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So the Fed raised policy rates 25 bps: this tightening regime should not last very long

So the Fed raised rates 25bps, an outcome that was pre-ordained as long as a week ago, after the February jobs data exceeded expectations and following a round of Fedspeak in the week prior to the blackout period. The only drama left of the FOMC meeting was what signal the Fed sends with the statement, the nuances expressed during the press conference, and the rearrangement of the so-called "SEP dots." The Fed did not disappoint the monetary policy hawks with the overall message signalling general confidence in the economic outlook while providing assurances that the Fed is neither behind the curve nor intends to fall behind the curve. The Fed took the optimal route, giving itself room to tighten policy at a gradual pace if they so desire. Given the Fed's pent-up desire to normalize policy, and given the cover that they were provided by the labor data set, two further hikes this year is indeed gradual as viewed from the Fed's perspective and many market participants. But basically, the slightly accelerated tempo just puts the Fed back to where they started in 2016, except that (after the debacle of the December 2015 tightening), the Fed expects this "gradual" tightening regime to actually work out this time.

But we ask: "gradual" relative to what? And what makes them so sure (otherwise, they would not have raised rates) that there will be no repeat of the post-December 2015 climbdown? We have serious doubts that this long, so-called "gradual" tightening regime will gain much traction in the light of developments happening in the yield curve space and in some of the underlying data that matters. One feature of the bond markets that was brought about by the repression of the short-term rate since the Great Financial Crisis (GFC) is that most movements in the 3M/10Y yield curve now occur at the long end of the curve. Prior to the GFC, it was the other way around due to the sensitivity of short-term Treasury bond yields to adjustments in monetary policy.

Nonetheless, the negative comovement in the changes between the 3M/10Y and the Fed Funds Rate has remained – and is a testament to the flat nature of the short end rate – most of the changes in the curve is accounted for by the long rate which is a strong discounter of future events. And the crucial element in the relationship is that changes in the yield curve tends to lead the changes in the policy rate, exactly due to the anticipatory characteristic of the now more active long rate (see chart below).

We routinely use the 3-month Treasury bill rate as a proxy for the Fed's policy rate (the Fed Funds Rate, FFR). Therefore, it makes sense that if you juxtapose the yield curve against the FFR, changes in the yield curve provides a view of what to expect from the FFR future moves, with a lead of at least one quarter (see first chart on next page).

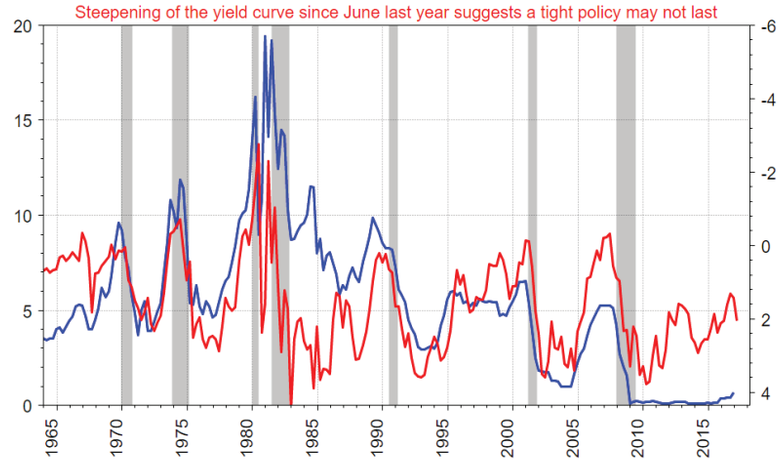
The usual narrative about the slope of the yield curve that you read in the media has not been "upgraded" by the fact that the Quantitative Easing (QE) programs conducted by the Fed as a response to the GFC has changed the nuances in the relationship of many financial variables. The narrative remains the same. "Raising short end rates does not shift long-term yields. As a result, the yield curve becomes flat and in some cases, inverted. This is important as an increase of spreads usually indicates that investors are optimistic about the growth rate of the economy while, on the other hand, a narrowing of spreads implies a weakening economic outlook." This interpretation is not essentially incorrect, but it misses the important nuances in the signalling process provided by the yield curve on monetary policy. Steepening of the yield curve does not necessary imply that investors are optimistic about the economy – the shift in the orientation of the slope from flat to steep merely means that investors begun to anticipate that the tightening regime of the Fed is about to end, or is not going to last long if the steepening happens at the start of a tighter policy regime. And that curve steepening opens a can of worms insofar as economic growth is concerned, and investors have no reason to cheer a steeper curve if its implications to credit supply and to job creation are properly understood.

One implicit reason for the Fed's resuming the tightening regime is that growth will be "stable" – but this assumption may be tested in a few weeks when Q1 2017 GDP growth will be reported. It is looking a little grim, if the Atlanta Fed's GDP Nowcast is to be believed. Its real

The negative comovement between 3M/10Y yield curve and Fed Funds Rate

Flatter curve since 2010 suggests policy has been tightening since then despite a flat FFR

Steepening of the yield curve since June last year suggests a tight policy may not last



US FED FUNDS EFF RATE (W)
US TREASURY CONST MAT 10 YEAR less US T-BILL - 3 MONTH (RH Scale), INVERTED, lagged 1 Quarter

Source: Thomson Reuters Datastream / Copyright. Robert P. Balan Models (c)

GDP growth (seasonally adjusted annual rate) Nowcast in the first quarter of 2017 is at 0.9%. Another reason for concern is a development, which may or may not be linked, to this grim growth outlook being projected by the Atlanta Fed growth model -- a sudden collapse in loan growth in general, and in the crucial Commercial and Industrial Loan segment in particular. It is a collapse which has the normally staid Wall Street Journal describing it as an «ominous economic signal.» Total loans and leases by U.S. commercial banks are currently rising at an annual pace of about 4.6%. which is down from a 6.4% pace for all of 2016, and from the peak rates of circa 8% during mid 2016. This is the slowest pace of debt creation since early 2014. The WSJ noted that «is at odds with the idea of a stronger economy and rising sentiment,» as deceleration has been broad-based among business, real estate and consumer lending. The decline in growth rates and in nominal volumes have been particularly sharp in the Commercial and Industrial loan category, which has unexpectedly fell to just 4.0% as of the latest week, relative to the pace of growth of 10% during the first half of 2016. The falloff was circa 50% lower than the 7% growth posted earlier in the year. The current loan growth is the lowest pace since July 2011.

Simply put, the banks did hit the brakes on lending, and it has something to do with the improvement in their Net Interest Margins (NIMs). The current improvement in NIMs has something to do with the steeper yield curve which we saw from June 2012 to January 2014. It takes a while before the steeper curve translates into wider NIMs, which started to expand since Q2 last year. In a sense, the current fall-off is a stronger response into that widening, and bank lending drought will continue for some time, perhaps until at least late Q3 this year. But the flatter yield curve between July 2015 and September last year should bring relief to the loan situation shortly. The lags between the yield curve and actual changes in micro-data are long, at least 5 quarters even 7 quarters in some cases, so it is easy to overlook the rationale for a micro-event that is happening now. There is no "efficient economy hypothesis" for yield curve related financial phenomena.

The impact of the yield curve-NIM dynamics does not stop with the banks' credit-creation process. If we go back to First Principles and identify the crucial data sets which influence the jobs market in the core, there nothing more primary in this regard than credit extended by commercial banks, the steepness of the yield curve, and the banks› consequent Net Interest Margin (NIM) – and now this foundation of the current job phenomenon is under attack. To understand how this comes about, we have to follow the narrative from the outset (see second chart above). Collectively, if banks´ non-performing assets are high, their NIM will go down if the interest earning assets are steeply reduced by non-performing assets, and vice versa. A steeper yield curve provides better conditions for the banks› NIM to rise, which reduces the need for larger portfolios for riskier loans - hence loan levels fall when the yield curve steepens. The linkage to the job sector flows from the steepness of the yield curve to the amount of lending then to the jobless insurance claims and the unemployment rate. Put another way, when the yield curve steepens, commercial lending volume falls, and the tighter credit situation impacts hiring and payroll growth after a lag, with concomitant effects on unemployment and jobless insurance claims.

Developments in lending usually take several quarters to manifest in the jobs market, so it may be that we have a few more months of jobs growth. But it is increasingly becoming clear that the upswing phase of the current Business Cycle is starting to show signs of aging. Under these conditions, we do not expect the Fed to be able to tighten policy for as long and as quickly as they have indicated in their current Summary of Economic Projections (SEP) dot plots.