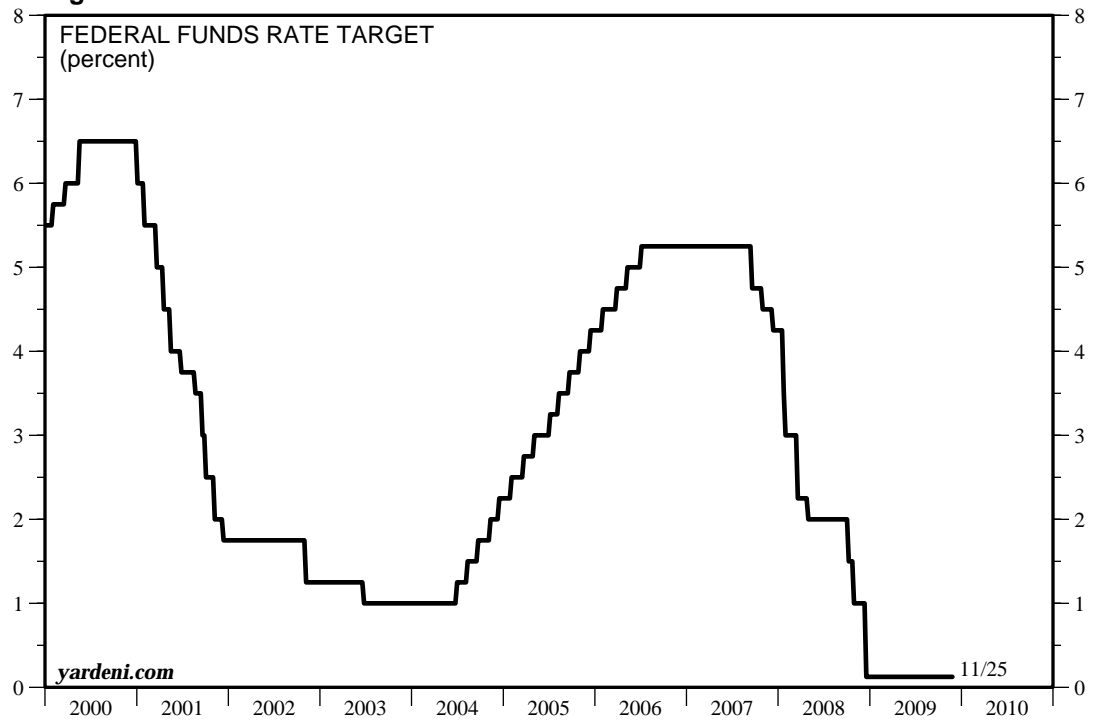
funds rate too low and then raising it so incrementally in such a predictable fashion, the Fed set the stage for the next round of irrational exuberance. This time the bubble was in housing and mortgage finance.

When this bubble started to burst, the Fed began a series of rate cuts at the September 18, 2007 meeting of the FOMC that took the federal funds rate down to zero at the December 16, 2008 meeting. Asset bubbles are already making a comeback in stocks and commodities around the world. The biggest bubble may be in government securities.

The Fed really should start raising rates and resist providing any guidance on the likely pace of tightening. Providing strong guidance as to the likely direction of monetary policy simply encourages speculators to take more risk. Declaring that the federal funds rate will remain at zero for an extended period of time is especially likely to inflate asset bubbles, while deflating the willingness of bankers to lend. It's time to zap ZIRP.

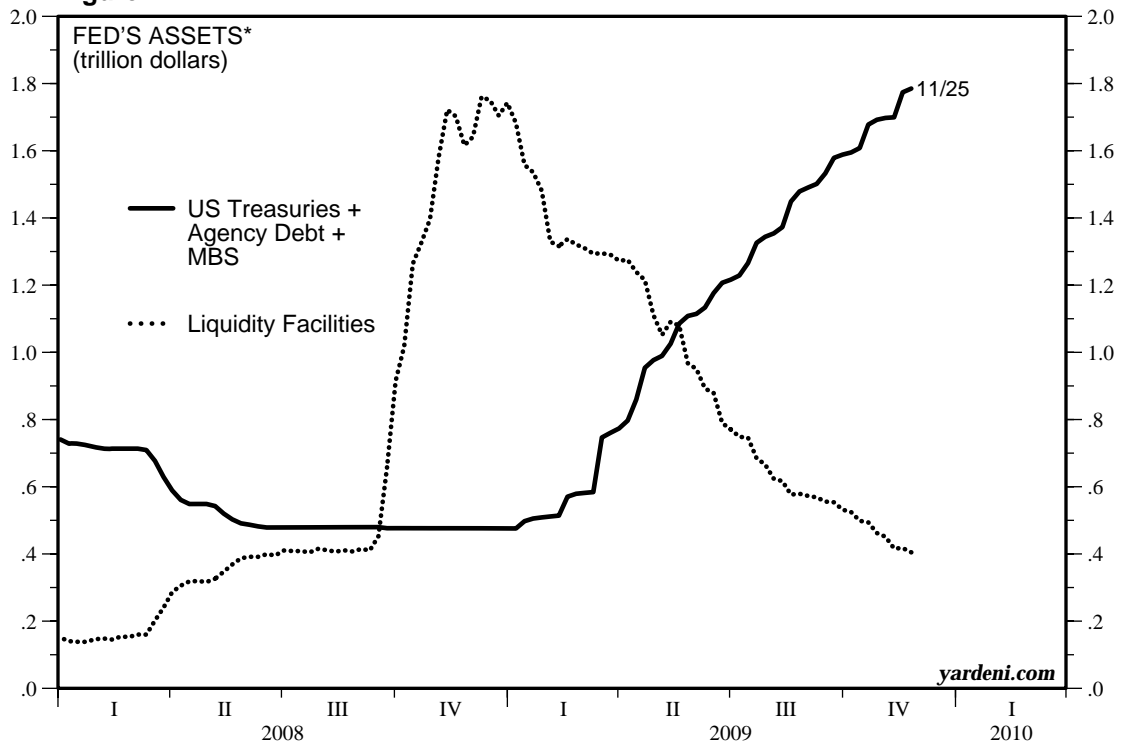
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Figure 1.



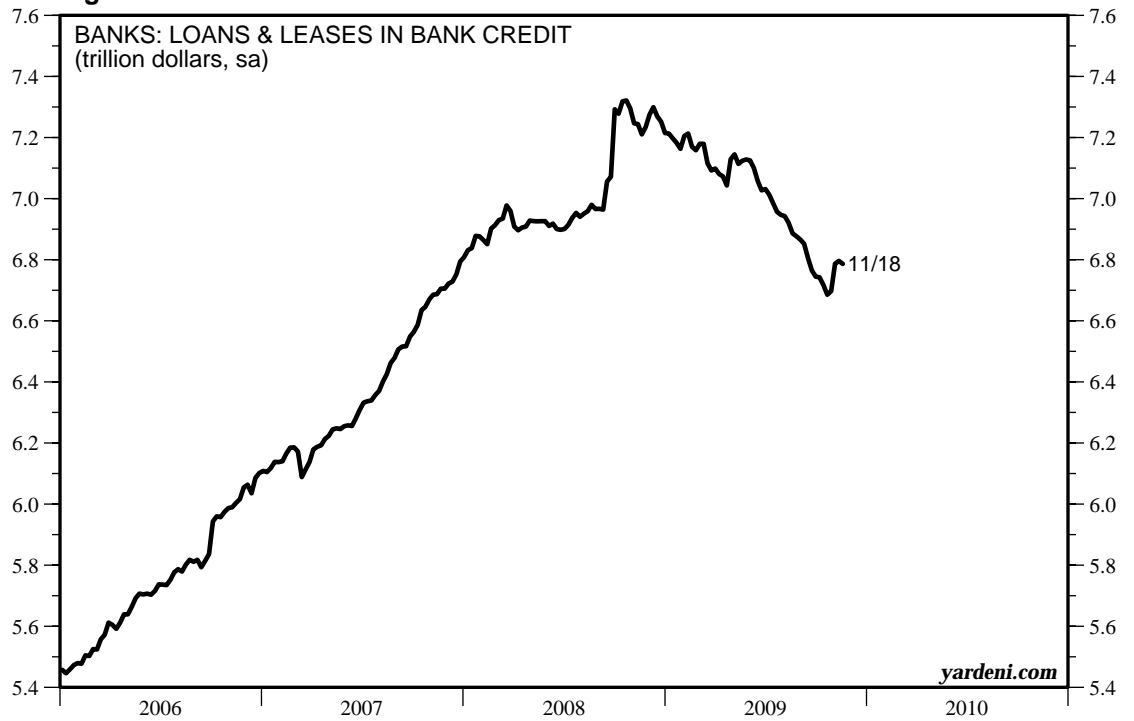
Source: Board of Governors of the Federal Reserve System.

Figure 2.



* Average of daily figures for weeks ending Wednesdays.
Source: Federal Reserve Board.

Figure 3.



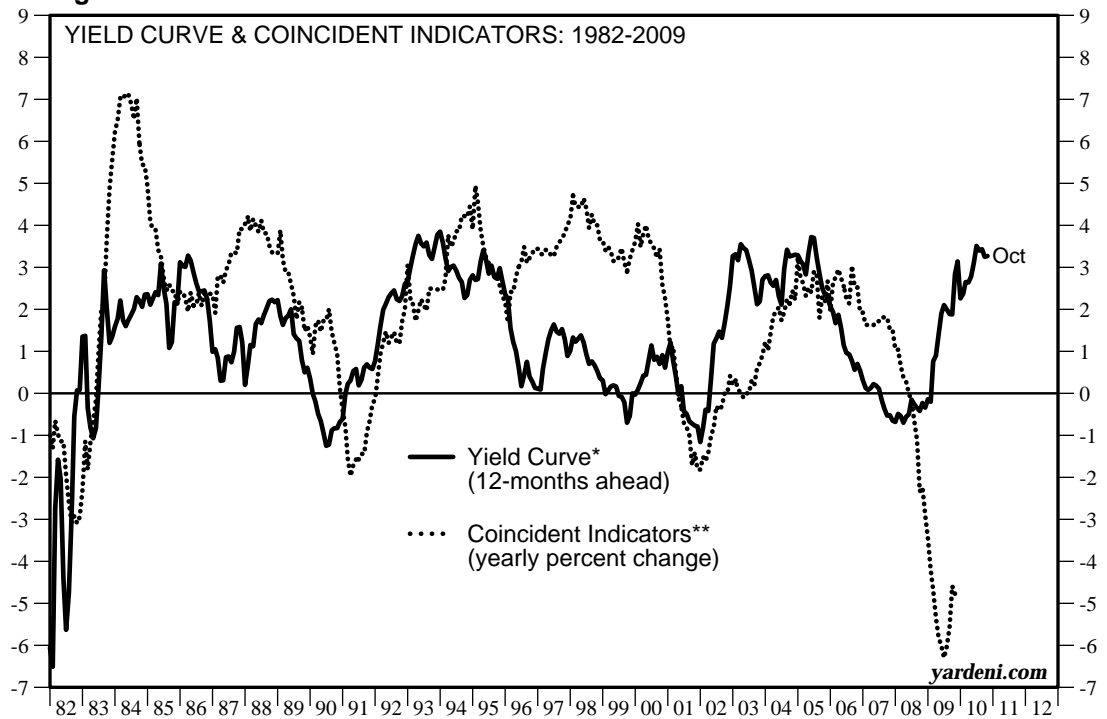
Source: Board of Governors of the Federal Reserve System.

Figure 4.



Source: Board of Governors of the Federal Reserve System.

Figure 5.

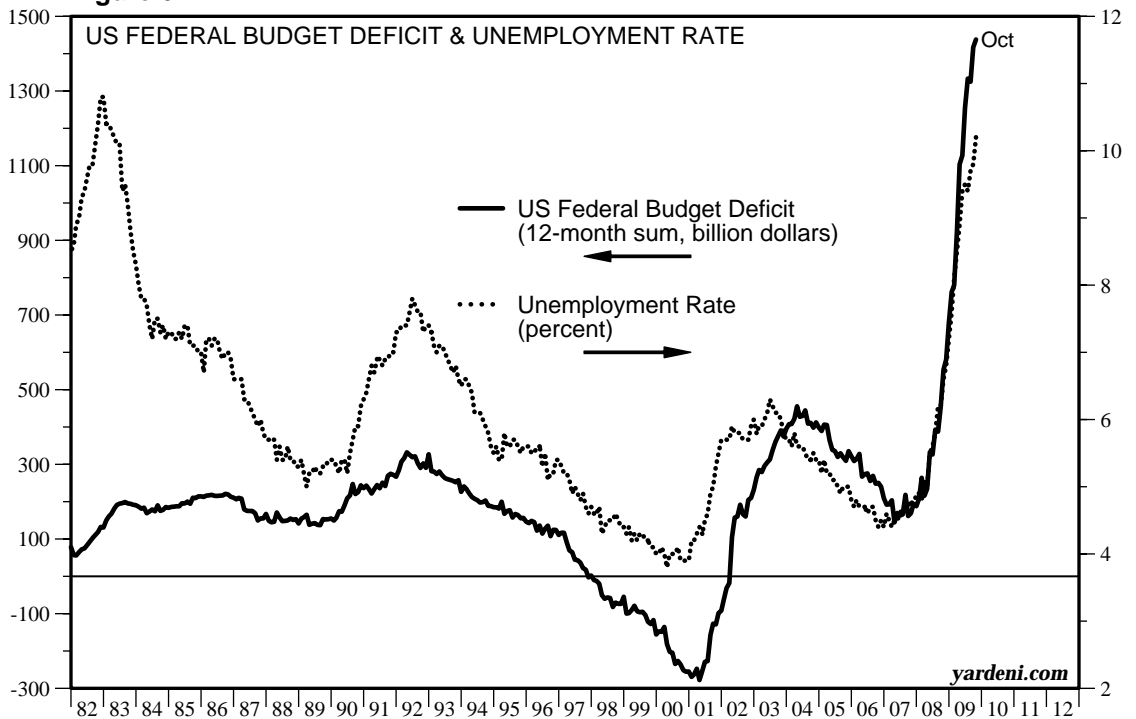


* Ten-year Treasury yield less federal funds rate.

** Includes industrial production, manufacturing and trade sales, payroll employment, and personal income less transfer payments.

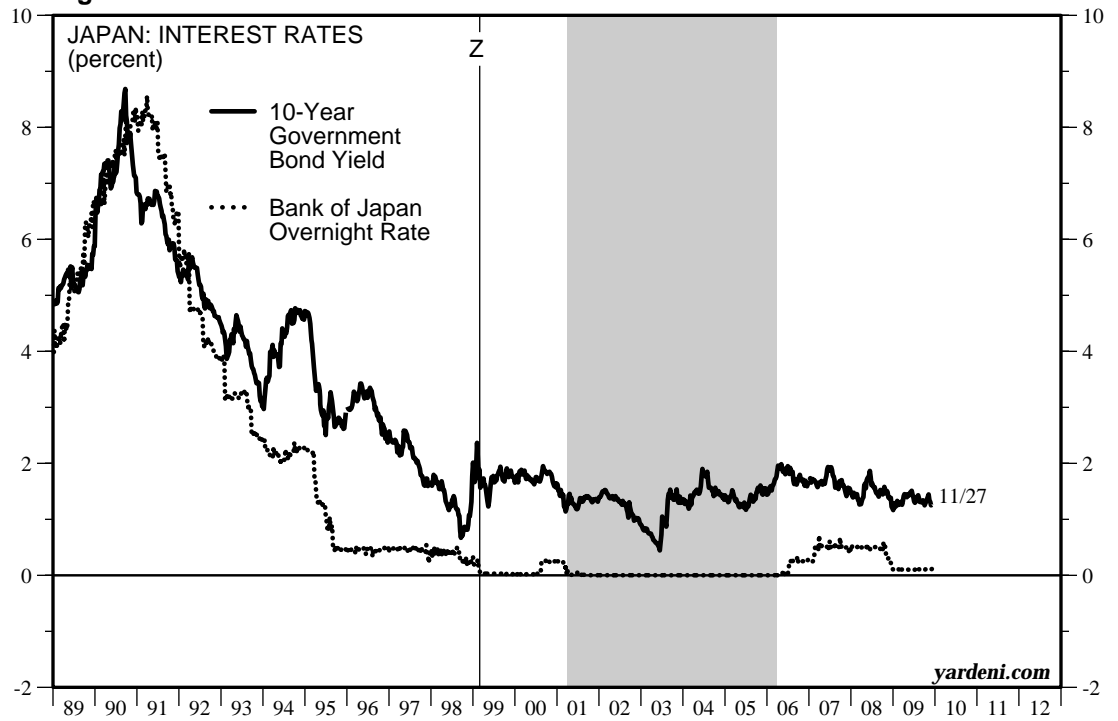
Source: Board of Governors of the Federal Reserve System and the Conference Board.

Figure 6.



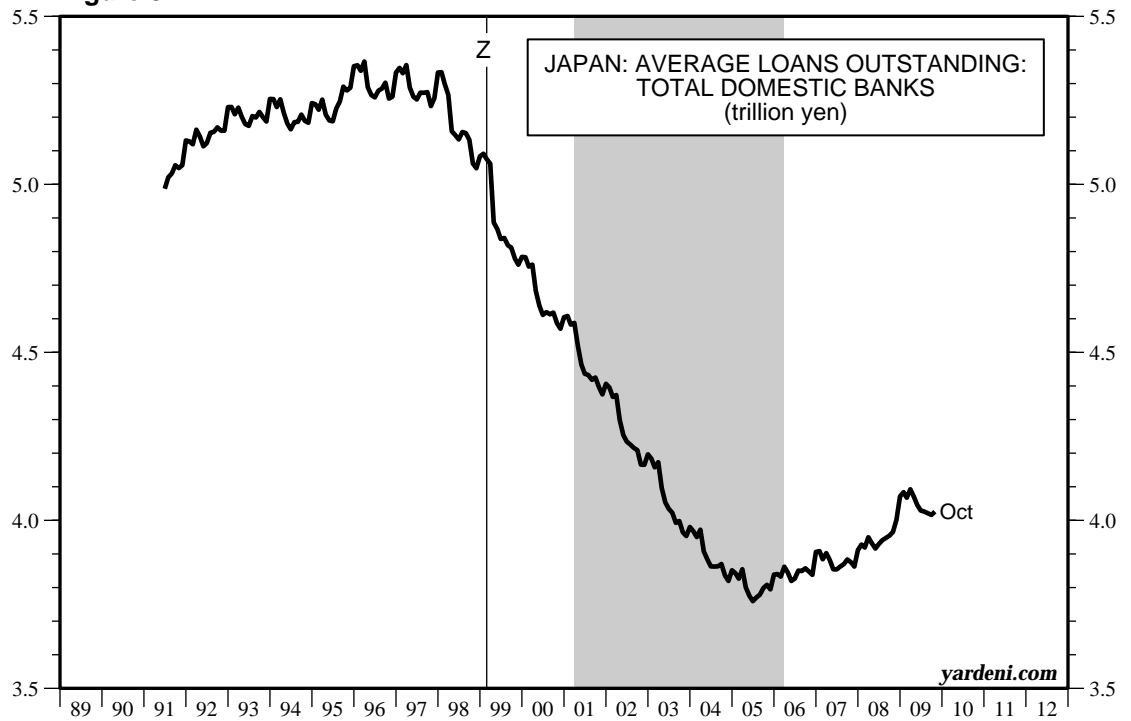
Source: Bureau of Economic Analysis and US Department of Labor.

Figure 7.



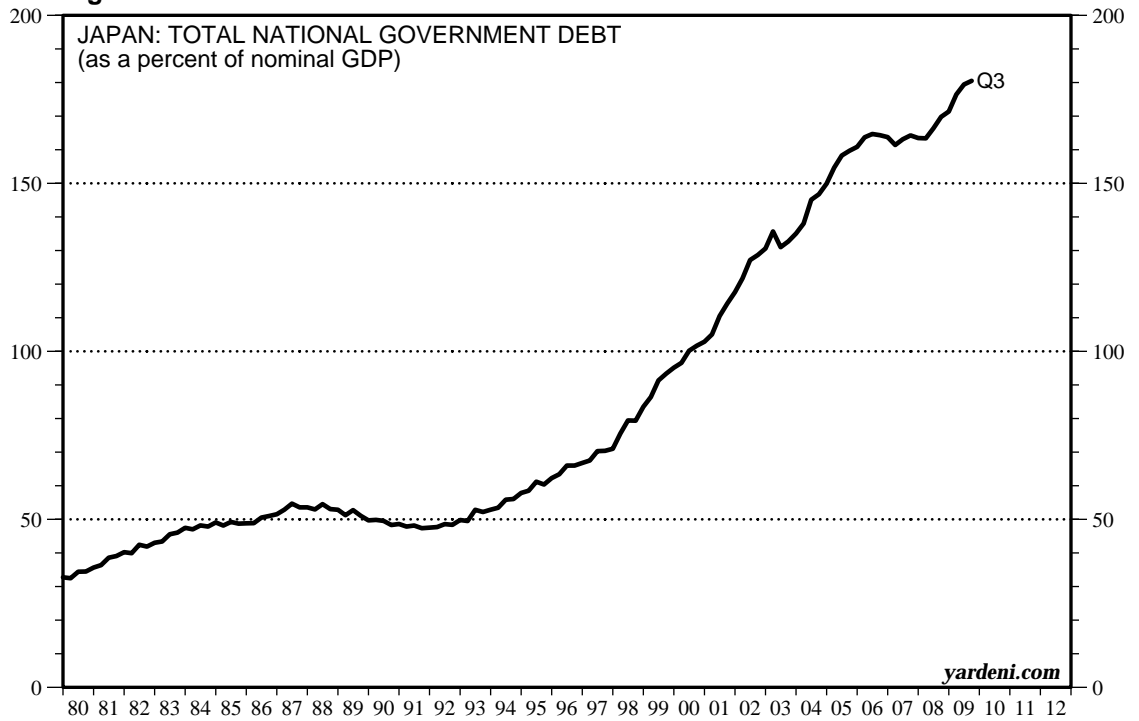
Z = Zero Interest Rate Policy
Grey shade is Quantitative Easing Policy.
Source: Bank of Japan.

Figure 8.



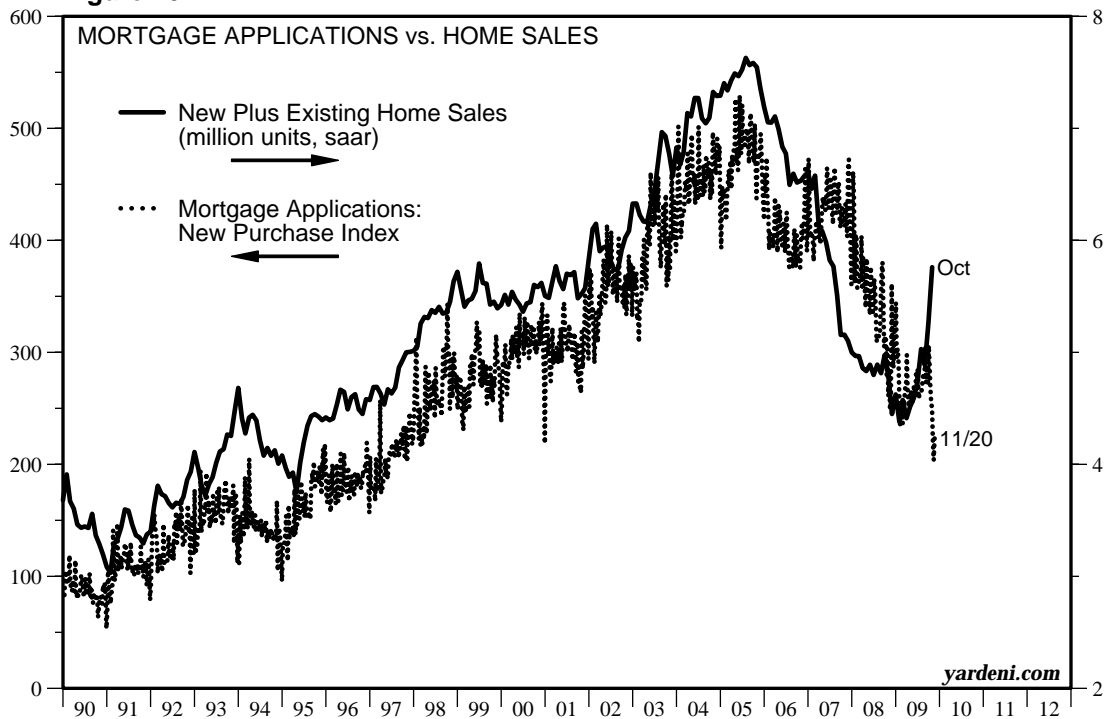
Z = Zero Interest Rate Policy
Grey shade is Quantitative Easing Policy.
Source: Haver Analytics.

Figure 9.



Source: Bank of Japan.

Figure 10.



Source: Mortgage Bankers of America and US Department of Commerce, Bureau of the Census.

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