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Flash Economics

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Could US finance and the Federal Reserve now trigger another global financial crisis?

US finance knows how to exploit the Federal Reserve's laxity (its choice to not intervene to prevent overborrowing or asset-price bubbles in expansion periods) to develop activities that could be termed "speculative".

In the second half of the 1990s, this was the case with the equity market - especially new technologies - which increased to unreasonable valuations.

This equity bubble ended in a crisis and recession in 2001, which spread to Europe.

From 2002 to 2007, it was the case with household mortgage debt (especially subprime debt) and mortgage loan securitisation, with abnormally low risk premia, which led to the subprime and Lehman crisis, which then became a global crisis.

US monetary policy has been highly expansionary since 2008 and remains so despite the fact its normalisation is underway. Are there signs that US finance has once again used this monetary laxity to develop risky activities?

There are no signs at present of any major financial imbalances in the United States, but there is a large number of "small" imbalances regarding equity valuation and share buybacks, commercial real estate prices, acquisitions and consumer loans. So, unlike in the past, there is no great anomaly, but rather many small anomalies. Like in the past, they relate to US finance exploiting monetary laxity. This large number of small financial anomalies is certainly a risk for the United States; is it also a global risk?

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ECONOMIC RESEARCH

The exploitation of the Federal Reserve's monetary laxity by US finance

In the second half of the 1990s and from 2002 to 2007, there was **"collusion" between the Federal Reserve's monetary laxity and the behaviour of US finance.**

In the second half of the 1990s, the Federal Reserve did not react to the sharp rise in share prices (Charts 1A and **B).**

Chart 1A
United States: Fed Funds rate and S&P index

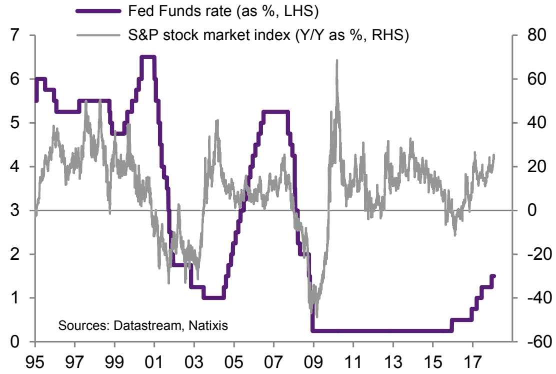
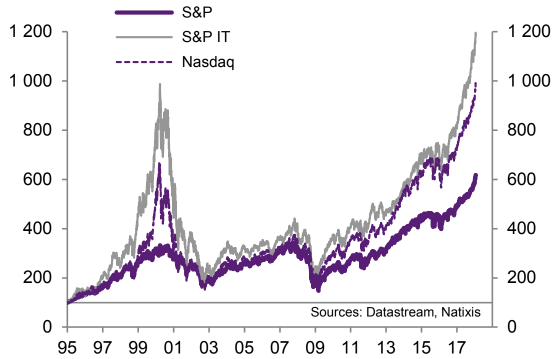
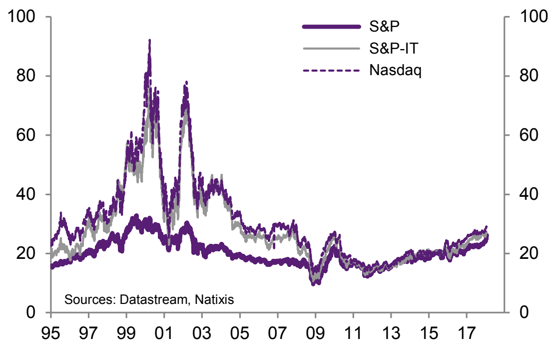


Chart 1B
Total stock market index and equity market indices in technology (1995:1 = 100)



This paved the way for equity valuation to become extremely high at the end of the 1990s **(Chart 1C).**

Chart 1C
PER



When the equity bubble burst, due to excessive valuations and a (slight) increase in interest rates, **the United States entered into recession,** as credit and corporate investment fell **(Chart 1D). The fall in share prices and the recession spread to Europe (Charts 1E** and **F).**

Chart 1D
United States: Business loans and productive investment (Y/Y as %)

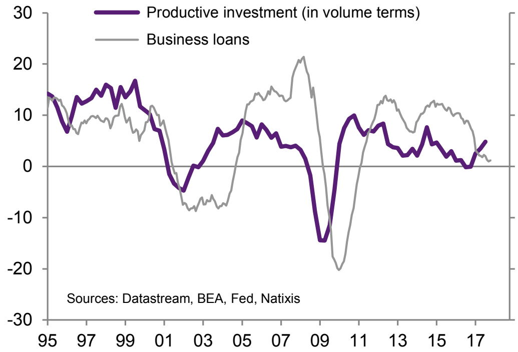


Chart 1E
Stock market indices (1995:1 = 100)

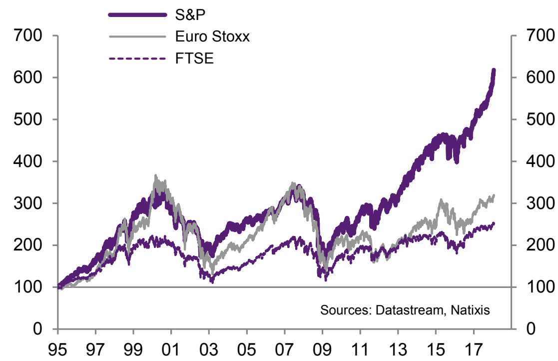
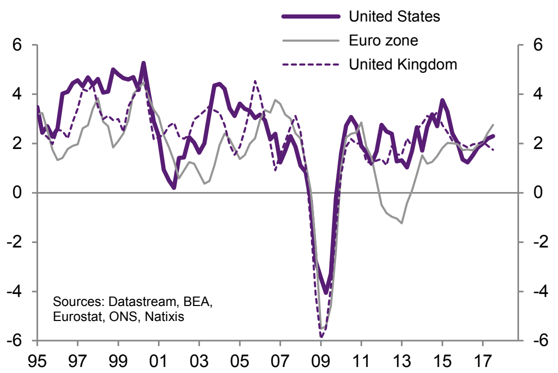


Chart 1F
Real GDP growth (Y/Y as %)



From 2002 to 2008, the Federal Reserve did not react to rising household debt (Chart 2A) or rising property prices (Charts 2B and **C).**

Chart 2A
United States: Household debt and loans to households

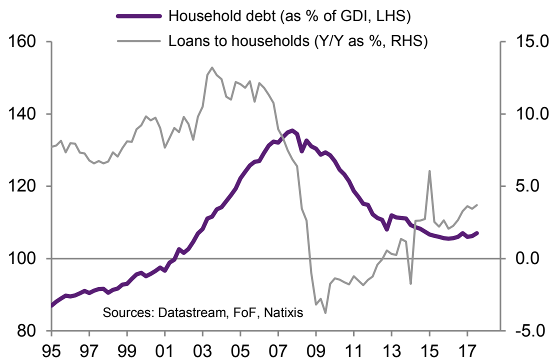


Chart 2B
United States: Residential real estate prices and central bank key interest rate

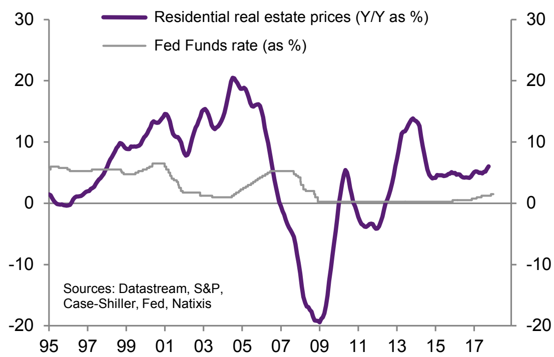
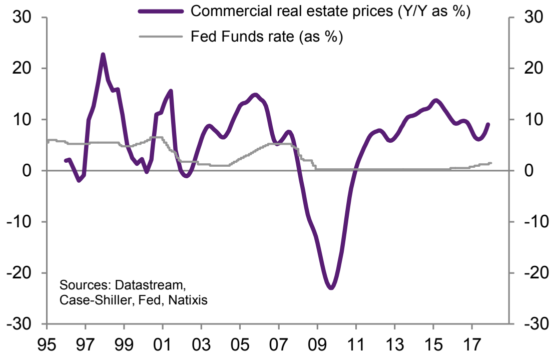


Chart 2C
United States: Commercial real estate prices and central bank key interest rate



This allowed US finance to expand mortgage lending, especially in the form of subprime loans (lent to low-income households, Chart 2D), and to develop the securitisation of these loans (Chart 2E) with abnormally low risk premia **(Chart 2F).**

Chart 2D
United States: Outstanding loans (in USD bn)

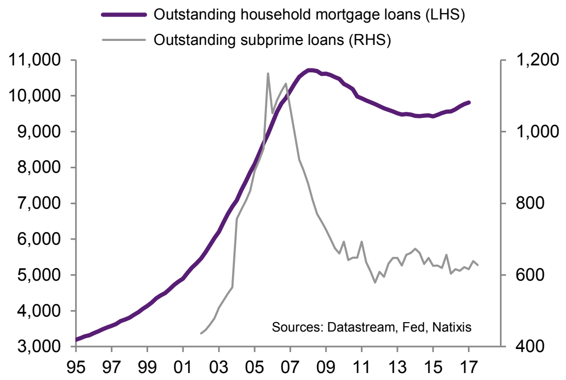


Chart 2E
United States: Outstanding ABS (USD bn)

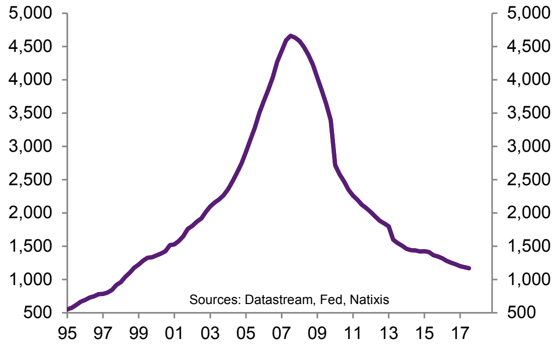
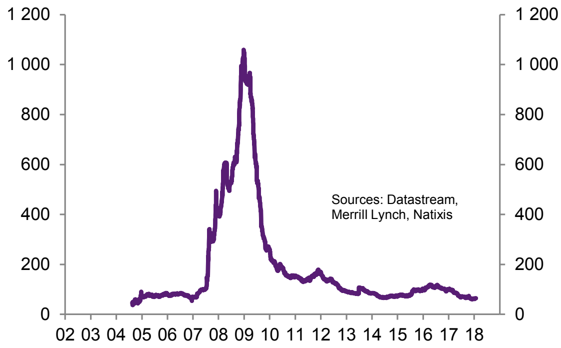


Chart 2F
United States: RMBS spread against swaps (AAA, in bp)



When property prices fell (in 2007-2008, **Charts 2B** and **C** above) under the effect of a (slight) increase in interest rates and excessive real estate values, **borrower default rates increased considerably (Chart 3A),** the securitisation market contracted sharply and **ABS prices collapsed** (**Charts 2E** and **F** above). This triggered **a banking crisis** which spread to other countries **(Chart 3B),** resulting in **a widespread fall in lending (Chart 3C) and a deep recession (Chart 3D).**

Chart 3A
United States: Household default rate on mortgage loans (as %)

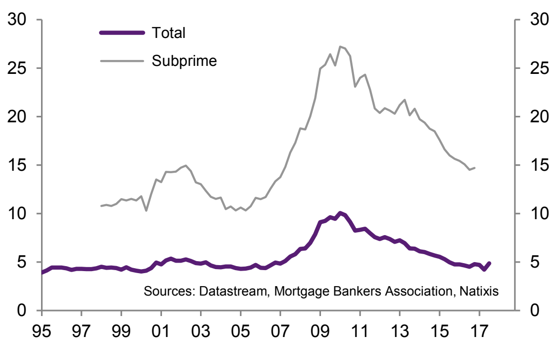


Chart 3B
Bank CDS (5-year, in bp)

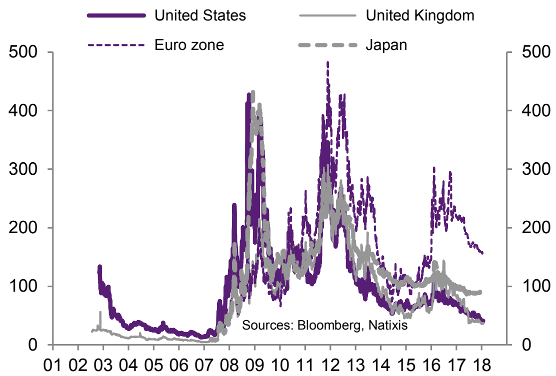


Chart 3C
Loans to households and companies (Y/Y as %)

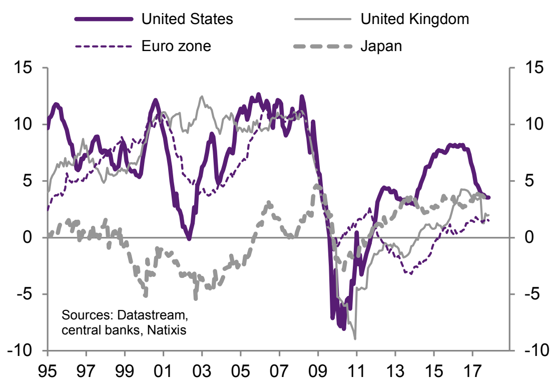
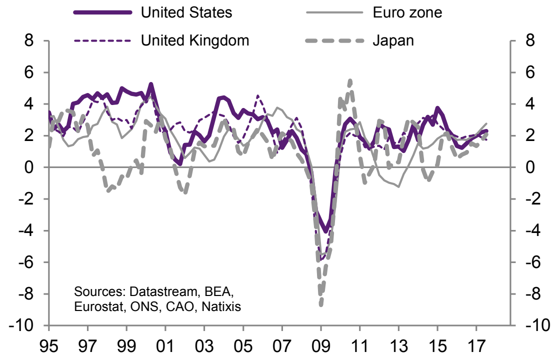


Chart 3D
Real GDP growth (Y/Y as %)

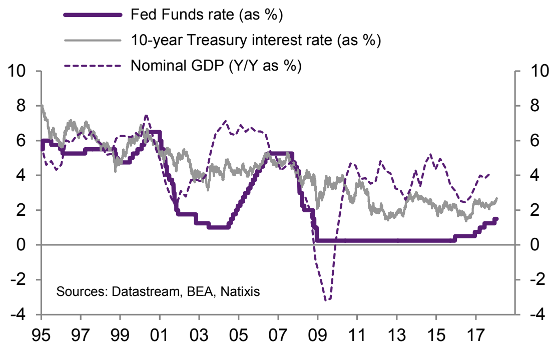


Is this configuration present again today?

We have seen that in the past, **US finance has taken advantage of the Federal Reserve's monetary laxity to develop risky activities that have been lucrative in the short term.**

Since the 2008 crisis, US monetary policy has been highly expansionary, and continues to be today - despite having begun to be normalised - as shown by the relative levels of the growth rate and interest rates **(Chart 4).**

Chart 4
United States: Nominal GDP, key interest rate and interest rate on 10-year Treasuries



Has US finance been using this "monetary laxity" again to develop risky "speculative" activities?

There is no sign at present of any major imbalances (such as share prices from 1996 to 2000 or household debt and property prices from 2002 to 2007), **but there are numerous "small" imbalances in the United States:**

- **The high equity valuation (Chart 5A)**, due in particular to share buybacks **(Chart 5B)**;

Chart 5A
S&P: Forward PER

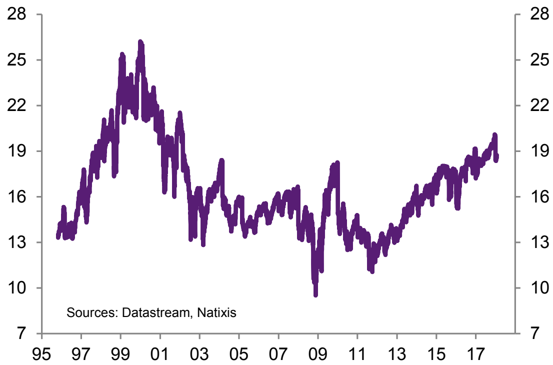
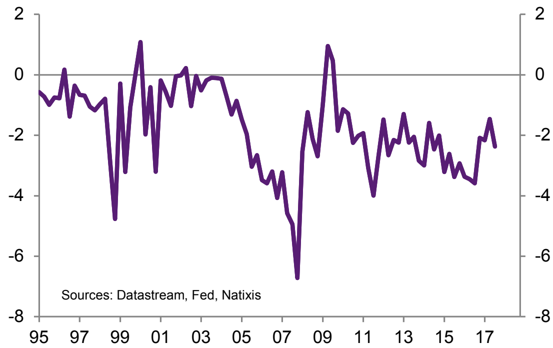


Chart 5B
United States: Net share issuance by non-financial corporations (as % of nominal GDP)



- **The high level of property prices,** especially commercial **(Chart 6A), combined with rising debt (Chart 6B);**

Chart 6A
United States: House prices and commercial real estate prices (1995:1 = 100)

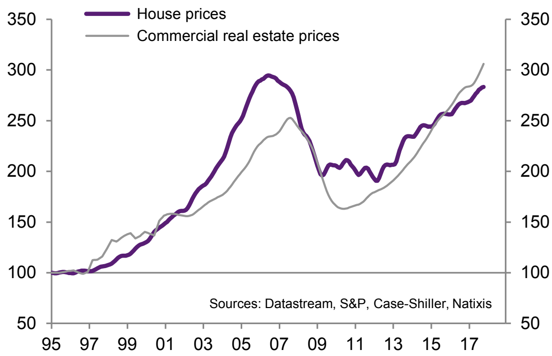
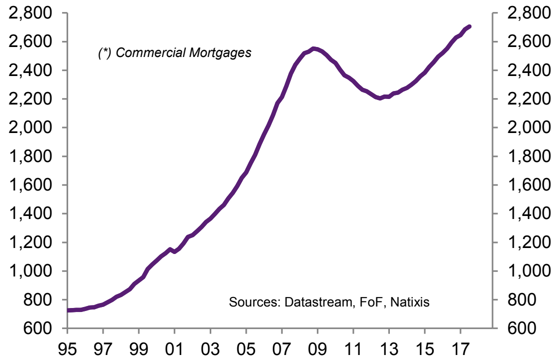


Chart 6B
United States: Outstanding commercial mortgage loans* (in USD bn)



- **The increase in M&A activity (Table 1)** at ever-higher prices;

Table 1: Mergers and acquisitions (transactions carried out, cumulative amounts for the year)

Year	United States
1995	356.0
1996	495.0
1997	657.1
1998	1,992.9
1999	1,425.8
2000	1,740.0
2001	771.4
2002	439.5
2003	464.9
2004	777.1
2005	885.0
2006	1,308.7
2007	1,714.5
2008	903.0
2009	712.9
2010	696.7
2011	861.4
2012	882.1
2013	864.6
2014	1,154.2
2015	1,522.4
2016	1,518.5
2017 Q3	1,109.4

Sources: Thomson Reuters, Natixis

- **The growth in consumer loans (Chart 7A),** which is starting to drive up default rates **(Chart 7B).**

Chart 7A
United States: Loans to households (Y/Y as %)

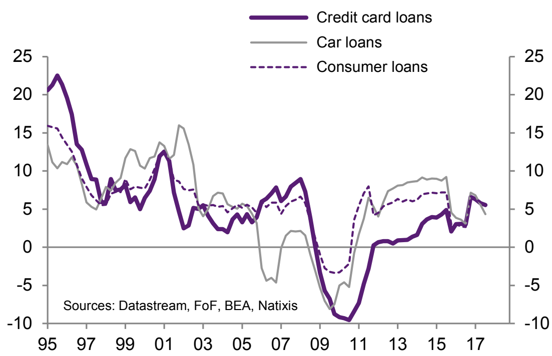
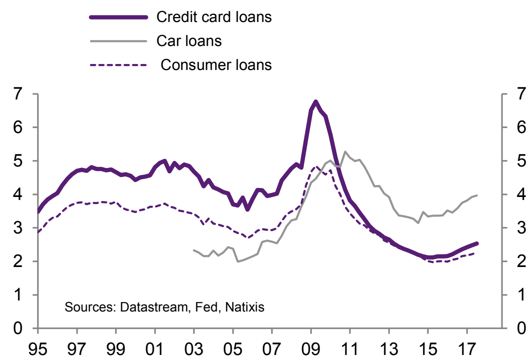


Chart 7B
United States: Household default rate on... (as %)



Conclusion: What to think of the fact there are numerous “small” imbalances and no major imbalance?

In the recent period also, there has therefore been **“collusion” between the Federal Reserve,** which has offered an expansionary monetary policy and has not reacted to financial imbalances, and **US finance,** which has exploited this “monetary laxity”.

But **in the past, there was one large financial imbalance concentrated in one market:** equities in the second half of the 1990s; real estate and mortgage loan securitisation from 2002 to 2008.

Now, as we have seen, there are numerous financial imbalances in the United States, none of which is very serious in isolation.

So what to make of the current situation? **It is probably dangerous for the United States, but less dangerous for the rest of the world given the modest size of each risk** (equities, real estate, acquisitions, consumer loans) **taken in isolation.**

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