

## Why the Fed Is the Root of Much Market Turmoil

Fed is a key reason markets have plunged and risk of recession rising

Not long ago, this week's Federal Reserve meeting looked like a nonevent. Having begun to raise rates from near zero in December, the central bank was expected to stand pat in January while signaling more increases later on.

Now, after a bone-jarring start to 2016, many investors hope the Fed is having second thoughts about hiking rates three or four more times this year. That raises the stakes around what the central bank says in the statement it will release Wednesday afternoon.

The newfound attention on the January meeting illustrates something few people, even at the central bank, truly appreciate. An important reason markets have tumbled and the risk of recession, though low, is edging up is the Fed's shift to less stimulative monetary policy.

How could a quarter-point rise in rates—the total the Fed has so far delivered—send markets into a tailspin, much less threaten to pull the U.S. into recession? Most analysts blame anxiety about China, emerging markets and oil, none of which have any direct relationship with the Fed.

Those are indeed factors. But the Fed's influence goes far beyond short-term interest rates. Instead, it is also felt through a constellation of financial conditions: stock prices, corporate bond yields, exchange rates and most critically, yet least quantifiable, the appetite for risk.

Unlike short-term rates, the Fed doesn't dictate the behavior of these broader conditions. It is less orchestra conductor than leader of a mob it inspires but doesn't control. This creates a dilemma: Even when the Fed sets interest rates correctly for the needs of the economy, markets routinely overreact, frustrating its plans.

In U.S. business cycles, legitimate investment and financial excess have always co-existed: bank loans to less-developed countries in the 1970s and commercial real estate in the 1980s, stocks and bonds issued by technology, media and telecommunications companies in the 1990s and subprime mortgage-backed securities in the 2000s. Just as the Fed doesn't determine the breadth of the boom, it can't control the scale of the bust.

The latest cycle follows the pattern, with an important difference. After the Fed cut short-term rates to near zero in 2008, it was forced to rely on other forms of stimulus: purchases of bonds and promises not to raise rates, which worked in great part by raising confidence and risk appetites throughout financial markets. But by relying so much on broader financial conditions to drive growth, the Fed has even less say in the outcome relative to prior cycles.

"If you are a central bank reliant on increasing risk as your method for stoking spending you're going to run into a major problem," says Peter Berezin of BCA Research. "You can only increase risk so much. And when investors pull back, they do so in a very sharp way."

None of this means the Fed was wrong to pursue such aggressive monetary policy in the years since the financial crisis. It has brought unemployment down to 5%, a reward almost certainly well worth the associated financial risks.

Yet when the "neutral" interest rate, which keeps the economy at full employment, is so low, the Fed's efforts to maintain growth can easily result in financial excess that can unravel at the first hint of tighter Fed policy. This leaves the Fed with little margin for error and few options to stanch any bleeding.

"It's no longer neutral because it's not consistent with long-term stability," says Mr. Berezin of BCA Research. "You end up with this possibility that there is no neutral rate at all. So what then is a central bank to do? There's nothing it can do."

The commodity boom had real drivers, namely the U.S. shale-oil revolution and China. But central banks greased the skids. Investors, seeking something better than the paltry returns on bank deposits and Treasury bonds, threw money at emerging-market countries and energy companies.

The oil and commodity selloff is similarly rooted in real factors, notably Saudi Arabia's decision to stop defending the price of oil in 2014. But that has been amplified by the reversal of the flow of easy money, catalyzed by the Fed's determination, starting in early 2015, to move toward normalizing rates.

Short-term rates and short-term bond yields don't capture how much the Fed has actually tightened. Since the end of 2014 the trade-weighted dollar has risen more than 20% and risk premiums, or yields on junk-rated bonds relative to those on safe Treasuries, have jumped by three percentage points. And the S&P 500 index, down 1.6% on Monday, is down 8.2% on the year at 1877.08.

Even the confusion and capital flight triggered by China's devaluation carry the Fed's fingerprints. The yuan was pushed higher as the greenback, to which it was closely pegged, rose on expectations of Fed policy normalization. This imparted deflationary pressure that Chinese authorities have sought to counter.

While a quarter-point rise in interest rates shouldn't tip the U.S. into recession, an across-the-board tightening of financial conditions merits attention. J.P. Morgan Chase economist Jesse Edgerton reckons recent real economic indicators such as business sentiment and building permits imply a 21% probability of recession in the next 12 months, marginally above the 18% average of any given year. But financial indicators such as stocks and corporate bonds put the probability at between 30% and 40%.

Some argue the financial excesses of recent years had no real economic benefit so their end won't carry any real economic cost. That seems too sanguine.

A study by Jeremy Stein of Harvard University and David López-Salido and Egon Zakrajšek of the Fed finds that when corporate bond sentiment—as reflected in spreads between yields on corporate and Treasury bonds—is unusually optimistic, growth is measurably weaker and unemployment higher two to three years later, because such optimism usually reverses. Importantly, their methodology shows that bond investors aren't forecasting a downturn in activity, they are causing it.

These dynamics may be playing out in markets now. But the downturn need not turn into a recession: It's something for Fed officials to weigh as they contemplate what signal to send.

This article discusses the course of action the **Federal Reserve System**<sup>1</sup> (the U.S. central bank that controls the lending activity of the nation's banks and thrifts and thus the money supply) has chosen to take and how it has affected our economy. It's been proven time and time again that economic turmoil is inevitable and we have had one nearly every decade since the 1970s. More importantly, it is a matter of what policies are put in place for our recovery.

In order to understand what happened, we need to first understand the role of the **Federal Reserve Banks**<sup>2</sup> (the 12 banks chartered by the U.S. government that collectively act as the central bank of the United States. They set monetary policy and regulate the private banking system under the direction of the board of governors and the federal open market committee). The Feds are the regulators, policy makers, and **money suppliers**<sup>3</sup> (a nation's supply of currency plus assets with very high levels of liquidity) for the U.S. economy. They are the ones that loan money to the **commercial banks**<sup>4</sup> (a firm that engages in the business of banking) and **thrift institutions**<sup>5</sup> (a savings and loan association, mutual savings bank, or credit union), where it is then loaned to the public. The Feds control the money supply through our open-market operations (the purchases and sales of U.S. government securities that the Federal Reserve undertakes in order to influence interest rates and the money supply).

With that being said, there were a number of factors that contributed to the recession in 2008. One of them was because of the **mortgage-backed securities**<sup>6</sup> (bonds that represent claims to all or part of the monthly mortgage payments from the pools of mortgage loans made by lenders to borrowers to help them purchase residential property). Mortgage-backed securities themselves weren't the issue, it was when the banks issued **subprime mortgage loans**<sup>7</sup> (high interest rate loans to home buyers with above-average credit risk), and repackaged it with other funds and loans as securities. This made the matters more complex and our economy could not handle the amount of loans **defaulting**<sup>8</sup> (situations in which borrowers stop making loan payments or do not pay back the loan).

Although we have a **built-in stabilizer**<sup>9</sup> (a mechanism that increases government's budget deficit during a recession and increases government's budget surplus during an expansion without any action by policymakers), we need other policies to assist with the recovery. Therefore, one of the policies the Feds instigated a **Zero Interest Rate Policy**<sup>10</sup> (ZIRP; a monetary policy in which a central bank sets nominal interest rates at or near zero percent per year in order to stimulate the economy) to encourage **investments**<sup>11</sup> (spending for the production and accumulation of capital and inventory) and spending to stimulate the economy. It has now been nearly a decade since the recession, and the Feds have been anticipating to normalize the **prime interest rate**<sup>12</sup> (the benchmark interest rate that banks use as a reference point for a wide range of loans to business and individuals) in four increments this year, especially after the oil prices dropping which lead to increase consumer spending. However, the article mentioned how businesses and investors are not ready for this increase after this last financial quarter. This last quarter and 2015 fourth quarter did not meet the optimistic projections. In addition to that, keeping the interest rates low had given the government very little room for error. As the intent of the lower **interest rates**<sup>13</sup> (a percentage of the borrowed amount) was to increase the money circulation, it may have adversely stagnated investment spending because there was less incentive to invest. It is noted that the Feds aggressive **monetary policy**<sup>14</sup> (a central bank's changing of the money supply to influence interest rates and assist the economy in achieving price-level stability, full employment, and economic growth) did help keep **unemployment rates**<sup>15</sup> (the percentage of the labor force unemployed at any time) down.

As we continue to invest in bonds and such, the article discussed the projections may have been overly optimistic on yields for corporate **bonds**<sup>16</sup> (a loan that the borrower is to pay principal and interest for a specific time period) and **U.S. Government Securities**<sup>17</sup> (the U.S. Treasury bills, notes and bonds used to finance budget deficits; part of public debt) and did not take into consideration the possible declines in return. Therefore, causing planned investments to increase when it should not.

In addition to the Feds actions, the Obama Administration had tried to push for an **expansionary fiscal policy**<sup>18</sup> (an increase in government purchases of goods and services, a decrease in net taxes—any variations to increase aggregate demand expanding real output) with congress, but was not successful. As far as the public was concerned, many people did not want to increase the **budget deficit**<sup>19</sup> (amount of expenditures exceeding revenue in the year) and did not want to owe **external public debt**<sup>20</sup> (the portion of the public debt owed to foreign citizens, firms, and institutions) a large sum of money to China in fear that they would have political influence over the United States. The misconception was that much of that debt was actually **public debt**<sup>21</sup> (the total amount owed by the federal government to the owners of government securities).