SNL Blogs

Friday, February 01, 2013 11:50 AM ET

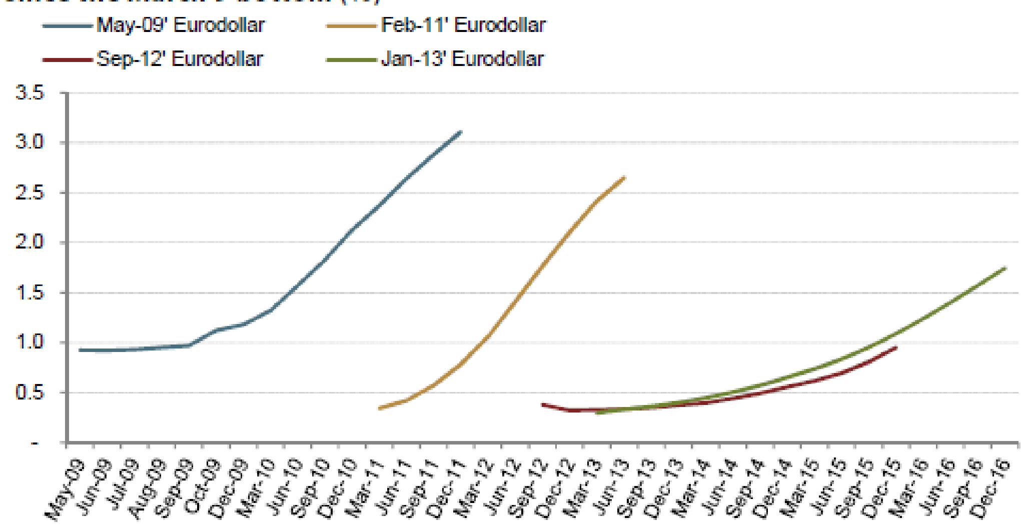
Fed policy — It is until it isn't

By Jeff K. Davis

Yesterday's release from the Federal Open Market Committee entailed no surprises. The Fed will continue to purchase monthly $40 billion of agency MBS and $45 billion of longer-term Treasuries, while reinvesting cash flow from the existing portfolio to maintain downward pressure on rates. The FOMC went on to note that policy will remain "highly accommodative" for a "considerable time" after the bond purchases end. No termination date has been set for the purchases. Therefore the Fed funds target range will remain at 0% to 0.25% "at least as long" as the unemployment rate (U3) exceeds 6.5% and expected inflation over a one-to-two year horizon is no more than 0.50% above the Fed's long-term inflation target of 2.0%.

The FOMC can change its mind. The 10- and 30-year Treasury yields have drifted higher recently on an expectation of better economic growth and, in the view of some, the potential end of the highly accommodative policy sooner than expected. But the history since the financial crisis eased has been for the market to adopt the Fed's view given sluggish GDP growth (e.g. -0.1% for 4Q12; 1.5% for 2012).

Forward Eurodollar 90-day spot rates at four points in time since the March 9 bottom (%)



Forward curves are as of 5/4/09, 2/2/11, 9/13/12 and 1/30/13.
Source: Wall Street Journal for contracts traded on the CME.

As shown in the accompanying graph, the history of forward short-rate expectations following the aftermath of the banking crisis has been for the market to gradually reflect that of FOMC policy. The graph reflects forward spot rates for Eurodollar contracts, which are based upon 90-day LIBOR. As the recession ended in mid-2009, investors assumed the Fed would begin to raise short rates by early 2010 (note: the spread between 90-day LIBOR and the Fed funds rate was then wider). By early 2011, the expectation was that the Fed would soon be raising short rates following then renewed bond buying and an accompanying uptick in the economy. The Fed's forecast assumed GDP growth would be 3.0% to 3.6% in 2011 and 3.6% to 4.5% in 2012 per the November 2010 FOMC minutes (see here).

Growth has since disappointed and forward rate expectations have trended lower as reflected in the flatter curves as of September 2011 and yesterday following the FOMC's release. In effect, until the economy materially improves, which would reflect banks reporting broad-based loan demand, the Fed seems destined to maintain its current policies unless the bond market revolts.

The analogy is similar to investors' views of the earning power of highly asset sensitive companies such as Comerica Inc., which has a high level of noninterest bearing deposits and loans that are tied to 30-day LIBOR. In 2010, investors tended to think about earning power based upon a net interest margin that would be closer to 4% than the then-3.3% level based upon rising short rates in the following year. Today, investors have readjusted earning power views based upon the current rate structure (Comerica's NIM was 2.87% in 4Q12). Whenever short rates rise, Comerica and others with similar business models and balance sheets will make a lot more money, but not before then. Also, the flatter yield curve the Fed has engineered is now negatively impacting bond-heavy banks, mortgage REITs and life insurance companies among other entities.

I may be proven wrong in time, but I continue to come back to the conclusion that NIMs will be much lower than the Street envisions in 2013 and 2014 due to loan pricing competition, very low reinvestment yields for bond portfolios and the absence of much additional cost of funds leverage. The temptation by non-regulated financial entities to use leverage to generate income will be tremendous; let's hope they term it out rather than using excessive amounts of short-term funding as was the case with Lehman Brothers Holdings Inc., Bear Stearns Cos. LLC and others. Markets tend to periodically blow-up.

Jeff K. Davis, Managing Director of Mercer Capital's Financial Institutions Group, is a regular contributor to SNL Financial. He can be reached at jeffdavis@mercercapital.com or 615.345.0350.