Daily Note

# FED BECOMING TOO PATIENT TO EASE?

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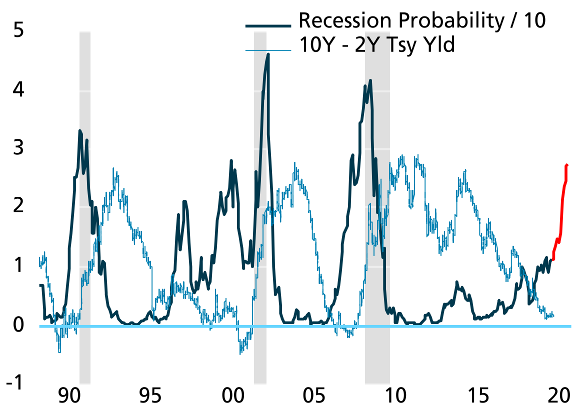
- **Patience to tighten is easy - there is no pressure to raise rates**
- **Benefit from easing is balanced against cost of more leveraged lending**
- **Fed acted pre-emptively to ease financial conditions in January to great effect. Are they reverting to form and will wait too long to ease?**

**Patience was the watchword in the minutes of the FOMC April/May meeting, but patience to what end?** The implication is the Fed will be patient before tightening again, but there is nothing to be patient about near-term with productivity rising, capacity utilisation falling and the yield curve flat to inverted depending on which maturities you cherry-pick to compare. They do believe the economy will right itself soon, following a few quarters of slow growth (they include Q1) and acknowledging very real downside risks. Their upbeat view is built on strong labour markets, an improving world economy and a stable Brexit (they will obviously re-examine their global outlook at the next meeting), and that easier financial conditions - their handiwork - boosted consumer and business confidence. The steady rise in the NY Fed's recession probability index suggests their optimism may be misplaced (see chart below).

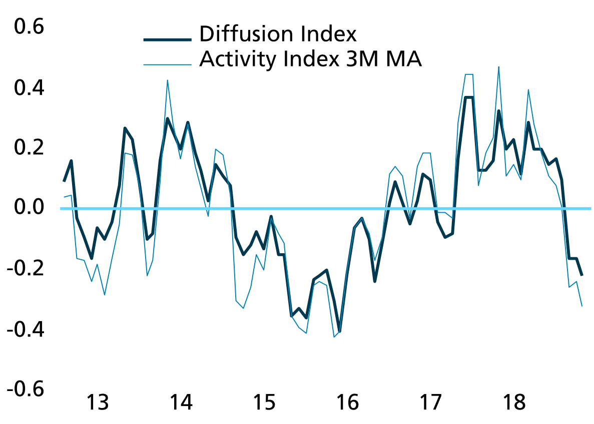
**They are equally convinced that the first-quarter fall in inflation was solely the result of transient factors and that inflation will revert towards 2% soon enough. It won't.** The negative numbers for the Chicago Fed National Activities Index (chart below) tell us to expect sub-trend growth, and price pressures don't build up when growth is below trend. The FOMC's conviction inflation goes back up to 2% is odd considering how they see policy rates at neutral (the market thinks rates are above neutral), fiscal stimulus is ebbing and the dollar is strong. This leaves their inflation story tied to steady growth and rising resource utilisation with the economy

NY Fed Recession Probability




Source: Thomson Reuters Datastream, TS Lombard

Chicago Fed National Activity Index

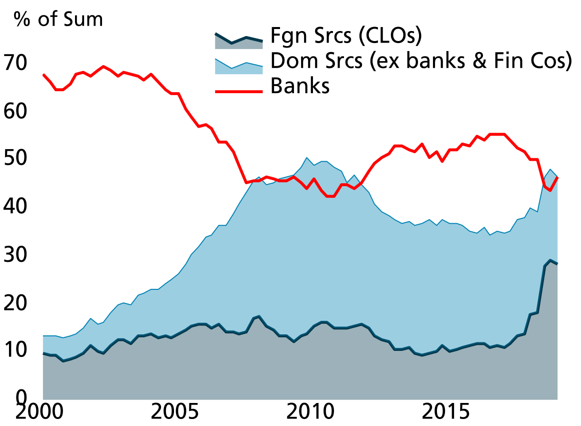



Source: Thomson Reuters Datastream, TS Lombard running close to full capacity, wages and prices being pushed up as a result. They have been singing this song for a number of years now but, based on market yields, no one is left listening to the choir. Underscoring this point, we read in the minutes "a few other participants observed that subdued inflation coupled with real wage gains roughly in line with productivity growth might indicate that resource utilisation was not as high as the recent low readings of the unemployment rate by themselves would suggest". The staff presentation added that "core PCE price inflation was expected to move up in the near term but nevertheless to run just below 2 percent over the medium term".

**Why then be patient and not just ease instead?** Some on the FOMC espouse the notion that faster growth and inflation is coming. But we assume it is the trade-off between how much inflation a 25bp "insurance cut" would "buy" versus triggering more growth in leveraged loans. The minutes say: "A few participants suggested that heightened leverage and associated debt burdens could render the business sector more sensitive to economic downturns than would otherwise be the case… A couple of participants suggested . . . increases in bank capital . . . A couple of participants observed that asset valuations in some markets appeared high, relative to fundamentals." Count Chair Powell among the few, perhaps even the couple, given his credit experience at the Carlyle Group and recent speeches. He argues that leveraged loans pose a less serious threat than mortgages did heading into the crisis because the market isn't as large (true) and there has been no run-up in asset prices (less true, see quote above). The real concern for the Fed is that this lending is beyond their regulatory reach (see chart below) and a lot of borrowers are privately owned – meaning no transparency for the Fed or any other regulator. The FOMC is also dodging a similar discussion in the mortgage market: the biggest lenders are internet-based firms such as Quicken Loans. They sit outside the Fed's regulatory structure and are probably insufficiently capitalised to cover rising default rates in the event of a sharp slowdown.

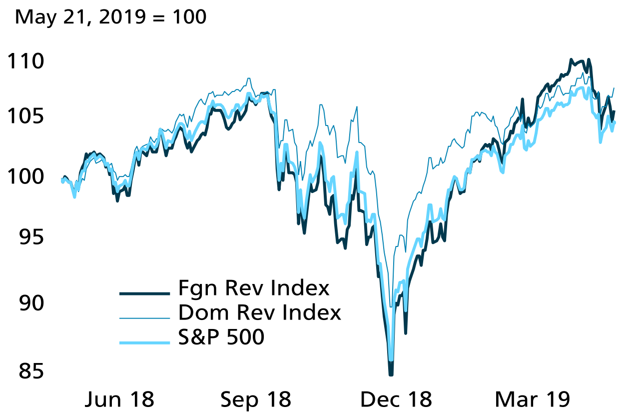
**The point is not that the leveraged loan market will crater the economy, it is that the problem is sufficiently large to make the FOMC think twice about cutting rates.** Assuming the trade war with China is not settled anytime soon and may get worse - a sound assumption - the patience needed to keep from easing will be severely tested sometime in the months ahead. The equity market, whose overall performance is more closely tied to firms with revenues concentrated from foreign rather than domestic sources, what led the market down last fall, is not likely to be so patient (chart below). Remaining on the sidelines waiting for solid evidence of a slowdown means the Fed will be easing too late, thereby reverting to their usual form, forgetting the lessons learned from January, and setting the stage for more than one rate cut.

Sources of NFC Short-Term Debt (ex gvt)




Source: Thomson Reuters Datastream, TS Lombard

S&P 500, S&P Fgn Rev, S&P Dom Rev




Source: Thomson Reuters Datastream, TS Lombard