Whither the U.S. Credit Markets?

Construction Financial Managers Association
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I am delighted to be here this evening to meet with the Construction Financial Managers Association at this meeting co-sponsored by the Associated Builders and Contractors and the Builders Exchange. I had originally planned to provide an overview of the state of the economy but decided instead to concentrate on the very unusual situation in today's credit markets. I think this decision is fully appropriate given that interest rates and credit availability are critical issues for all parts of the construction industry.

The U.S. financial landscape changed dramatically in mid-August of this year. Initially, what we saw was a dramatic widening of quality spreads as lower-rated corporate bonds fell in yield relative to Treasury bonds. In the ensuing weeks we found that the number of new bonds coming to market fell dramatically from the pace earlier in the year. In addition, the stock market became much more volatile and on average equity prices declined. As in the bond market, the number of new issues coming into the equity market declined substantially.

What I want to do this evening is to discuss in some detail what has happened in the credit markets and to work on providing a deeper understanding of these events and of their possible implications for the U.S. economy.

THE FINANCIAL MARKETS SINCE AUGUST

Let me begin this discussion by referring to Figure 1 reporting corporate bond spreads monthly from 1959 to date. The bold line in the figure shows the spread of the Aaa average bond yield over the ten-year Treasury yield. The daily average of that spread was about 185 basis points so far in October, compared with an average over the entire period since 1959 of 68 basis points. The figure also reveals that the spread in today's market is indeed higher than we have seen since 1959.

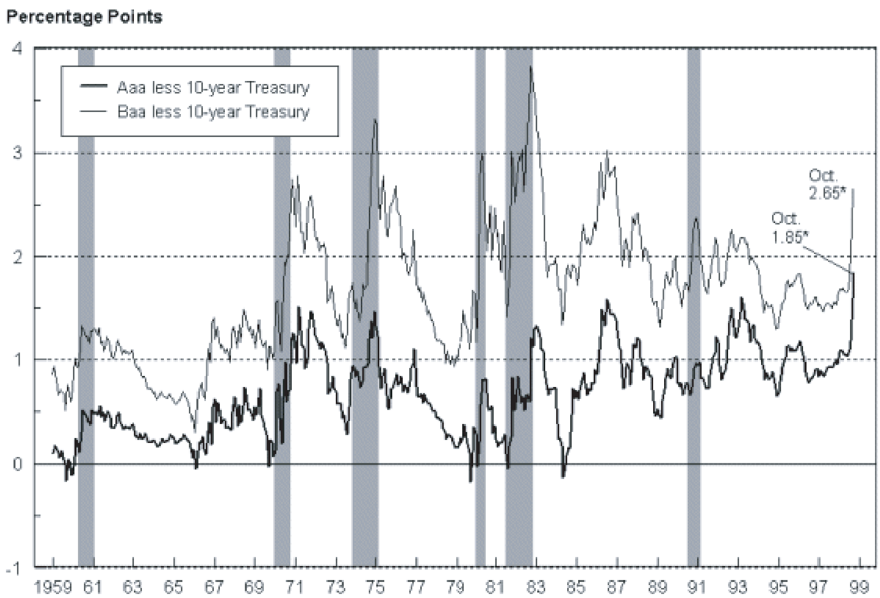
The lighter line in Figure 1 shows the spread of lower-rated corporate securities—those carrying a Baa rating—over the 10-year Treasury yield. So far in October that spread has averaged 265 basis points. As we can see from the figure, this spread is higher than normal—the average over the entire period is 167 basis points. However, a spread this large is not all that uncommon since 1959.

We should also compare the current spreads to their recent levels before August. Over the past several years, the Aaa spread has been in the neighborhood of 100 basis points and the Baa spread has been in the neighborhood of 150 basis points. So, clearly the spreads have increased sharply since August and that is the phenomenon we need to understand and that monetary policy makers need to confront. At this point, I want to put aside policy discussion; we must look much more carefully at understanding the situation before we discuss the policy response.

The vertical shaded areas in the figure show periods of recession as defined by the National Bureau of Economic Research. In almost all cases historically, spreads widened only *after* a recession was clearly underway. Such behavior makes perfectly good sense as periods of recession bring declining corporate earnings and less earnings coverage of corporate debt service. The effect is more important, of course, for lower-rated bonds such as the Baa bonds. With increased risk of

Figure 1

Corporate Bond Spreads



(Mean Aaa spread 0.68, mean Baa spread 1.67)
* Average of business days ending October 22, 1998

default, investors demand higher yields. Moreover, in general we can observe that the increase in the spread is greater the deeper the recession. The recessions of 1973-75 and 1981-82 were more serious than the other recessions shown in the figure, and the peak spreads were higher. If we go back further in U.S. history, we would observe exactly the same thing.

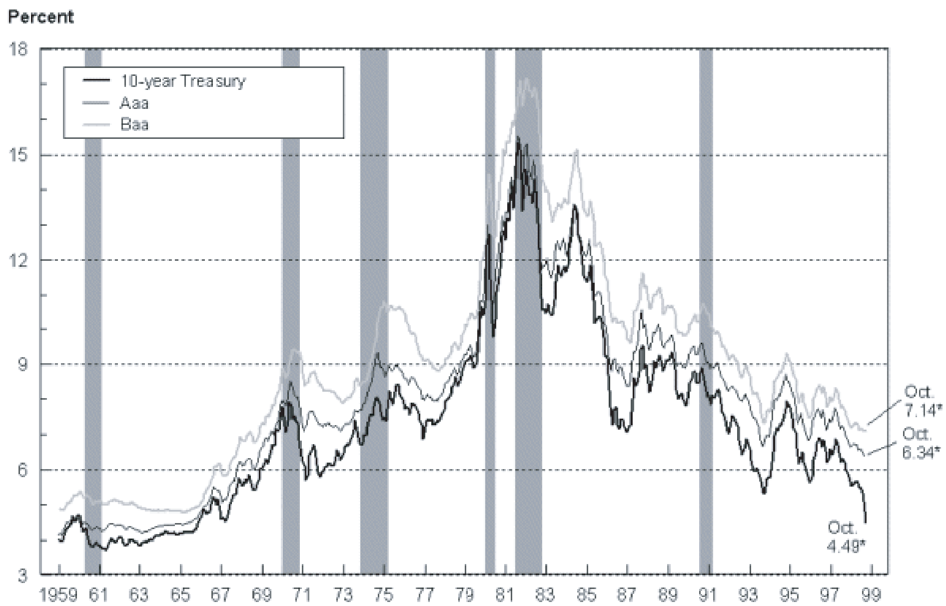
Many observers have commented on figures similar to Figure 1, although to my taste they too often concentrate on only the last few years with the consequence that the lessons from history are missed.

I now want to turn to a different way of looking at this same subject by examining the absolute levels of the yields. Figure 2 provides the information we need. The bold line in the figure shows the 10-year Treasury bond yield. As we can see, that yield has dropped dramatically in recent months. The Aaa and Baa yields have also fallen somewhat, although not as much. Therefore, the spread that has opened up is quantitatively more a consequence of the steep decline in the Treasury yield than a consequence of an increase in the Aaa or Baa yields. If we look at the lower-rated bonds the market refers to as "junk" bonds, the story is broadly the same except that the junk-bond yields have gone up in absolute value so that the spread has become quite large. Based on the Merrill Lynch high-yield bond series, this spread averaged 566 basis points in September compared with more recent experience in 1997 and 1998 until August of a spread closer to 300 basis points.

We can tell a broadly similar story at the short-end of the market. The spread between the yields on bank CDs relative to the three-month Treasury bill rate has opened up to the tune of 142 basis points for the week ending October 16 compared with an average spread over the period since 1964 of 81 basis points. This year before August the spread was closer to 60 basis points.

Figure 2

Long-Term Bond Yields



(Mean Aaa 8.01, mean Baa 9.00, mean 10-year Treasury 7.34)
* Average of business days ending October 22, 1998

Thus the CD spread has increased by something in the order of 80 basis points since August. What this means is that the cost of purchased funds to large banks has risen substantially relative to the Treasury bill rate.

The commercial paper rate has also risen relative to the Treasury bill rate. In mid-October that spread was about 127 basis points compared with an average spread since 1971 of 71 basis points. The average spread this year before August was more in the neighborhood of 50 basis points, which means that the commercial paper spread has risen by something in the order of 80 basis points since August, or about the same as the increase in the CD spread. Thus the cost of financing to the large corporations that utilize the commercial paper market has risen by 80 basis points relative to the Treasury bill rate. Here again, as in the bond market, the absolute cost of financing in the CD and commercial paper markets has not gone up; the spreads have widened because the T-bill rate has gone down substantially.

Spreads do not tell the entire story. I don't have the volume numbers at my fingertips, but it is evident that the number of new issues has declined quite substantially. To what extent volume is down because potential borrowers simply cannot place riskier bonds due to weak demand for such bonds and to what extent volume is down because potential borrowers are simply waiting for spreads to narrow I do not know. Either way, the sharply reduced volume is another measure of the magnitude of the current disturbance in the credit markets.

Finally, because of the wide reporting of the stock market, everyone is familiar with the declines in the equity market and the greatly increased volatility in that market. The increased volatility is indeed quite dramatic; we have all experienced the gut-wrenching up and downs—the downs hit deeper in the gut than the ups—in the stock market.

One other thing that has happened—little noted by the general public, but much commented upon by market professionals—is the spread that has opened up *within* the Treasury bond market between on-the-run and off-the-run issues. For example, the longest bond outstanding, which has a maturity of a little less than 30 years, was recently trading at a yield of about 35 basis points less than the next longest bond. That spread narrowed somewhat last week. Ordinarily, this yield difference is in the neighborhood of five to eight basis points. The same phenomenon can be seen when comparing 10-year and 9-year T-bonds, and 5-year and 6-year T-bonds. The market liquidity is far higher for the on-the-run issues at 5, 10, and 30 years than for the neighboring bonds. For some reason, the market concentrates on those particular maturities. Finally, bid-asked spreads for any given issue in the Treasury market have also widened.

It seems reasonable to interpret these yield spreads within the Treasury market as providing a measure of the market's tremendous hunger for liquidity and the market's tremendous uncertainty. The on-the-run issues can be traded in much larger volume and with a much lower bid-asked spread—although a higher bid-asked spread than normal—than the neighboring issues, so these are the issues where market professionals place funds on a temporary basis. It may seem strange that traders would use a thirty-year bond as a place to park funds temporarily, but that seems to be the way the market works.

So, to summarize, throughout the credit markets we see evidence of a very large change in investors' attitudes starting in mid-August. The equity markets are on average down and much more volatile. Quality spreads have opened up substantially in the bond market and in the money market. The volume of new issues in both the equity market and the bond market has declined very substantially. Within the Treasury bond market, off-the-run issues trade at much higher than usual yields relative to on-the-run issues. And bid-asked spreads throughout the bond market, including the Treasury bond market, are higher than normal.

UNDERSTANDING THE CREDIT MARKET DISTURBANCE

Now that we have reviewed what has happened in the credit markets, let's talk a bit about trying to understand these events. I already commented briefly that in the bond market, as you can see from the figures I distributed, the spreads historically have been related to recessions. I also commented that it makes perfect sense for spreads to widen under such circumstances. One possible interpretation of the increased spreads today is that a recession has already started. That possibility seems remote to me, as the current economic data simply do not point to an actual decline in economic activity already in place. The most recent data suggest that the rate of growth has slowed a bit, but not that the overall economy is already on a downward track. Moreover, most forecasters are calling for continued expansion next year, although there are a few who believe a recession is on the way.

My personal observation on a recession forecast is that if a recession does start early next year, the circumstances surrounding it will be unique in U.S. business cycle history. As far as I know, looking back on the entire chronology of recessions starting in the 1850s, there is no case in which the period leading up to a recession was characterized by low-to-declining inflation, declining interest rates well in advance of the cycle peak, and high-and-rising money growth. I've learned not to say that something is impossible in this business, but we must form our judgments from our experience and to me it seems unlikely that a recession is either already underway or just around the corner.

When we look at the spreads at the short end of the market—the CD and commercial paper spreads—we can observe two features of our experience since 1959. First, the spreads are characterized for the most part by short, sharp peaks. Second, we can identify specific events that triggered the sharp increases in the spreads. It is useful to recount these specific events to understand better what is going on.

In 1970, the Penn-Central Railroad declared bankruptcy. Penn-Central had issued commercial paper which the rating agencies had rated prime. Holders of prime commercial paper issued by other corporations were understandably taken aback when they heard of the Penn-Central default. Their reaction was perfectly natural and understandable: they asked whether other commercial paper rated prime might also be suspect. The immediate effect was a sharp increase in the commercial paper spread over T-bills as investors insisted on a higher yield to protect themselves. Before very long, however, the market sorted out the borrowers that truly were prime from others that were more questionable. The questionable borrowers were no longer able to borrow at prime and the prime borrowers borrowed at a normal spread over the T-bill rate. The hiccup in the market disappeared quickly.

Similar disturbances that resulted in sharply increased spreads can be identified. The Franklin National Bank failed in 1974, Continental Illinois Bank nearly failed in 1984, and the stock market crashed in 1987. In all these cases we observe spikes in spreads in the CD and commercial paper markets. But the key point is that in a chart the spreads look like spikes rather than long plateaus at the times of these events. In these cases I've mentioned, and others, the market straightened out the matter quite literally in a matter of weeks.

This time, the disturbance has lasted somewhat longer so far than similar disturbances in the past. The shock to the markets was a particular piece of news—the Russian default on its debt in mid August, or debt rescheduling for those who want to be polite and strictly accurate. Apparently, the Russian situation led many investors to think much more carefully about risks in the marketplace and to wonder whether spreads were adequate to cover those risks.

We really do not know how long spreads will remain high and the volume of new issues abnormally low; the current experience is more general and pervasive than the examples we see in history. But my own personal guess is that the market today is well into the process of sorting out the solid credits from the less solid ones. There are straws in the wind suggesting that the flows of financing through the markets are picking up once again and that we are headed back toward a more normal state of affairs. Spreads have narrowed a bit in recent days, and the stock market is up significantly from its lows. But, I do want to emphasize that my observations reflect straws in the wind, and I would not personally be surprised if the situation either lasts longer or sorts itself out quickly. Put another way, there is necessarily a wide variance to any reasonable forecast about this matter.

Now let me try to put these observations in a somewhat general framework. Here is how the process works as best I can understand it. Some shock or piece of news hits the market and takes people by surprise. Many investors run for cover until they can sort out the situation. Investors move away from more risky securities and park funds temporarily in safe, highly liquid Treasury securities. However, the wide spreads that open up provide the incentive to the markets to sort out the problem quickly. After all, if you can invest in a slightly risky security at a spread over a Treasury security that more than amply compensates for the risk, then why not go for it? The market is in the business of assessing risks and obtaining the highest possible yield consistent with the risk being assumed. So, while the market in general may be dominated for a few weeks by highly risk-adverse investors, more astute and adventurous investors will start to place funds in the securities that offer a high yield relative to the risk involved. This process gradually spreads to the rest of the market, and not always so gradually. That is why the figure on the spread shows spikes rather than long plateaus.

I haven't mentioned bank lending as yet, because not much has happened on that front. The information I have indicates that large banks may have pulled back a bit, looking harder at the riskiness of potential loans and shying away from some they would have accepted before August. However, most small- and medium-sized banks have continued their lending policies largely unchanged.

IMPLICATIONS OF THE CREDIT MARKET DISTURBANCE

It is pretty obvious that if the spreads remain high for an extended period of time, and if the flow of new credit to borrowers who would have readily qualified for funds only a short time ago remains largely cut off, then the economy will almost certainly slow substantially. But, please do note the qualifying phrase, "if the disturbance continues." *If* spreads remain high, *then* the effect on the economy will be substantial. Put more precisely, the longer the disturbance continues, the greater will be the effect on the economy. I am confident that in the sweep of history the disturbance will be temporary, but I do not know today whether "temporary" means a matter of a few more weeks or a matter of a few more months. So, clearly we at the Federal Reserve need to watch this situation closely and to adjust monetary policy in line with our best current estimate of the probable effects of the financial market behavior on the general economy.

Let me emphasize my personal conviction that we need to focus on the economy itself and not aim our sights at the financial markets per se. The Federal Reserve has only one policy instrument, which is the amount of money it creates. As a tactical matter, the Fed sets an operating target for the federal funds rate. With one policy instrument, the Fed can at best be successful in pursuing one policy objective. In my view, that objective ought to be the performance of the U.S. economy, and most especially a low and stable rate of inflation. No aspect of the performance of the financial markets should itself be a policy objective, given that the Fed has only one policy instrument, but the Fed should, in my view, do the best it can in assessing how financial markets may affect the economy. In due time, and conceivably quite quickly, the current financial disturbance will peter out, and then my job will be to do the best I can in figuring out the economy's direction given the resumption of normal credit flows.

Let me finish with a few observations on the current economic situation. The fundamentals of the U.S. economy really do seem to me to be sound. I am not trying to sound optimistic in an effort to calm the market, or for any other purpose. Such a stance wouldn't work for the Fed for more than a few days if the flow of news reflects fundamentals that are not really sound. It is true that the credit markets might have been reacting to something that I don't see—I am not infallible in these matters and certainly have made my share of mistaken judgments in the past. However, I do have to call things as I see them and I have tried to give you a very open opinion about my assessment. The fundamentals of the economy are strong because the inflation environment is benign—inflation has been stable to declining and inflation expectations are that inflation will remain benign. The labor force is fully employed.

I want especially to emphasize that the banking system is strong; increases in bank capital over recent years have meant that bank losses from some recent loans that have gone bad do not threaten the solvency of the banks. Bank capital is doing exactly what it is suppose to do. This situation is quite different from that in the early 1990s when we did have a rather prolonged period of credit stringency related in good part to the weakness of bank capital at that time.

In sum, I believe that the U.S. economy is in as strong a position imaginable to withstand the sudden burst of risk aversion that has affected the credit markets since mid August in the pervasive way I have been discussing tonight. I have tried to understand what is going on in the credit markets by drawing on a combination of economic theory and historical experience. I believe that the Fed's policy response to this situation, emphasizing its possible effects on the U.S. economy, has been fully appropriate. That's my message. It will be interesting indeed to see how these conditions evolve in the months ahead.