US Macroeconomics

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Financial Conditions Are Still Tighter Than You Think

The sharp rally in 10-year Treasury notes, which gave a further lift to stock prices, has technically loosened financial conditions over the last week. Some have speculated this will cause the Fed to sound more hawkish and raise the possibility of another interest rate hike while also reinforcing the “higher for longer” mantra. But have financial conditions really eased that much? We do not think so, and here is why.

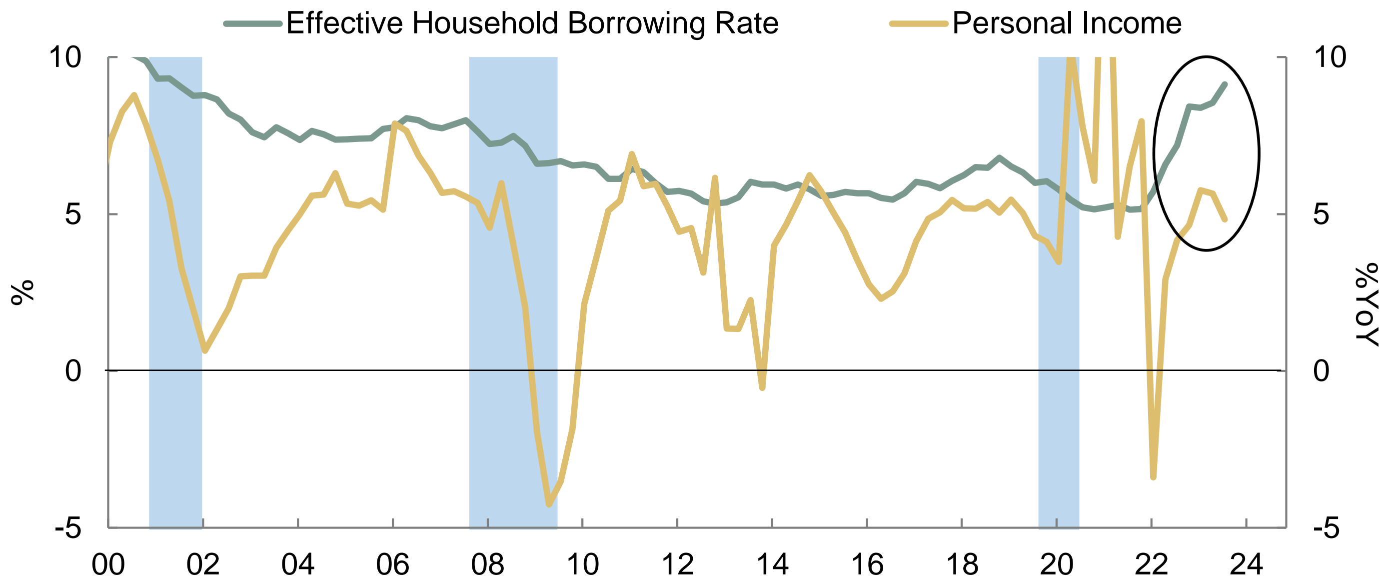
The consumer dominates the economy, accounting for 70% of expenditures-based GDP. Over the last week, interest rates have rallied about 40 basis points while the equity market is up about 6%. No doubt, if sustained, this will lift business and consumer sentiment, thus acting as a tailwind to the economy. But everything is relative. Right now, **effective household borrowing costs are at a multi-decade high, especially relative to personal income growth** as shown below.

The effective borrowing rate is a weighted average of outstanding auto, credit card, mortgage, and personal debt — the rate is around 9%. While that rate may edge down a bit if 10-year Treasury yields fall further as we expect, borrowing costs will still be extraordinarily high. How so?

Right now, **the cost of borrowing greatly exceeds the growth in personal income**. As we can see, the spread between the two series is wide, with borrowing costs above income. This signals restrictive monetary policy because debt is prohibitively expensive for households. Notice that borrowing costs are still rising while the pace of income has topped out, consistent with moderating job gains. In other words, the current trends are worsening for future consumption prospects.

If the Fed does not cut interest rates, households net interest expense is poised to rise further. In turn, the ability of households to finance their debt will deteriorate. In theory, if credit was abundant, households could take on more debt in the short-term, waiting for rates to eventually fall. But commercial banks have been tightening credit meaning households are facing higher borrowing costs *and* reduced credit availability. Consumer spending is bound to slow.

With the bulk of the economy (i.e., households) suffering from the effects of tight money, investors’ focus on easing financial conditions is misplaced. Stay tuned.



Sources: NY Fed, Freddie Mac, BEA, Haver, SMBC Nikko

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