Opinion **Federal Reserve**

Flashing red metrics give the US Federal Reserve a reason to act

The right question is whether new risks to financial stability have arisen

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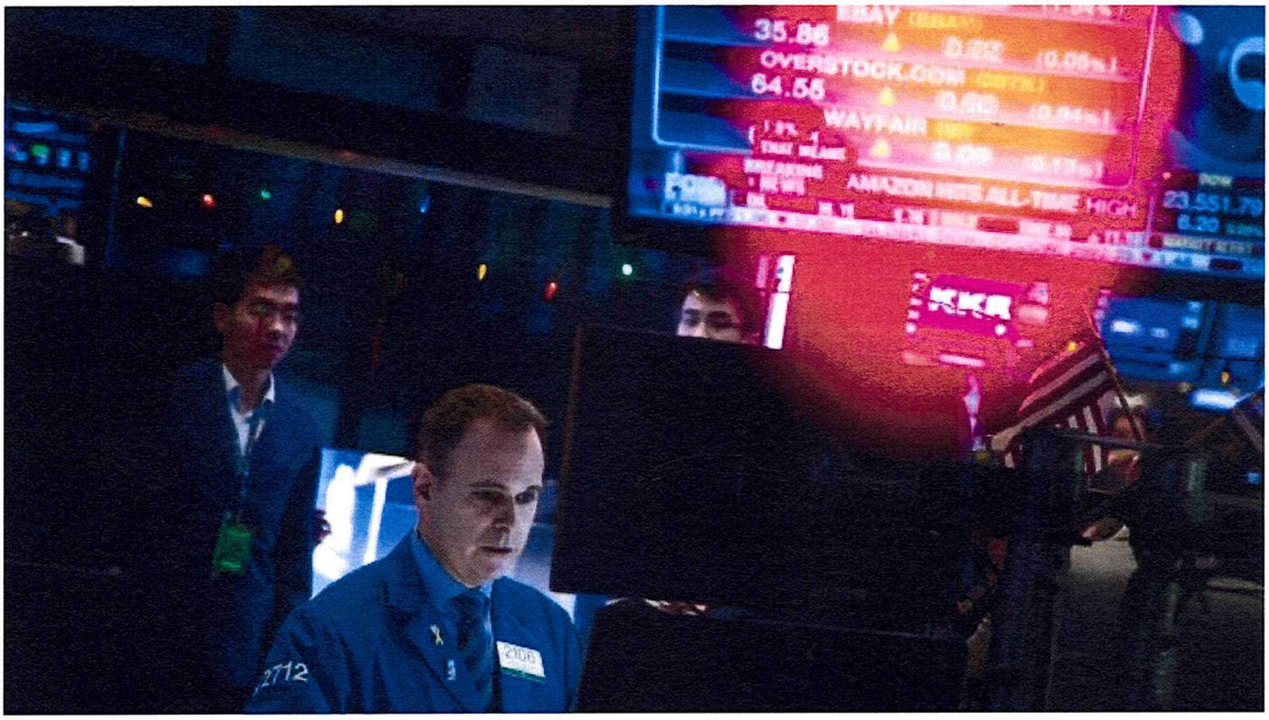

US stocks increased by a fifth last year and have already broken records. Even accounting for low interest rates, equities are expensive © Bloomberg

Jason Cummins
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There is nothing "flashing red" about financial stability risks, Janet Yellen, US Federal Reserve chair, said at her final press conference, "or possibly even orange".

Yet several metrics of market valuation are indeed flashing red. Equities have added to last year's 20 per cent gains and already broken records. The recent interest in bitcoin is reminiscent of the kind of investor mania that often precedes a financial crisis. The cyclically adjusted price/earnings ratio currently exceeds the peak seen on the eve of the stock market crash of 1929 and is approaching the all-time high seen during the tech bubble in 2000. Even accounting for low interest rates, stocks are relatively expensive.

Credit valuations are similarly high despite a flood of issuance. High-yield and investment-grade volumes reached record levels in 2017. Default rates are still declining, but the rate has slowed and the credit risk premium is at cyclical lows.

Moreover, there appears to be a growing problem with the plumbing of the financial system. In the $1tn leveraged loans market, 75 per cent of new issuance is defined as covenant-lite, a sure sign investors are reaching for yield.

Given that the two most recent recessions were caused by financial market excesses rather than macroeconomic ones, it is worth asking what role monetary policy should play. The Fed's view is that the banking sector is well capitalised and overall leverage is moderate. But, like a general fighting the last war, asking whether the economy is going to repeat the last crisis is the wrong question. The right one is whether there are new risks to financial stability.

Large-scale purchases of riskless Treasury and mortgage-backed securities seem like a poorly designed tool to deal with a fall in risky asset prices

The conventional wisdom among economists is that credit bubbles are more dangerous than equity ones. Indeed, the economy suffered a massive recession after the housing bubble of 2007-08 but a mild one after the dotcom boom ended. However, that assessment is dangerously complacent. The Fed cut interest rates by 550 basis points in the wake of the technology crash and fiscal policy became very expansionary in the early 2000s.

By contrast with earlier periods, monetary and fiscal policy tools are limited. The Fed is unable to respond as much as it typically would during a downturn because policy is constrained by the zero lower bound on nominal interest rates. The recently passed tax reform takes away $1.5tn of the fiscal space that would normally be used to stimulate the economy in recession.

Investors might take comfort from the Fed's unconventional monetary policy. However, large-scale purchases of riskless Treasury and mortgage-backed securities seem like a poorly designed tool to deal with a fall in risky asset prices. By the time the Fed would be restarting quantitative easing, yields on 10-year Treasuries would likely be at rock bottom on flight-to-quality flows.

Furthermore, it seems politically naive to fight a stock market crash by trying to bail out Wall Street again. The US is as politically divided as it has ever been during the strongest economic and financial conditions in decades. If the country is split under these circumstances, imagine the political environment in the event of even a garden variety recession.

The good news is that the Fed has ways to be proactive rather than reactive. First, the Fed needs to use pro-cyclical macro-prudential tools rather than just talk about them. Finally, nominal interest rates should be pushed up so that real rates are no longer negative in order to deter risky speculation. Being proactive is not the same thing as being hawkish. This combination could help constrain financial excesses, extend the expansion for many years to come, and ensure the Fed meets its dual mandate targets for employment and inflation.

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