NASHVILLE NOTES

Let the market set rates

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By Jeff K. Davis

With the Federal Reserve set to ease its policy rates at least a couple times this fall, President Trump and the bond market are going to get what they want. The downward revision to US job growth of nearly one million for the 12 months ending in March is icing on the rate-cutting cake.

It is news to no one other than recent college graduates that there always has been politics around the Fed with a permanent constituency for lower rates, especially among real estate developers and presidents, or in the unusual circumstance when an individual happens to be both.

I recall Alan Greenspan once commenting that in his long Fed tenure, he never once had a congressperson ask him to raise rates. In late 1965, Lyndon Johnson reportedly shoved Fed Chair Martin into a wall during a "visit" to his Austin ranch after the Fed voted 5-4 to raise the discount rate to 4.5% from 4.0%. President Carter might be a notable exception. He let Paul Volcker do what he needed to do to get inflation under control, but doing so likely cost Carter the 1980 election.

Other than when inflation soars, Wall Street can be counted on to cheer from the rafters for lower rates, too. Easy money supports asset prices and reduces competition for equities and other risk assets.

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So, the setup today is similar to last September, when the Fed would reduce its policy rate by 100 basis points via three cuts beginning with a 50-basis-point cut. Although then-candidate Trump saw the rate cut as political, it was justified by the bond market in which the short-term policy rate — interest on excess reserves (i.e., cash that banks deposit at the Fed) being the most important — was 5.4%, compared to a yield on the 10-year bond below 4%.

In my ideal world — maybe an ideological one — the Fed would let the market set short-term policy rates rather than a committee with its bias and other human frailties, as the market does with intermediate- and long-term rates. It would be simple. The rate the Fed pays banks to deposit excess cash with it (i.e., the interest rate on excess reserves) would be based on an average of short-term Treasury bill yields over a 30-day period minus 25 basis points.

Yes, short-term rates might be volatile at times with every 30-day reset, but so what? That would be the point, because the market would dictate when conditions should loosen and tighten.

It is a counterfactual argument, but I do not believe the market would have maintained rates near zero in 2020 once it was clear that the economy should fully reopen by mid-year, and would have forced rates higher during 2021 before inflation gained too much momentum. Likewise, rates would have been low but likely not anchored near zero for years after Lehman failed as they were under the Bernanke and Yellen Fed.

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My musings here are Austrian economic follies. A market-based approach to "setting" short-term policy rates will never occur. Politics since the dawn of time has been about power and money, not ideology. Washington, regardless of the party that runs it, wants a say, if not below-the-table control of the front end of the yield curve. So, let's take the handwringing about Fed independence with a grain of salt.

As for bank stocks, the cuts last year that helped improve net interest margins, combined with a reinvigorated leveraged loan market and unfolding regulatory reform this year, have been good. The S&P 500 Regional Bank Index has risen about 17% in the past year through Sept. 9. Rate cuts this fall probably will not help margins as much because most of the post-Silicon Valley Bank high-cost funding has been replaced, but cuts will be good for sentiment.

Longer term, banks have to produce earnings growth and competitive returns on equity, something that "higher" rather than "lower" rates help, given the importance of low-cost core deposits to the banking model in which equity is levered to fund interest-earning assets.