The Fed is Focusing on the Wrong Measure of Financial Conditions

Market participants and monetary policymakers are placing too much weight on the recent easing of financial conditions. In particular, the collective rally in stock prices, decline in long-term interest rates, tightening in credit spreads, and softer dollar are making the Fed think it needs to hike the funds rate even higher from an already restrictive level. This would be a major policy mistake.

Abundant and affordable credit is a prerequisite for healthy consumer spending and a robust economy since the former accounts for 70% of total economic activity. Households get mortgages to fund home purchases, borrow from commercial banks to buy motor vehicles, and use credit cards to manage intra-month spending needs. Some consumers also have student debt. Credit provides the lubrication necessary for the smooth running of the economy.

Consequently, if the cost of credit becomes excessively expensive as it is now, households will eventually rein in their expenditures, and real GDP growth will decline. This is evident in the chart below, which shows a weighted-average effective household borrowing rate. The weights are based on each borrowing component’s respective share of total consumer debt.

Through Q4 2022, the effective household borrowing rate was 7.4%. This is the highest since Q2 2002 (7.7%). Moreover, the surge in borrowing costs is without recent precedent. For example, households were paying an effective rate under 4% before the Fed began raising rates. Thus, the cumulative increase in rates is a stunning 342 basis points from Q4 2021.

With respect to “traditional” financial conditions, mortgage rates have fallen back below 7% but are still double where they were last year. To be sure, if 10-year treasury notes rally, mortgage rates will fall further. However, credit card and auto loan rates are sticky as they tend to move only with changes in the fed funds rate. Therefore, effective household borrowing costs are likely to remain elevated until the Fed reverses course.

The bottom line is that monetary policymakers and analysts alike are looking at the wrong metric. Broad financial conditions have eased, but this is not particularly relevant to US consumers. Rather, they are paying record high rates to purchase homes, autos, and fund everyday expenses. The Fed should relent and relent soon.
Disclaimer

This presentation is for discussion purposes only and is not intended to be an offer to sell or the solicitation of an offer to buy any securities, or any commitment to underwrite, subscribe for or place any securities, is not an offer or commitment to provide any financing or extension of credit or service, and does not contain any tax or legal advice. This presentation has been prepared by SMBC Group (which may include, collectively or individually, any of the following entities in the Americas Division: Sumitomo Mitsui Banking Corporation (“SMBC”), SMBC Nikko Securities America, Inc. (“SMBC Nikko”), SMBC Nikko Securities Canada, Ltd. (“Nikko Canada”), SMBC Capital Markets, Inc. (“SMBC-CM”), SMBC Leasing and Finance, Inc., JRI America, Inc., and SMBC Rail Services LLC) and is being furnished by SMBC Group solely for use by the client or potential client to whom such materials are directly addressed and delivered. This presentation is confidential and is the property of SMBC Group subject to copyright. Any reproduction of this presentation, in whole or in part, is prohibited, and you may not release these materials to any person, except to your advisors and professionals to assist you in evaluating these materials, provided that they are obligated, by law or agreement, to keep the presentation confidential. These materials do not constitute research, a recommendation or an offer or solicitation to any person to enter into any transaction or adopt any hedging, trading, or investment strategy. Prior to participating in any such transaction, you should consult your own independent, competent, legal, tax, accounting, and other professional advisors.

In preparing this presentation, SMBC Group has relied upon information available from third parties, including public sources, and we have assumed, without independent verification, the accuracy and completeness of such information. Specific prices, indices, or measures, including ranges, listed in this document were prepared at the time the document was prepared, and are subject to change without notice. SMBC Group makes no representations to and does not warrant this presentation’s accuracy or completeness. SMBC Group expressly disclaims any liability for any use of the information set forth herein, including, without limitation, any use of the information set forth herein in the preparation of financial statements or accounting material.

These materials may contain forward-looking statements, which may include projections, forecasts, income estimates, yield or return, future performance targets or similar analysis. These forward-looking statements are based upon certain assumptions. All forward-looking statements are based upon currently available information and SMBC Group is not obligated to provide an update. Actual events may differ from those assumptions. Opinions, projections, price/yield information and estimates are subject to change without notice. There can be no assurance that estimated returns or projections will be realized, that forward-looking statements will materialize or that actual results will not be materially lower than those presented. Past performance is not necessarily indicative of future results. Any transactions or strategies addressed may not be suitable for all parties. The value, price or income from transactions or strategies may fall as well as rise. SMBC Group or an affiliate may have a position in any of the underlying instruments, assets, indices, or rates mentioned in this document. You should make your own independent judgment or seek independent financial and tax advice with respect to any matter contained herein.

SMBC is subject to Japanese firewall regulations and therefore absent client consent, non-public client information may not be shared with SMBC Nikko Securities Inc.

SMBC Nikko is a U.S. registered broker-dealer of SMBC Group. Nikko Canada is a U.S. and Canadian registered broker-dealer of SMBC Group. SMBC-CM is provisionally registered as a U.S. swap dealer with the CFTC. Capital markets and other investment banking activities for SMBC Group are performed by a combination of SMBC Nikko, Nikko Canada, SMBC Nikko Securities Inc. and SMBC-CM. Lending and other commercial banking activities are performed by SMBC and its banking affiliates. Derivative activities may be performed by SMBC-CM or SMBC. SMBC Group deal team members may also be employees of any of the foregoing entities. SMBC Group does not provide tax advice. Accordingly, any discussion of U.S. tax matters contained herein (including any attachments) is not intended or written to be used, and cannot be used, in connection with the promotion, marketing or recommendation by anyone unaffiliated with SMBC Group or for the purpose of avoiding U.S. tax-related penalties. © 2022 SMBC Group. All rights reserved.