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The Fed Blinked.

Why Restructuring Professionals Should Care

By Michael Eisenband

Back in October we asked when the training wheels should come off the bicycle that is the U.S. economy with respect to normalizing monetary policy. We have since gotten an oblique answer of sorts from the Fed, specifically the Federal Open Market Committee (FOMC)—not now.

Despite Chairman Powell's insistence that political considerations "have played no role whatsoever in our discussions or decisions about monetary policy", it's hard to read FOMC meeting minutes and comments from Powell since late December without concluding that the Fed has yielded to the forces of financial markets and the White House, which were both urging the Fed to back off. Characterizing the sudden pause by the Fed as a capitulation is a widely held opinion expressed by many prominent market commentators in recent weeks. A more dovish tone was first articulated in Powell's press conference of December 19th following the committee's decision to raise the targeted Fed Funds rate by 25 basis points. Powell referenced "some crosscurrents" that have emerged that suggested moderating global economic growth which would "give the Committee the ability to be patient in moving forward." He has since used the word "patient" several times in reference to policy around rate hikes. Chairman Powell also reduced the number of expected rate hikes in 2019 to two from three in his comments.

In fact, these crosscurrents, mostly occurring on the global stage, have been in place for many months but hadn't previously given the Fed pause with respect to expected rate hikes or its scheduled balance sheet runoff. It was also unusual to hear a Fed chair cite economic developments abroad as a consideration for U.S. monetary policy. On the domestic economic front, Powell's comments continued to laud the strength of the U.S. economy.

Much more likely to have influenced Fed policy considerations was the vicious selloff in financial markets beginning in early December in response to the prospect of several more Fed rate hikes in 2019. We all had a glimpse of what can happen in equity and credit markets when players suddenly decide to take their marbles and go home. To put it cynically, the message coming from financial markets and influential commentators was a resounding one: the Fed's priority should be to keep inflated the asset bubbles that it created.

Now there is nothing unreasonable about Fed rate policy being data dependent or postponing a rate hike until there is greater economic clarity. Monetary policy should be flexible enough to adjust to changing economic conditions. More troubling though is an expected tapering of the Fed's balance sheet runoff and a growing belief that it will end the controlled runoff altogether in mid-2019 when it still will have some $3.6 trillion of purchased securities on its books—far above its targeted final range. Such speculation was set off by FOMC comments in late January which stated that the committee was prepared to alter the size and composition of its balance sheet if conditions warranted and that banks' need for reserves would drive those decisions—an entirely different message and tone than Powell's December comment that the balance sheet runoff was on automatic pilot.

To quickly review: the Fed aggressively began to purchase treasury and mortgage-backed securities in 2009 in order to revive financial markets in the wake of the collapse of Lehman Brothers. Its securities holdings went from $500 billion in 2008 to $4.3 trillion by 2015 (Exhibit 1)—a tremendous infusion of liquidity into the financial system. Bond purchases by the Fed associated with three rounds of quantitative easing (QE) ended in late 2014. The Fed paid for these purchases by crediting banks' reserve accounts with the Fed. This created nearly $3 trillion in excess reserves for federally chartered banks, which allowed them to greatly expand their own balance sheets via new business loans, mortgages and other lending. These activities eventually got the U.S. economy untracked and growing while much of the industrialized world still flirted with near-zero real growth. This coincided with QE activities by other central banks that eventually injected more than $10 trillion of very low cost capital into the global financial system. This liquidity has been nearly the equivalent of helicopter money for many large financial institutions and their institutional clients.

With the U.S. economy having strengthened sufficiently and financial markets hitting all-time highs, the Fed began the process of withdrawing this liquidity in late 2017 by allowing its securities portfolio to run off at a controlled rate of $30 billion per month, increasing to $50 billion monthly in late 2018. This unwinding is also referred to as quantitative tightening (QT) and it was widely understood that this process would take several years to run its course.

When credit markets convulsed in December, one popular explanation was that the Fed's scheduled runoff of its securities portfolio was draining too much liquidity from the U.S. financial system, as excess reserves of U.S. banks had "dwindled" to $1.6 trillion from $2.7 trillion in late 2014 as a result of their own balance sheet expansions. The concern now is that the continued runoff of securities will soon reduce excess reserves below levels that markets and regulators would feel comfortable with—unless banks contract their own balance sheets, which, of course, would be heresy in the eyes of markets and investors.

So here we are confronting the possibility that a bazooka-like injection of liquidity intended to be a once-in-a-generation stimulus at a time when markets were barely functioning cannot be withdrawn, even gradually, because it would be too disruptive for financial markets to handle. If so, it sounds like our rock-solid economic recovery is built on a foundation of sand.

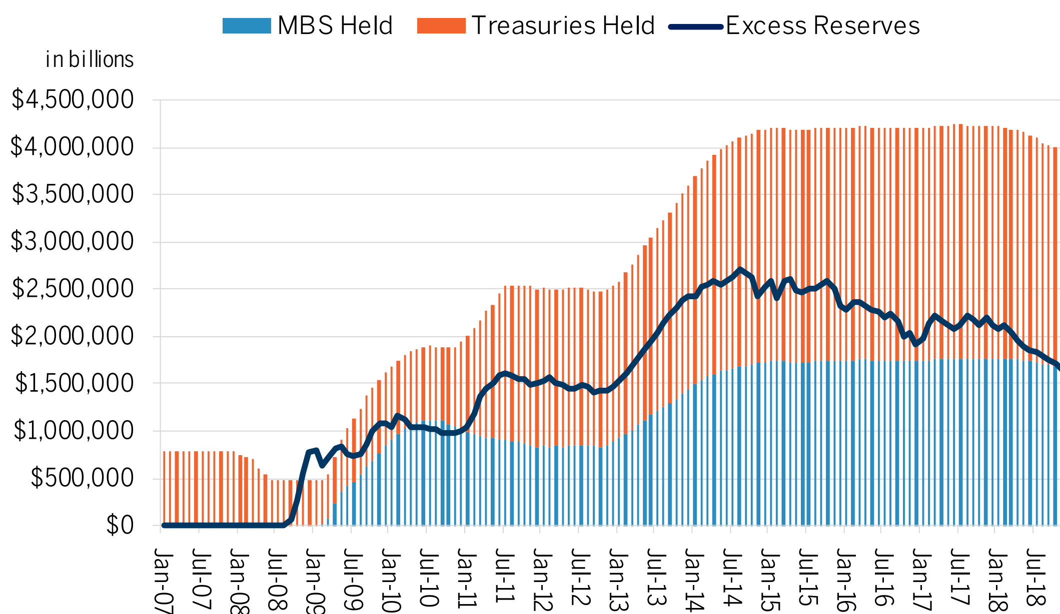
Why should restructuring professionals care about such wonky stuff? Because an extended pause or retreat by the Fed on these fronts likely will help extend this credit cycle well into 2019 and encourage more high risk, late-cycle loan underwriting, and provide lifelines to companies that might not have access to capital in a normal credit environment. If you doubt that, just look at the performance of leveraged credit markets in January, which have largely reversed losses and outflows from December. Financial markets have rejoiced in 2019 at the singular prospect that the Fed is now expected to stand pat this year.

We read business stories on a daily basis that bemoan shoddy corporate loan underwriting practices, weak lender protections and excessive leverage, especially those involving non-bank lending. Such warnings and admonitions

will fall on more deaf ears should the Fed decide to sit it out in 2019, and leveraged credit will probably continue to flow in abundance. There are many tens of billions of dollars (easily more than $100 billion) in dry powder earmarked for private credit in U.S. markets, and that capital will get put to work more liberally if lenders believe any prospect of restrictive monetary policy is off the table. Many folks in the lending trenches recognize what is happening here but their choices are stark. They can hold their noses and sign on to deals that leave them uneasy or they can pass on shaky loan participations and worry that deal flow won't come their way despite sitting on lots of lendable capital. There is too much money chasing too few creditworthy borrowers at a late stage in the cycle—a time when the worst deals are done. More of the same will keep the merry-go-round moving but everyone will be queasier when it eventually stops. For now, 2019 suddenly looks less promising for the restructuring profession than it did a couple of months ago unless the economy grinds much slower.

EXHIBIT 1

Federal Reserve: Securities Held & Excess Reserves



Source: The Federal Reserve Bank of St. Louis

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