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The Blame Game:
Fed Blaming for the Next Downturn Has Already Begun

By Michael Eisenband

In a rare display of public criticism by a sitting president of our central bank's policy decisions, President Trump recently said that the Federal Reserve was "…my biggest threat," after previously commenting that the "Fed has gone crazy," and was "out of control." The president's words for our independent central bank raised some eyebrows, but that was about the extent of the reaction to the bluntest comments aimed at a Fed chairman by a president since Richard Nixon.

However consider the Fed's offense: it had the audacity to raise the Fed Funds target range by 25 basis points, to 2.0%-2.25%, as the broad U.S. economy continues to expand. It was the third rate hike this year by the Fed—exactly in-line with the expectations of most Fed watchers coming into the year—following a gradually higher rate path after a near-zero Fed Funds rate policy from 2009-2015. President Trump also commented that its rate policy "…hurts all that we have done."

The president wasn't alone in his criticism of Fed policy. Other market pundits, notably CNBC host Jim Cramer, have also been highly critical of the Fed after its latest rate hike, mostly because it spooked equity markets from their lofty perch, with Cramer going so far as to say that he thinks the Fed is "traumatized." Some noted fund managers have commented similarly in 2018 that rising rates threaten U.S. economic growth and market gains. Such intense reactions to seemingly prudent efforts by the Fed aimed at normalizing interest rates and reducing its balance sheet after years of aggressive intervention raises an obvious question: When exactly should the training wheels come off this bicycle?

We are reminded constantly that the U.S. economy is outperforming. GDP growth has accelerated, as has consumer spending and borrowing, the jobless rate and initial unemployment claims are at multi-decade lows, corporate earnings are at all-time highs and still growing at double-digits rates, while equity markets are near all-time highs. Inflation has also picked up modestly and is approaching the Fed's longstanding target of 2%. Yet we are also supposed to believe that our economic juggernaut is so fragile, so precarious that any disturbance resulting from an appropriate uptick in interest rates would send it all crashing down. For instance, Jim Cramer opined that a 5% interest rate on a 30-year mortgage will kill the housing market. What does that really say about the underlying strength of the housing sector if a 110 basis point increase in mortgage rates from their lows of a year ago sends buyers running for the hills? (Does anyone remember a time when they were thrilled to get a 6% mortgage?) Similarly, others have commented that a four-handle on 10-year Treasuries would likely end the bull market in stocks. Furthermore, a scheduled step-up in the Fed's controlled run-off of its $4.2 trillion in security holdings, to $50 billion per month, has also encountered criticism by those who believe it is too aggressive for markets to handle, even though such a pace would require five more years

to shrink the Fed's balance sheet to targeted levels. In all, these comments speak to the persistent belief that the continued prosperity of our financial markets and economy remains highly dependent on unnaturally low interest rates some nine years after the brunt of the financial crisis.

We wonder aloud why more market commentators aren't equally critical of corporate credit market excesses—of new leverage buyouts getting done at 7X EBITDA right out of the gate, or leveraged borrowers that continue to pile into floating rate loans in a rising rate environment, or traditional lender protections that continue to erode in the face of ever more aggressive demands by sponsors. These dubious behaviors escape headlines and closer scrutiny because they are a vast multitude of mostly mundane transactions that attract little attention until they become problematic. Apparently, they haven't escaped the Fed's watchful eye. In the most recent release of minutes of the Fed's Open Market Committee meeting in September, in its commentary on financial market conditions, it stated, "Some participants commented about the continued growth in leveraged loans, the loosening of terms and standards on these loans, or the growth of this activity in the nonbank sector as reasons to remain mindful of vulnerabilities and possible risks to financial stability." That's rather blunt for Fed-speak and it's the first time we can recall that leveraged loans were specifically mentioned in the FOMC minutes.

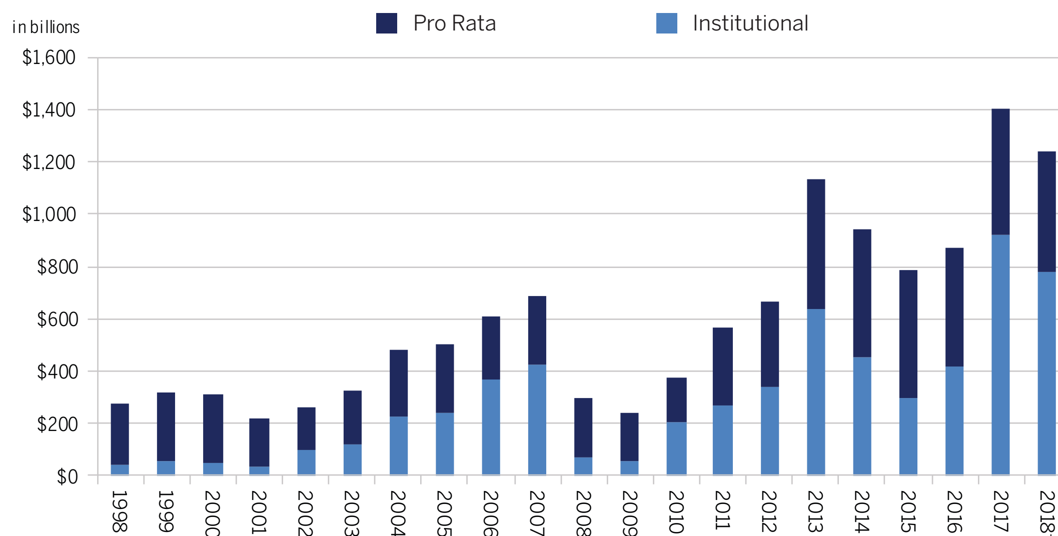
All of this may sound self-serving as part of our business aides corporates and their stakeholders navigate financial distress. And higher interest rates will rev up that engine. To that we say let the chips fall where they may. The Fed's accommodative monetary policies may have saved the global financial system back in 2008 and greased the skids for financial markets to function thereafter, but they also created an environment that has encouraged a lot of high risk activity in leveraged credit markets. The consequences to date have been modest. However, to argue that the Fed shouldn't tap the brakes now and work towards a normalized credit environment in an economy that's getting heated up because it could badly harm companies and lenders that were indulgent is short sighted and would only further encourage such high risk activities.

We don't know when the next financial downturn will occur. But you can be sure that whenever it hits there will be an abundance of critics that blame the Federal Reserve for ruining a party already in the wee hours that turned out to be too much of a good thing.

EXHIBIT 1

U.S. Leveraged Loan Issuance

Amounts include syndicated bank loans and exclude private lending platforms.



Source: Thomson Reuters LPC.
*Note that 2018 amounts are annualized YTD figures.

Michael Eisenband
Global Co-Leader, Corporate Finance & Restructuring
+1 212 499 3647
michael.eisenband@fticonsulting.com

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