

Financial Stability Report

Statement by Governor Lael Brainard

The latest Financial Stability Report provides valuable analysis to track increases in financial system vulnerabilities. I would highlight a few areas. Vulnerabilities associated with elevated risk appetite are rising. Valuations across a range of asset classes have continued to rise from levels that were already elevated late last year. Equity indices are setting new highs, equity prices relative to forecasts of earnings are near the top of their historical distribution, and the appetite for risk has increased broadly, as the "meme stock" episode demonstrated. Corporate bond markets are also seeing elevated risk appetite, and the spreads of lower quality speculative-grade bonds relative to Treasury yields are among the tightest we have seen historically. The combination of stretched valuations with very high levels of corporate indebtedness bear watching because of the potential to amplify the effects of a re-pricing event.

The FSR describes the failure of Archegos Capital Management and the associated losses at a number of large banks. It highlights the potential for nonbank financial institutions such as hedge funds and other leveraged investors to generate large losses in the financial system. The Archegos event illustrates the limited visibility into hedge fund exposures and serves as a reminder that available measures of hedge fund leverage may not be capturing important risks. The potential for material distress at hedge funds to affect broader financial conditions underscores the importance of more granular, higher-frequency disclosures.

With investors ebullient on expectations for a strong rebound, it is important to closely monitor risks to the system and ensure the financial system is resilient. With valuations and risk appetite at elevated levels, strong microprudential safeguards and macroprudential tools such as the Countercyclical Capital Buffer will be important to address risks to financial stability and enable monetary policy to focus on its maximum employment and average inflation goals.

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