In the past month, we’ve had some macro excitement around the world: dramatic sell-offs in some emerging currencies, widening of European bond spreads, concerns about global growth, and a Fed hike. All of these can be viewed as coincidences, each with its own unique cause. Anxiety about election results in Italy would seem to have little to do with financing a current account deficit in Argentina or the economic policies in Turkey. And yet there does seem to be a common theme behind these events: they are all are related to tightening monetary conditions, which have made the world more vulnerable to shocks. With the ECB moving cautiously and the BOJ making them look aggressive, it’s really all about the Fed. It’s unfortunate, but to the extent that you can find a macro cause for market moves, it keeps leading back to the Fed.

What we really want to know as investors is whether monetary policy is tight. If it is tight, we can expect that more things will break, and we’ll see more macro volatility. If it’s not, then we could see stronger growth. It’s not an easy question to answer. We need to know what economists refer to as the neutral rate, the level of rates which is neither stimulative nor contractionary. The problem is that we don’t. Some economists have come up with clever ways to estimate what it is, but there is no way to know it with certainty. The best we can do is guess.

Back in 1998, the Fed cut rates to 4.75% and U.S. markets took off because policy was considered loose. Now, after Wednesday’s hike, the Fed has gotten its key policy rate back to around 2% and we are talking about tightening conditions. What this tells us is that the nominal level of interest rates doesn’t give us much information about whether monetary policy is restrictive. Most economists prefer to look at real rates, which subtract inflation from nominal interest rates. Inflation is near the Fed’s target and thus the real Fed Funds rate is close to zero, which is very low by historical standards. So real rates are saying something similar to nominal rates. This is evidence that the neutral rate may be lower than it was in 1998, but it doesn’t tell us how much lower.

Tight monetary policy is important because of its effects on lending and credit, so looking at credit and loan data may be helpful. If monetary policy is tight, it literally means that the cost of borrowing is high and that people should be cutting back. In the past few months, we have seen some slowing in borrowing on the consumer side, but general loan growth is still relatively healthy. The problem with using this as an indicator of the tightness of monetary policy is that there may be a lag between restrictive monetary policy and its effects on loan growth. The technical name for this is the Wile E. Coyote effect. Like the coyote after he has run off of a cliff, lending continues despite tight conditions, then suddenly falls to the ground.

One way to get a timely indicator is simply to ask people if credit is tight. (“You can do that??”) Various research groups such as the NFIB and the Conference Board surveys ask variants of the question “Are loans hard to get?” The answers seem to indicate that loans haven’t become much more difficult to get as rates have risen, and they are nowhere near as hard to get as they were during tight monetary periods in the past. Measures of financial conditions that use market indicators of credit stress seem to say the same thing.

The slope of the yield curve seems to be saying a similar thing, though Wednesday’s Fed decision has flattened it further. All of this points to the conclusion that monetary policy is tighter than it was, but not tight on an absolute level. This means that current interest rates are probably a little lower than the neutral rate, wherever it may be. Sure, you can find a few isolated areas of stress, such as small bank lending, but this is not materially influencing the aggregate numbers. The fact that the U.S. data, including the recent employment number, has been good gives some comfort that monetary policy is not restricting growth. But then how do we reconcile that with some of the economic and market volatility we’re seeing in other parts of the world?

Perhaps the U.S. monetary policy is like the U.S. soccer team's failure to make the World Cup. A few Americans were upset, but it didn’t affect the aggregate mood of the American sports fan. However, “football” fans around the world were well aware of it. The big difference, however, was that the global fans' mood was joyous whereas international policymakers are concerned about tightening U.S. monetary policy.

There is little evidence that the reduction in the Fed’s balance sheet has had any effect on markets or the U.S. economy. But for countries that have difficulty getting foreign capital, even small changes in global funding supply can be a real problem. Higher rates in the U.S. may be crowding out the more leveraged borrowers around the world. A cynic might say that they no longer have the cushion of excessively loose policy and that exposes various policy issues.
That seems to be the pattern of monetary policy through many cycles. When it is very loose, there is little risk anywhere. As it moves toward neutral, a few weaker hands are called, but for most part things are okay. When it gets really tight, even the strongest businesses and countries are challenged. This cycle plays out slowly over the course of several years, and in the past few cycles it’s been particularly slow. This time it seems to be right on track.

What We Are Watching

Brazil Central Bank Meeting (Wednesday) Responding to sluggish growth and unusually low inflation, the Brazilian central bank (the BCB) delivered a series of steep rate cuts from the end of 2016 to the start of this year. In recent months, the Brazilian currency (the real) has come under downward pressure due to factors both domestic (concerns about upcoming elections in October) and external (rising U.S. bond yields and broad dollar strength). The BCB has been intervening directly in foreign exchange markets to try to halt the sharp sell-off in the real, but has so far downplayed the idea of raising interest rates to stabilize the currency. Nonetheless, local fixed income markets are pricing a significant possibility of rate hikes moving forward. This week’s meeting will be watched closely to see if the BCB mentions a potential need for higher rates or even chooses to announce an immediate rate hike. The central bank has historically preferred not to change policy right before elections, so may feel pressure to make a decision sooner rather than later.

Bank of England Meeting, Mansion House Speech (Thursday) Back in February, the Bank of England (BoE) warned market participants to expect a faster pace of rate hikes in the remainder of the year. Since that time, weaker than expected growth numbers and lower than expected inflation have undermined the argument for tighter policy to some extent. More recent communications have maintained that rates still need to rise later this year, but have acknowledged that the outlook may have grown cloudier. No change in policy is expected at this week’s BoE meeting, but the post-meeting statement and Governor Carney’s annual Mansion House Speech that evening may clarify the central bank’s current thinking. Governor Carney has made market-moving comments at the Mansion House event on several occasions in the past, and the tone of his speech could once again have a significant impact on the pound and U.K. fixed income markets.

Eurozone PMIs (Friday) While still at reasonably strong levels by historical standards, business surveys in the eurozone have steadily deteriorated since the start of the year. The Eurozone Manufacturing PMI published by Markit, for example, ended 2017 at a multi-year high but has ticked down every month since then. The preliminary PMI numbers for June may be of particular interest given the flare-up in market volatility in late May due to political uncertainty in Italy. Moves towards more protectionist trade policy in the U.S. may also be of concern to European manufacturers. If it appears that rising political risk is having a significant impact on business sentiment, it may imply downside risks to eurozone growth in the near term.

[1] The key number to watch related to the Fed is the Fed Funds rate, not the size of the balance sheet, which is a bit of a red herring. Also, often there is not a macro cause to market moves.


[3] On Wednesday, June 13, 2018, the Federal Reserve hiked its target range for the federal funds rate from 1.50%-1.75% to 1.75%-2.00%. Source: Federal Reserve: “Monetary Policy Statement,” 6/13/18.

[4] As of April 2018, outstanding consumer credit growth has slowed to 4.8% YoY relative to 6.1% YoY growth seen in April 2017, but the 4.8% YoY growth still remains fairly positive. Sources: Bloomberg, Federal Reserve.

[5] From the time the Fed started raising rates in December of 2016 to the latest data released for May 2018, the NFIB Small Business Credit Conditions Availability of Loans Diffusion Index has remained in a tight range, moving from -6.0 to -5.0, suggesting higher rates haven’t had much impact on loan availability over that period of time. Sources: Bloomberg, National Federation of Independent Business.

[6] The Goldman Sachs Financial Conditions Index has increased from a low of 98.19 on January 26, 2018 to 99.08 on June 13, 2018, but the latest reading is still near the looser end of the range of financial conditions over the past 28 years of the index history. Sources: Bloomberg, Goldman Sachs.

[7] After the FOMC meeting on June 13, 2018, the 2-yr vs 10-yr yield curve flattened from around 41bps before the monetary policy statement was released at 2:00pm ET to around 39.7bps by the end of the day. Source: Bloomberg.

[8] Folks always forget the lag.


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