UNITED STATES ECONOMICS FOCUS

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CAPITAL ECONOMICS

A closer look at financial conditions

- **Financial conditions have tightened in recent months, as the dollar has continued to trend higher, corporate credit spreads have widened and stock markets have suffered a correction. Nevertheless, while conditions are not as accommodative as they were, they are far from restrictive**.
- As Fed Chair Janet Yellen put it in her testimony yesterday, conditions are "less supportive" for economic growth, but that is very different from saying that conditions now represent a headwind. **If sustained, the tightening of financial conditions presents a downside risk to our forecast that GDP growth will be 2.5% this year, but the tightening is nowhere near enough (at least not yet) to suggest that a recession is coming**.
- The dollar's rise is the biggest negative for economic growth. Net external demand subtracted 0.5% points from overall GDP growth last year and the drag will be roughly the same magnitude this year as well. Over the past few weeks specifically, however, the dollar has actually fallen back quite sharply, particularly against the euro and the yen.
- The collapse in energy prices has triggered a surge in high yield bond spreads, as investors fear oil and gas firms will default this year. Banks are also more reluctant to lend to some businesses. Investment grade corporate bond spreads have risen, but much more modestly. Furthermore, the increase in those spreads is largely attributable to the drop in risk-free Treasury yields rather than an increase in corporate bond yields. Indeed, the latter have fallen in recent days. Accordingly, the cost of capital for most firms is actually a little lower than it was before. There are fears that rising energy sector defaults and/or a flat yield curve could impair the financial sector but, up to now at least, the LIBOR spread and financial sector CDS spreads remain low.
- Although some corporate borrowers have seen the cost of credit rise, other types of borrowers are unaffected. MBS and municipal bond spreads have risen only slightly, and almost entirely because safe-haven flows are driving down Treasury yields. Finally, the majority of banks still intend to loosen lending standards on credit card and auto loans to households. Accordingly, **while the tightening in financial conditions needs monitoring, what we have seen up to now is not enough to indicate that a recession is coming**.

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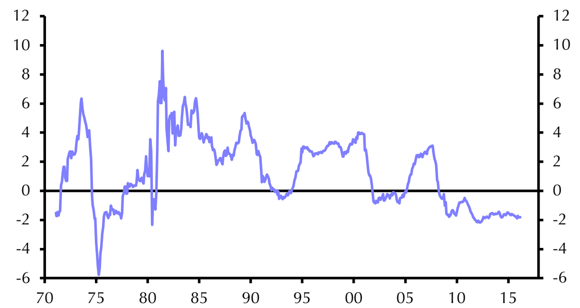
A closer look at financial conditions

The recent turmoil in financial markets has prompted claims that tighter financial conditions will choke off the economic expansion but, for now at least, most firms and households still have free access to credit and can borrow at rates that are still close to historical lows. If sustained, the tightening of financial conditions presents a downside risk to our forecast that GDP growth will be 2.5% this year, but the tightening is nowhere near enough to suggest that a recession is coming.

Financial conditions is a catch-all term to describe the overall stance of a wide range of financial variables that affect the behaviour of firms and households via the cost of capital or wealth effects and, consequently, economic activity.

There are numerous competing composite indices of financial conditions published by various public and private institutions. These indices differ in the exact variables included and the methodology used, but most incorporate the same basic elements. In addition to the level of risk-free short-term and long-term interest rates, the indices normally include a range of credit spreads, the exchange rate, stock market performance and the yield curve.

CHART 1: REAL FED FUNDS RATE (%)

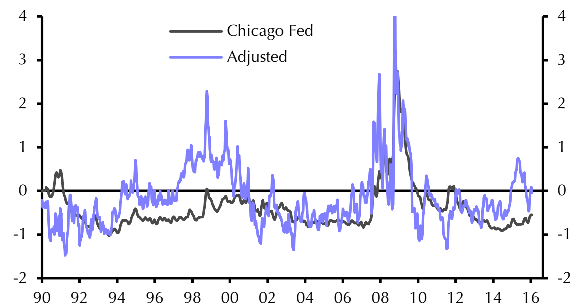


Sources – Thomson Datastream, Capital Economics

The first thing to note is that, based solely on the level of real short-term interest rates, financial conditions are unusually accommodative and the Fed's rate hike late last year has not generated any notable tightening. Even if the equilibrium real interest rate is now close to zero, conditions are accommodative because the actual real rate is deep in negative territory. (See Chart 1.)

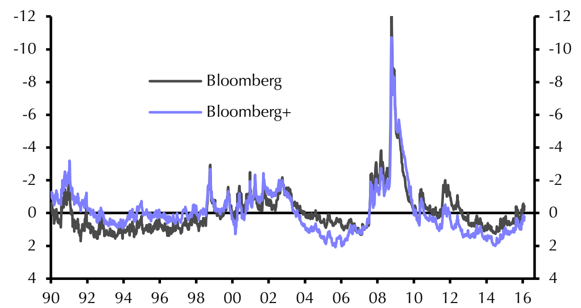
Most financial conditions composite indices suggest that, while financial conditions have tightened somewhat, conditions are now back to normal after a period of being more accommodative than usual. None of these indices suggest that conditions have tightened to anywhere near the same degree we saw in the run up to the recessions in 2001 and 2008. We present three of the most popular indices from the Chicago Fed, Bloomberg and Goldman Sachs, but others paint exactly the same picture (See Charts 2, 3, & 4.)

CHART 2: CHICAGO FED FINANCIAL CONDITIONS INDEX



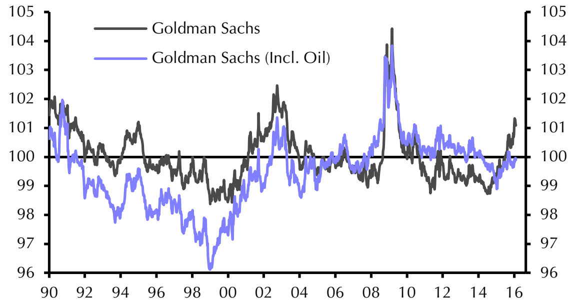
Source – St Louis Fed FRED

CHART 3: BLOOMBERG FINANCIAL CONDITIONS INDEX



Source – Bloomberg

Chart 4: Goldman Sachs Financial Conditions Index

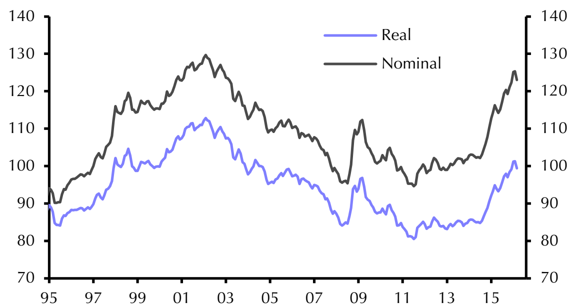


Source – Bloomberg

Rising dollar the key driver of tighter conditions

The near 20% surge in the broad trade-weighted dollar over the past 18 months is one of the key driving factors behind the tightening of financial conditions. The currency appreciation resulted in net external demand subtracting about 0.5% points from GDP growth last year and the drag will be of about the same magnitude in 2016 too. Nevertheless, while the dollar is still up by 3% since the Fed hiked rates late last year, it has fallen back in recent weeks, particularly against the euro and the yen. Moreover, in a relatively closed economy like the US, the dollar's rise is not necessarily a recovery killer. In real terms, the dollar is also still well below the peak reached in 2002. (See Chart 5.)

Chart 5: Broad Trade-Weighted Dollar Index

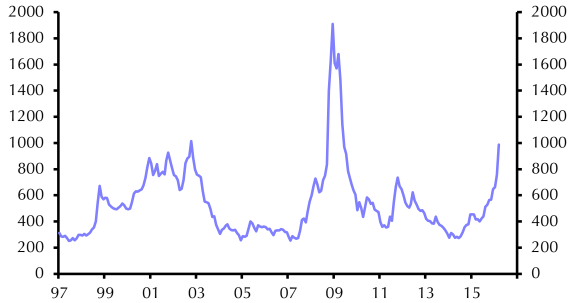


Source – Thomson Datastream

Credit spreads rising but rates remain low

The collapse in energy prices has triggered a big surge in high yield bond spreads, as investors fear oil and gas firms that issued high yield bonds during the recent energy boom will default this year. That said, while spreads have widened by almost 400 basis points since late 2014, they are still well below the levels reached in the early 2000s or during the 2008 financial crisis. (See Chart 6.)

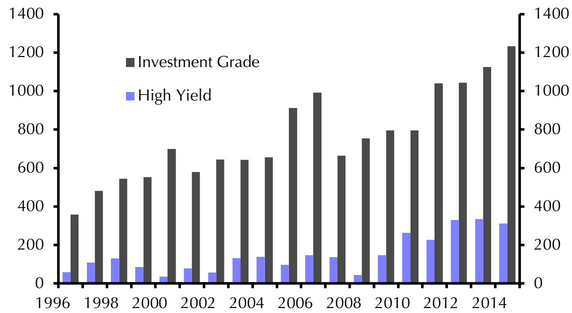
Chart 6: BofA High Yield Master II Bond Spread (bp)



Source – St Louis Fed FRED

We remain relatively sanguine about the impact that the shake-out in the high yield bond market will have on the wider economy. High yield bonds outstanding is around $1trn, but probably only one-third of that debt was issued by energy firms. Even if we assumed a 50% default rate on those bonds, the loss would be limited to $150bn, or 0.9% of GDP. Nevertheless, it is worth remembering that the 2008 financial crisis began with problems specifically in sub-prime mortgage-backed securities that, as the housing downturn worsened, spread to supposedly investment-grade securities. The risk is that the problems currently restricted mainly to the high yield market could spill over into the much bigger investment-grade market. (See Chart 7.)

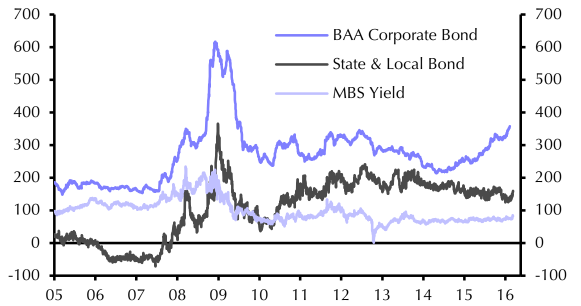
Chart 7: Corporate Bond Issuance ($bn)



Source – SIFMA

Spreads on investment grade corporate bonds have widened, but that has only taken them back to 2012 levels. (See Chart 8.) Moreover, other bond spreads remain largely unchanged. In particular, despite Puerto Rico's default, municipal bond spreads continue to trend lower, while MBS spreads are close to a record low.

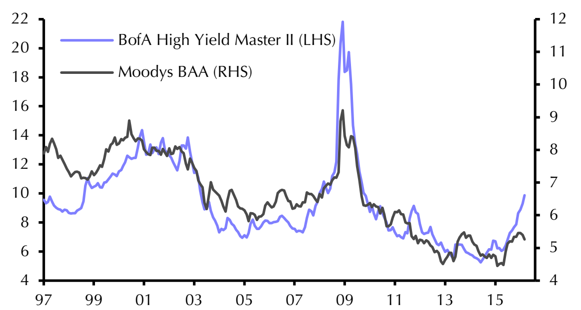
CHART 8: BOND SPREADS (BP)



Source – Thomson Datastream

It is also worth remembering that the rise in corporate credit spreads over risk-free Treasury yields is partly because those risk-free yields have been plummeting. The yields on investment grade corporate bonds have actually fallen in recent days. (See Chart 9.) While spreads provide a sense of the stresses in particular segments of the credit markets, it is the level of rates that determines the cost of capital to firms and feeds into their investment decisions.

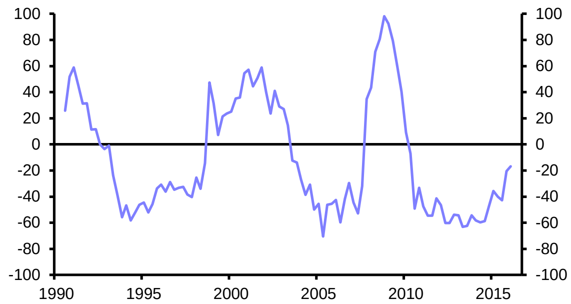
CHART 9: CORPORATE BOND YIELDS (%)



Sources – St Louis Fed FRED, Thomson Datastream

There is some evidence of a tightening in credit conditions not just in the bond markets, but in bank lending to the corporate sector too. It was notable that the Fed's latest Senior Loan Officer Survey showed a shrinking net proportion of banks is still narrowing the spread between business loan rates and the cost of funds. (See Chart 10.) Again, however, while there was a shift to a net proportion of banks widening those spreads ahead of both of the past two recessions, the current shift has been much more modest.

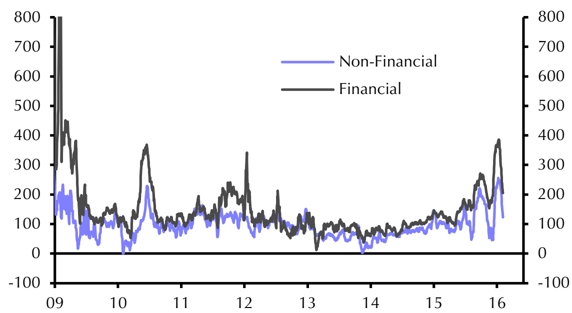
CHART 10: NET % OF BANKS INCREASING SPREAD BETWEEN BUSINESS LOAN RATES & COST OF FUNDS



Source – Thomson Datastream

During the 2008 financial crisis, the commercial paper market proved to be a source of distress, as borrowers, primarily in the financial sector, found themselves unable to roll-over their short-term funding. Commercial paper rate spreads also widened in the second half of last year but the increase is, up to now at least, quite modest. (See Chart 11.)

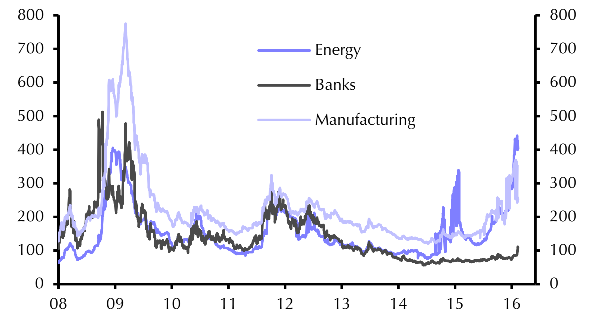
CHART 11: 3M COMMERCIAL PAPER RATE SPREAD (BP)



Source – Thomson Datastream

Finally, looking at credit default swap spreads, the surge in corporate default risk isn't just restricted to the energy sector. Manufacturing CDS spreads have also widened markedly. (See Chart 12.) But the increase in risk aversion is still industry-specific. Even financial sector CDS have remained low.

Chart 12: CDS Spreads (bp)

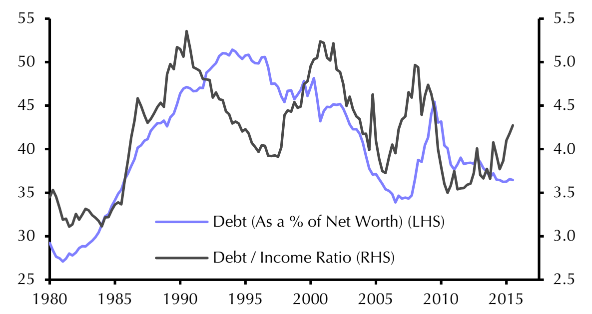


Source – Thomson Datastream

In summary, there are some signs of stress in corporate credit markets and bank lending, but it is far from universal. Those stresses are restricted to a few sectors, particularly mining and manufacturing firms. The impact on the wider economy, however, could still be limited. The fact that borrowing costs have soared for mining firms not already completely shut out of the credit markets is, as far as economic activity is concerned, largely academic. Mining investment has already plummeted by more than 50% over the past 12 months. Regardless of the potential supply of credit, oil & gas firms weren't going to seek funding for new projects with oil prices at $30 a barrel, because those projects would never have been profitable.

More generally, non-financial corporate debt leverage is low and, while the debt-to-income ratio has rebounded slightly, it is still close to a 30-year low. (See Chart 13.)

Chart 13: Non-Financial Corporate Debt & Leverage

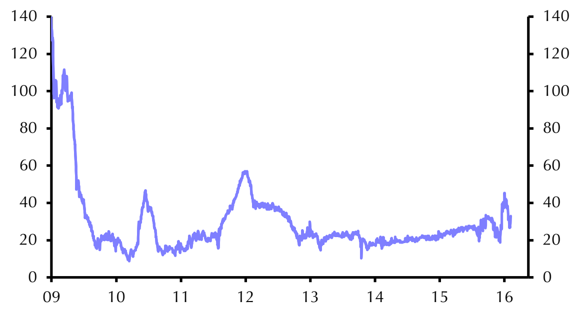


Source – Thomson Datastream

Financial sector stresses still limited

Within the past few days, concerns have begun to mount that the financial sector could also be hit by what is expected to be a surge in defaults in the energy sector and/or that negative interest rates will damage profitability. But, up to now at least, the LIBOR spread has increased only modestly and remains below the levels reached during the 2012 euro-zone crisis, when the viability of a number of European banks was questioned. (See Chart 14.)

Chart 14: 3m LIBOR Rate Spread (bp)

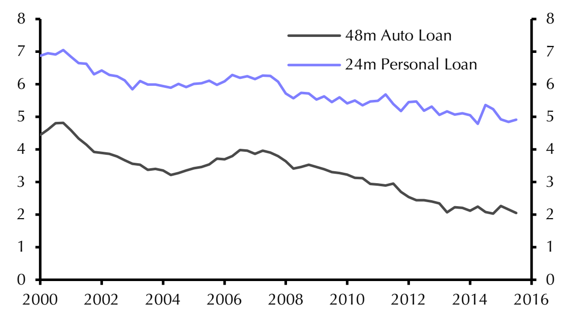


Source – Thomson Datastream

Households' credit conditions largely unchanged

Although commercial banks are more wary about making loans to corporate clients, there is no evidence that households are also seeing a tightening of credit conditions. As we showed earlier, MBS yields have not risen, which means that mortgage rates are also largely unchanged. Furthermore, there is no sign of any increase in the rates that banks charge on auto or personal loans. (See Chart 15.)

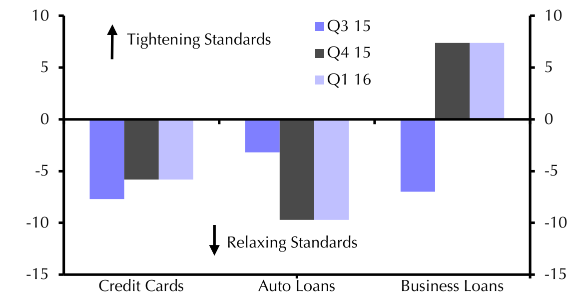
Chart 15: Commercial Bank Loan Rates (%)



Source – Thomson Datastream

The Fed's latest Senior Loan Officer Survey indicates that, in contrast to loans to businesses, a majority of banks still intend to loosen lending standards further for credit card and auto loans to households. (See Chart 16.)

CHART 16: % OF BANKS TIGHTENING STANDARDS ON LOANS

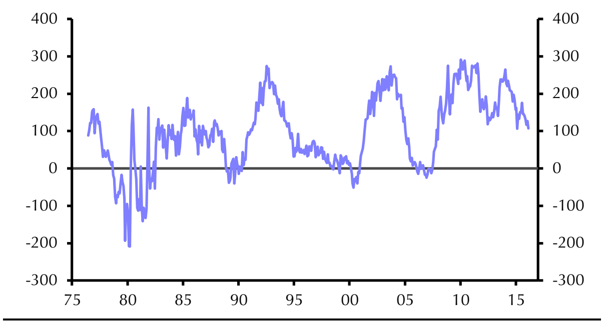


Source – Thomson Datastream

Other financial variable evidence mixed

The Treasury yield curve is often included in composite measures of financial conditions since, historically, it has been a surprisingly good leading indicator of economic recessions. (See Chart 17.) Some commentators have argued that with short-rates at near-zero, the curve cannot invert in the current environment, meaning that it no longer has any value as a recession indicator.

CHART 17: TREASURY YIELD CURVE (10S MINUS 2S, BP)



Source – Thomson Datastream

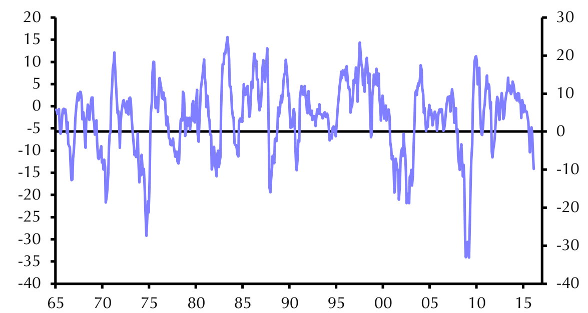
It may be true that the curve cannot invert, but if there was going to be a recession we would have expected it to be much flatter than it currently is. The spread between 10-year yields and 2-year yields is barely below its long-run average. Remember also that the Fed's quantitative easing was designed specifically to lower yields at the long-end of the curve.

We're a little sceptical of the current dismissals of the yield curve as a recession indicator because we remember hearing the exact opposite argument used when the curve did invert ahead of the last recession. At that time it was very popular to claim the inversion was largely due to distortions caused by the global saving glut, which was driving down yields at the long-end of the curve.

Stock market decline big, but not big enough

The correction in the S&P 500 increases the likelihood of a recession but, unless the correction continues, it is no guarantee that a recession is coming. Most recessions have been preceded by stock market corrections, but those corrections have tended to be much bigger than the current downturn. (See Chart 18.)

CHART 18: S&P 500 (% DIFFERENCE FROM 12M AVE.)

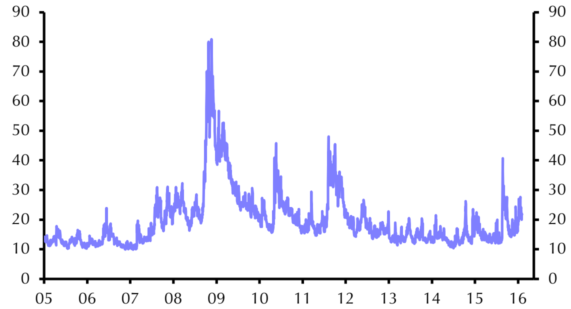


Sources – Thomson Datastream, Capital Economics

Of course, it is possible that the current correction could develop into a full-blown bear market. Until that happens, however, we would reserve judgement on what the current stock market decline means for the broader economy.

Finally, it is notable that stock market volatility has remained contained during the downturn that began at the start of this year. The VIX index still below the levels reached last August and a long way below the levels reached not only in 2008 but even 2012 too. (See Chart 20.)

CHART 20: VIX VOLATILITY INDEX



Source – Thomson Datastream

Conclusions

Financial conditions have undoubtedly tightened in recent months, as the dollar has continued to trend higher, corporate credit spreads have widened and stock markets have suffered a correction. Nevertheless, while financial conditions are not as accommodative as they were, they are still far from restrictive.

As Fed Chair Janet Yellen put it in her testimony yesterday, conditions are "less supportive" for economic growth, but that is very different from saying that conditions now represent a headwind to growth. If sustained, the tightening of financial conditions presents a downside risk to our forecast that GDP growth will be 2.5% this year, but the tightening is nowhere near enough to suggest that a recession is coming

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