NYU STERN

Federal Reserve Normalization and the EMs: Is This Time (Really) Different?

Viral V Acharya

Asian Monetary Policy Forum

May 2022

Contact: vacharya@stern.nyu.edu

What I will focus on

- Relation between the current macro scenario and the stagflation of 70s-80s

- Two risks:

1. Corporate leverage – Financial dominance of the Fed monetary policy?

2. Government debt – Fiscal dominance of the Fed monetary policy?

- Breakdown of +ve Stock-Treasury Bond correlation during stagflationary periods

What I will skip

Several other important issues:

- Housing markets
- Household balance-sheets
- Coordinated global rate hike cycle
- Impact of sanctions on the USD
- Crypto boom and bust cycle
- Anything else!

Jim Hamilton on Oil Price Shocks

Major historical oil supply disruptions were followed by recessions

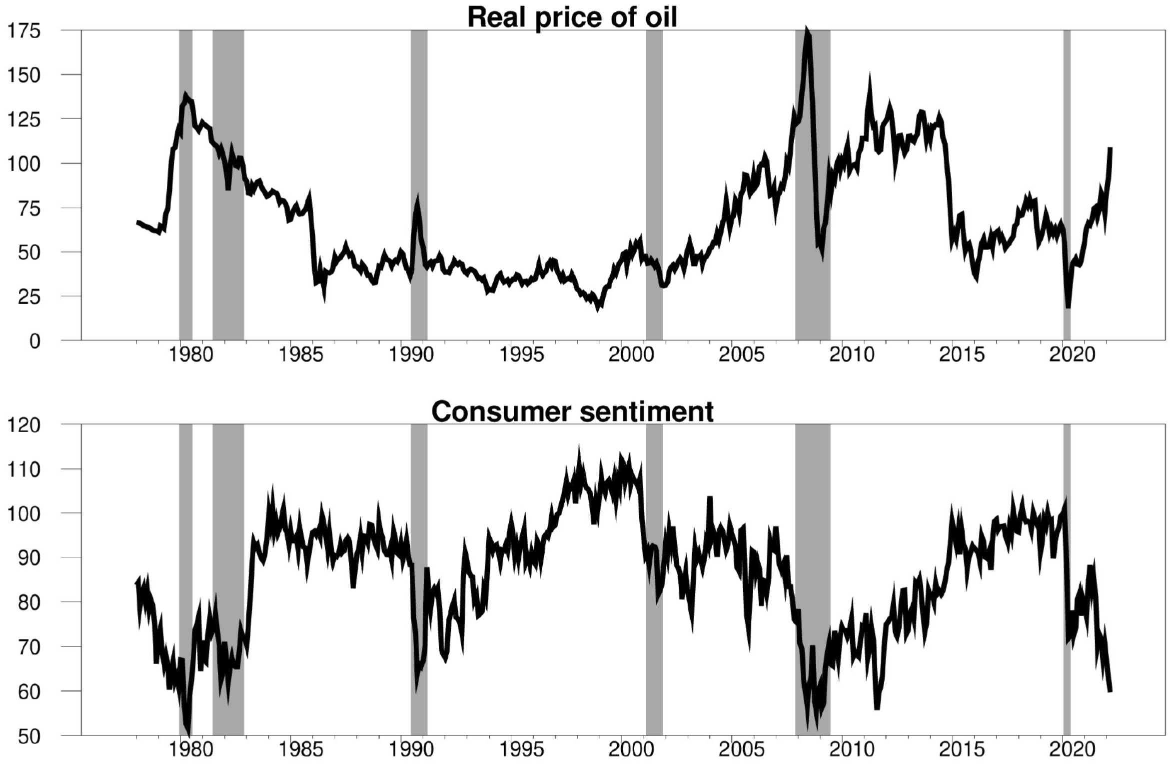
Date	Event	Supply cut (local)	Supply cut (global)	Price Change	Recession Start
Nov 73	OAPEC embargo	7%	7%	51%	Dec 73
Nov 78	Iran revolution	7%	4%	57%	Feb 80
Oct 80	Iran-Iraq War	6%	4%	45%	Aug 81
Aug 90	Gulf War I	9%	6%	93%	Aug 90

Decline in auto production made significant contribution to downturns

Period	Contribution of autos
1974:Q1-1975:Q1	-0.5%
1979:Q2-1980:Q2	-0.8%
1981:Q2-1982:Q2	-0.2%
1990:Q3-1991:Q3	-0.3%
2007:Q4-2008:Q4	-0.7%

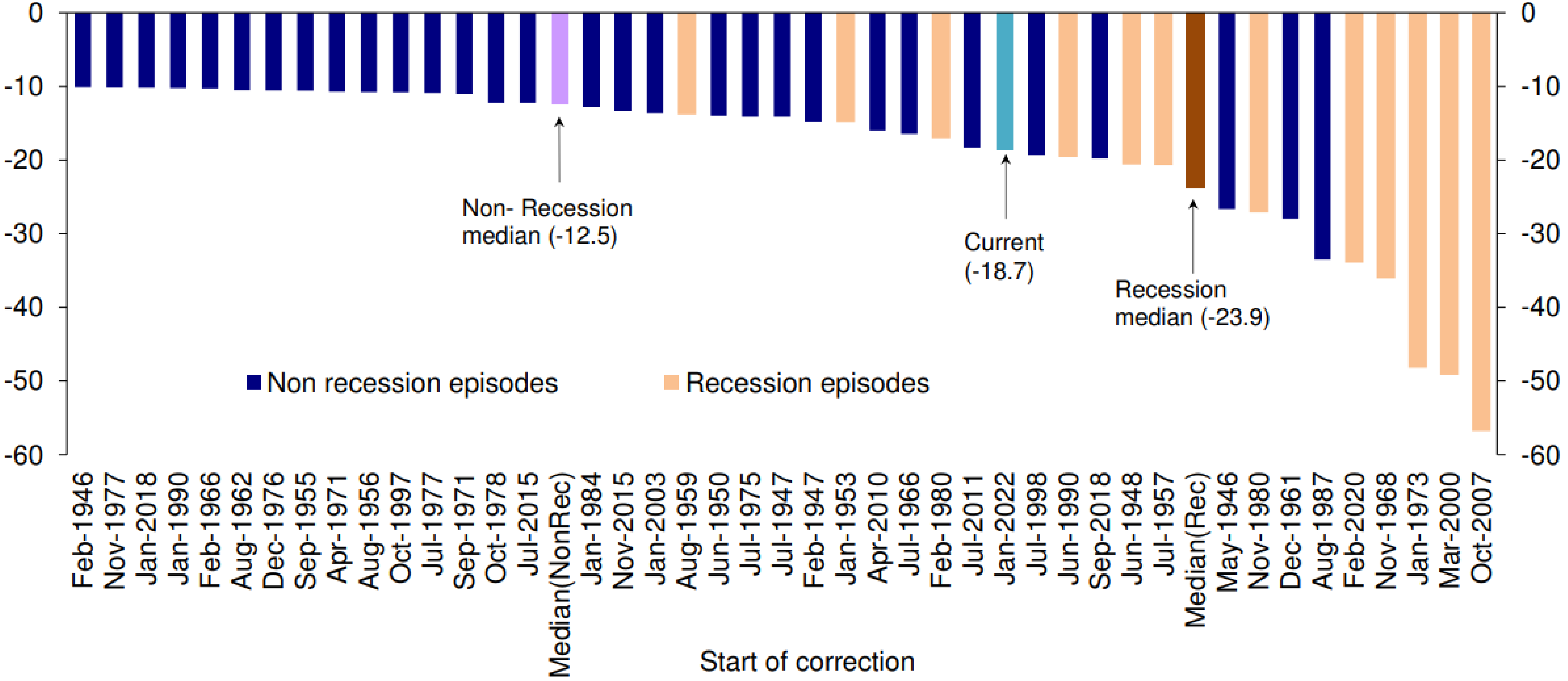
Source: Hamilton, “Major Historical Oil Shocks,” 2013

Consumers become more pessimistic when oil prices rise



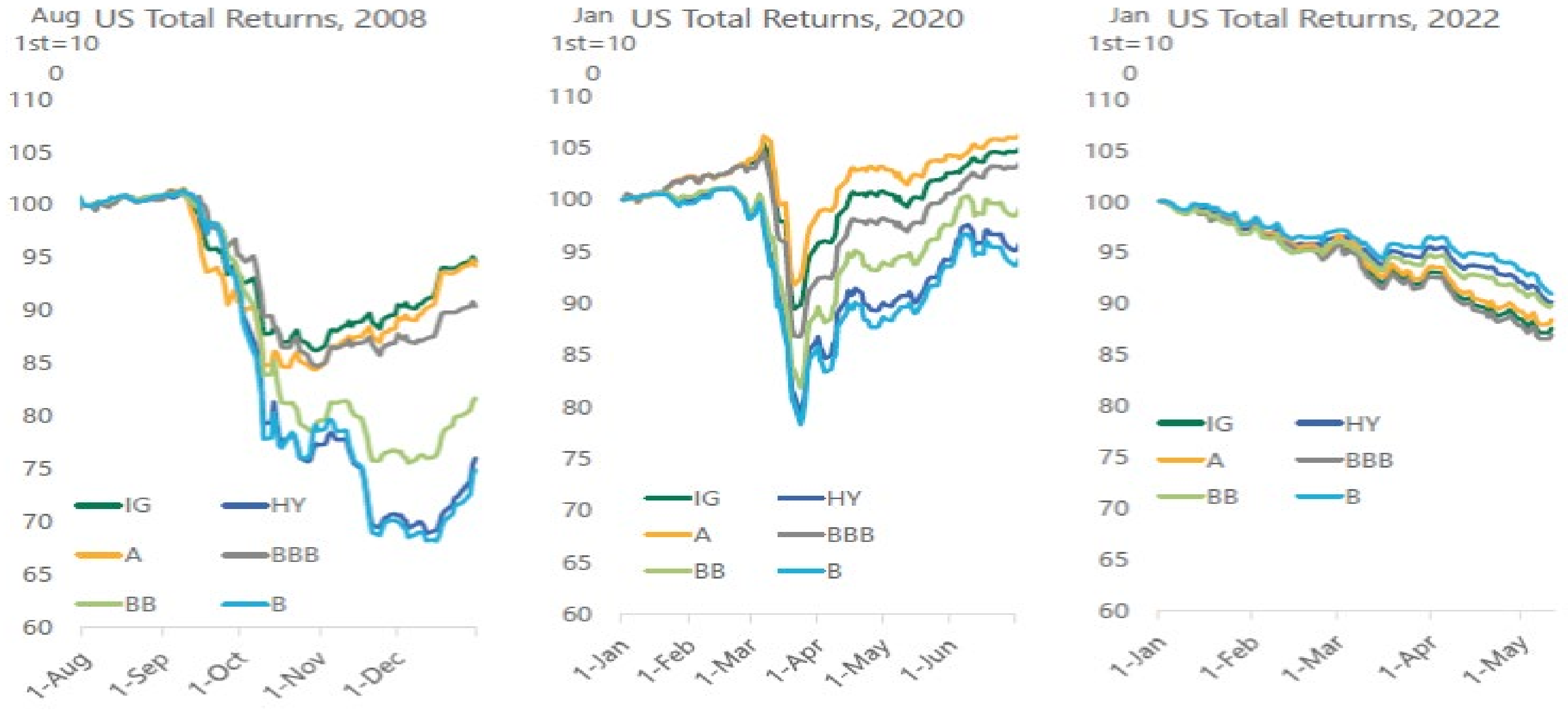
Stock and Corporate Bond Mkt Corrections

Figure 1: Size of S&P 500 10%+ corrections (%) (Post-war episodes)



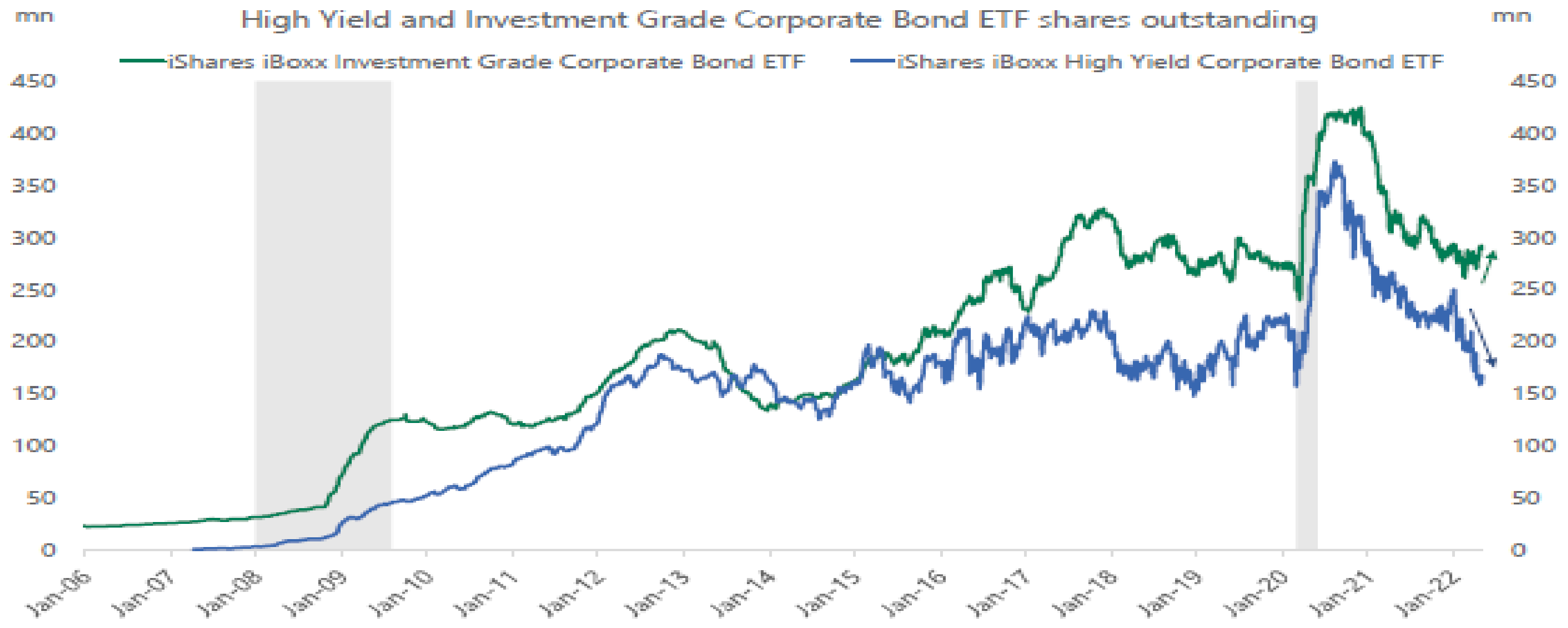
Source : Shiller data, Haver, Deutsche Bank Asset Allocation, Deutsche Bank

Very synchronized sell-off in credit so far



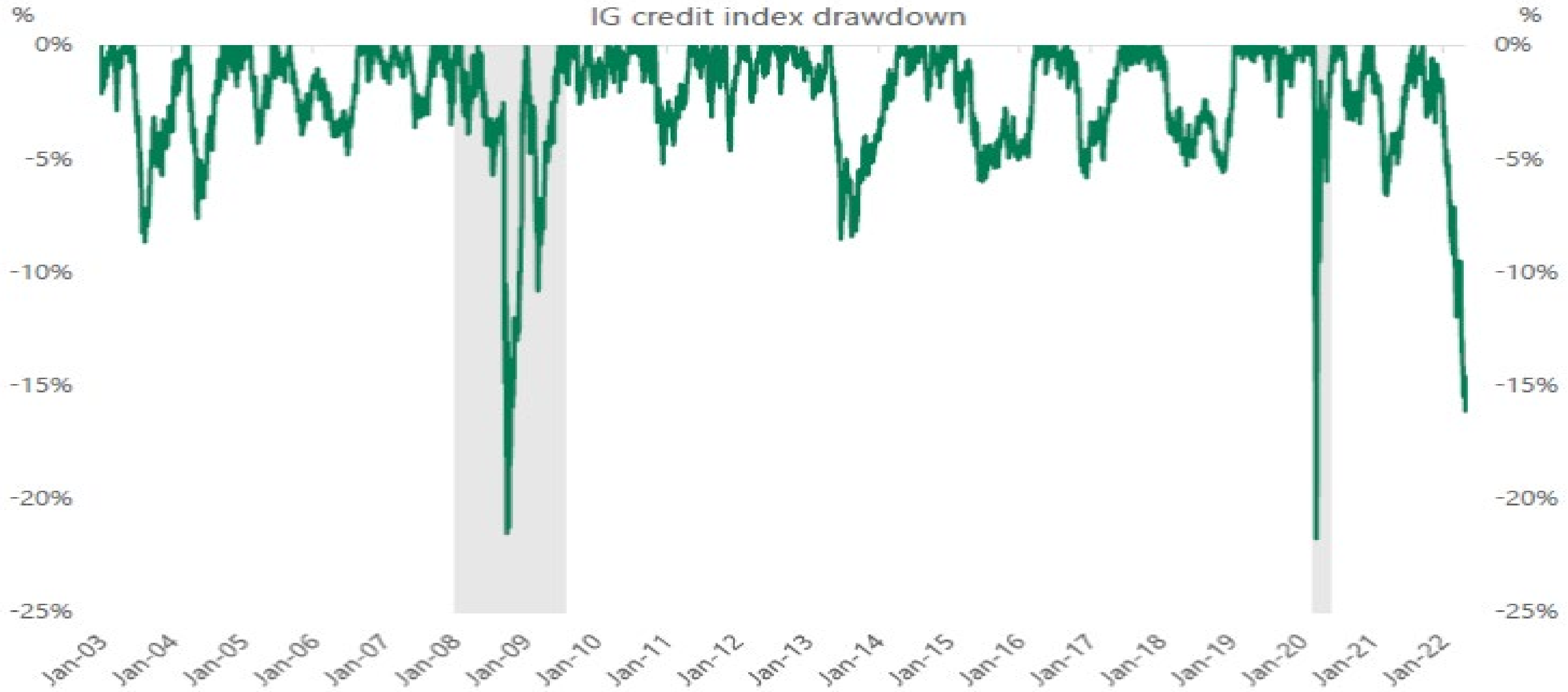
Source: Bloomberg, Apollo Chief Economist

Retail investors buying IG and selling HY in recent weeks



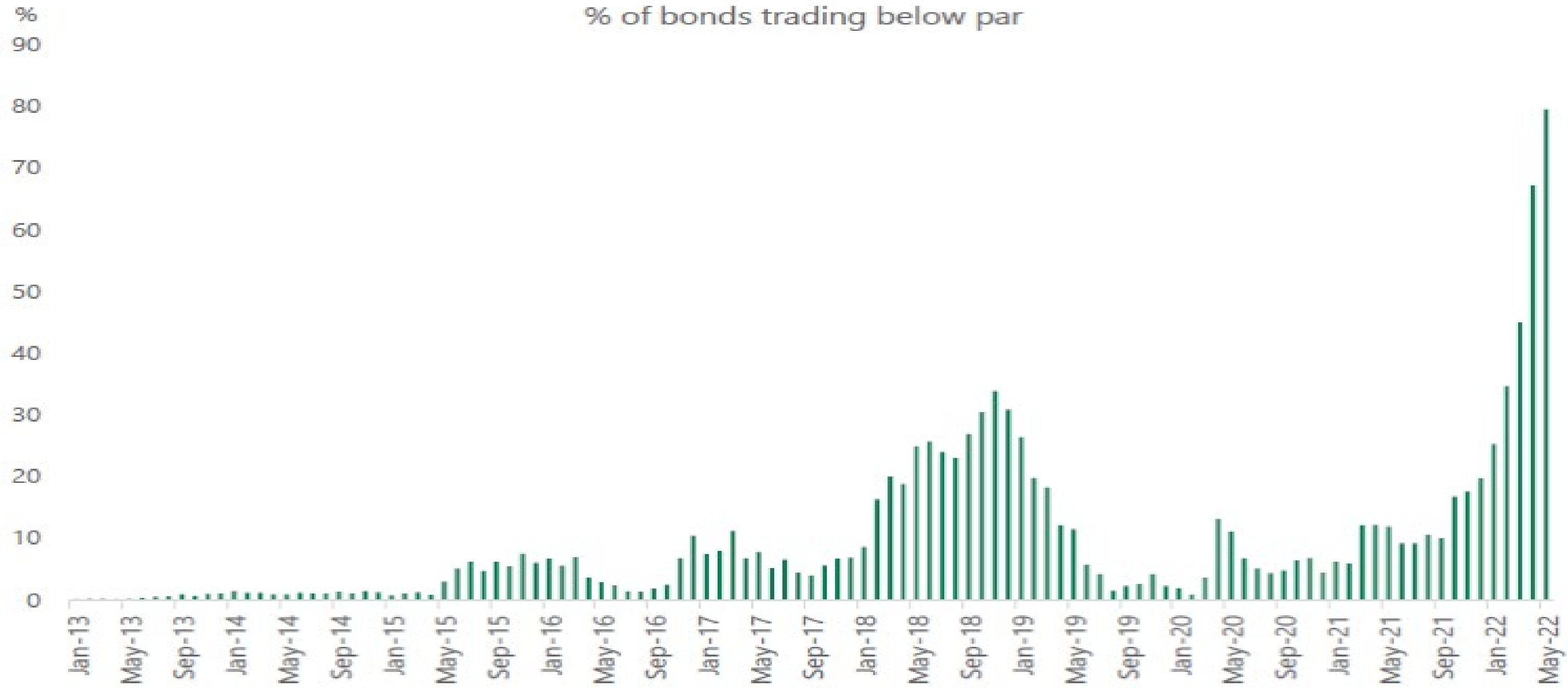
Source: Bloomberg, Apollo Chief Economist. Note: Tickers used HYG US Equity and LQD US Equity

Passive IG credit down 16% from its peak



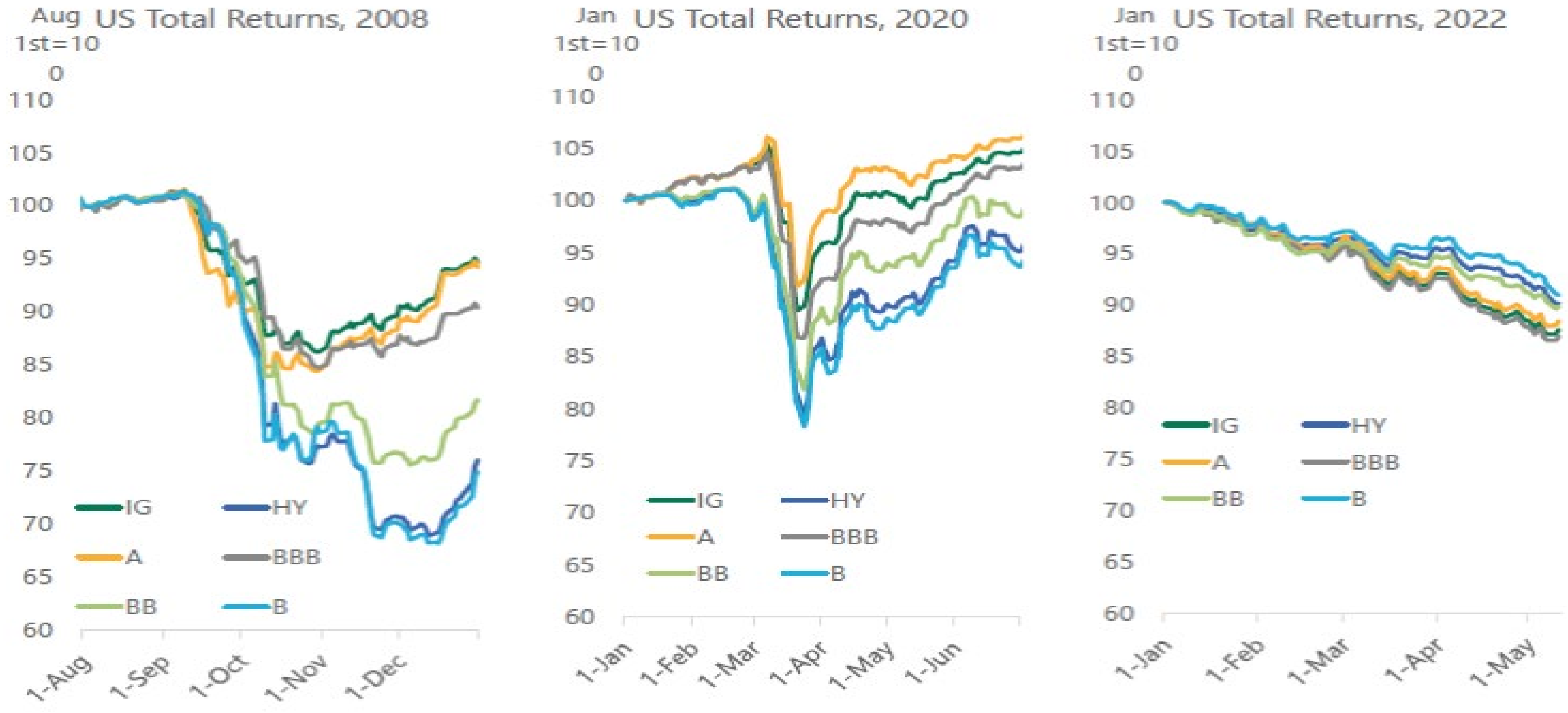
Source: Bloomberg, Apollo Chief Economist. Note: Bloomberg ticker used for the IG credit index: LQD.

80% of the US IG market trading below par



Source: Bloomberg, Apollo Chief Economist. Note: Data used for members in the LBUSTRUU Index as of 11th May 2022.

Very synchronized sell-off in credit so far



Source: Bloomberg, Apollo Chief Economist

BBB-rated US Corporate Debt:
A Ticking Time-Bomb?

Exorbitant Privilege? Quantitative Easing and the Bond Market Subsidy of Prospective Fallen Angels

Viral V. Acharya
NYU Stern, CEPR, ECGI, NBER

Ryan Banerjee
BIS

Matteo Crosignani
New York Fed

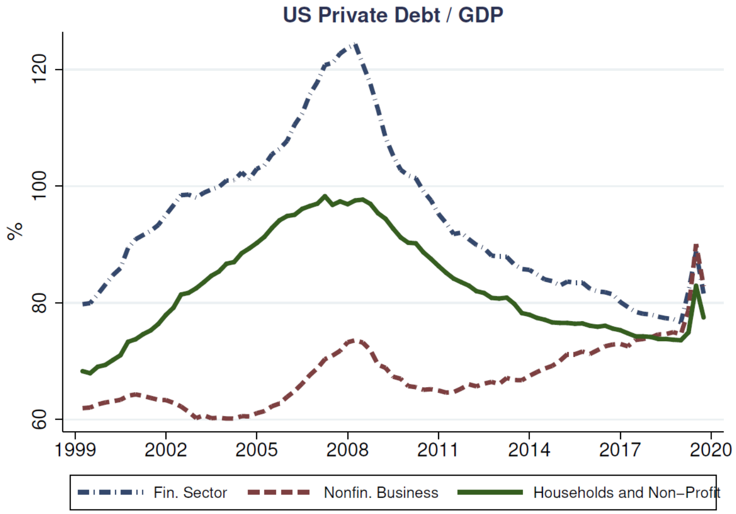
Tim Eisert
Erasmus Rotterdam, CEPR

Renée Spigt
Erasmus Rotterdam

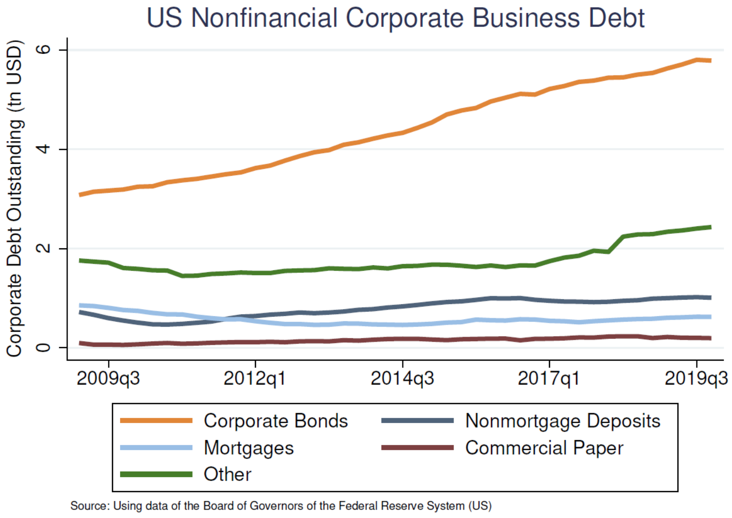
NYU Stern
April 1, 2022

The boom in the U.S. corporate bond market

- Non-fin. corporate debt is now the largest type of private debt (\$17.6T in 2020Q3)
- Credit cycle post-GFC driven by non-financial corporate debt
- U.S. corporate bond market doubled in size in 2009–19



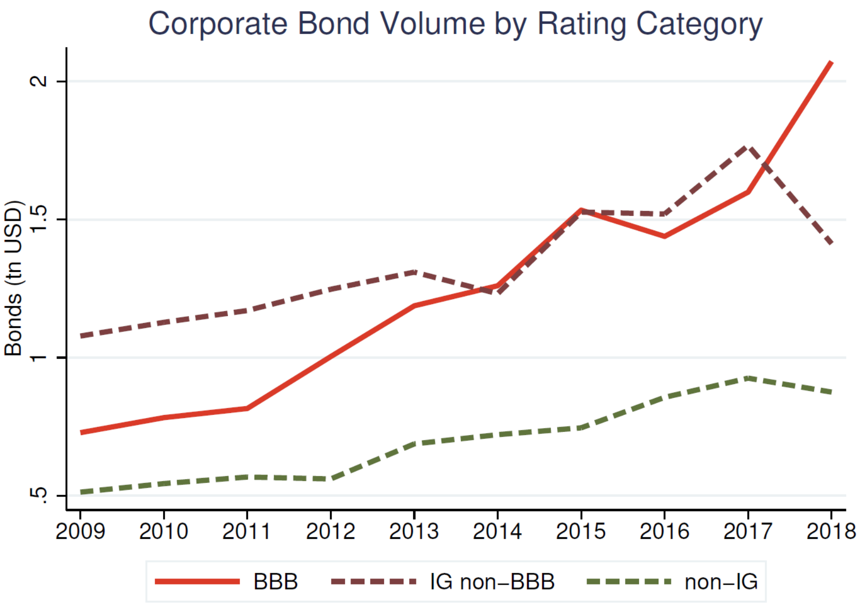
Source: FRED



Source: FRED

The boom in the BBB corporate bond market

- Non-fin. corporate debt is now the largest type of private debt ($17.6T in 2020Q3)
- Credit cycle post-GFC driven by non-financial corporate debt
- U.S. corporate bond market doubled in size in 2009–19, driven by BBB segment

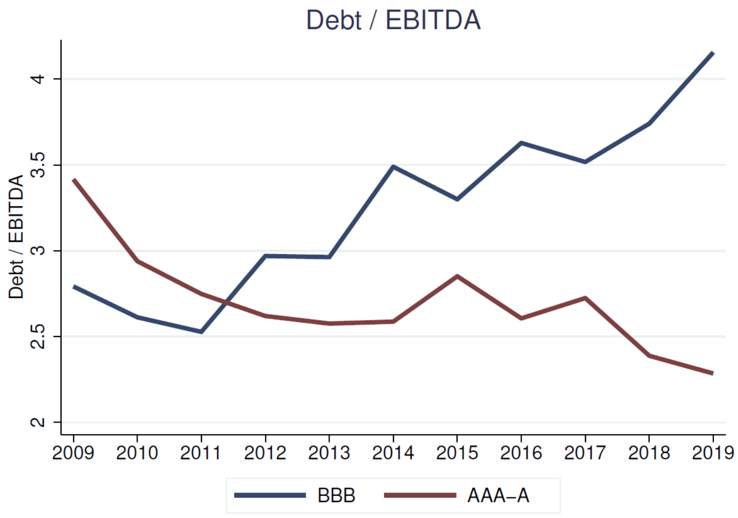


Source: Capital IQ and Thomson Reuters

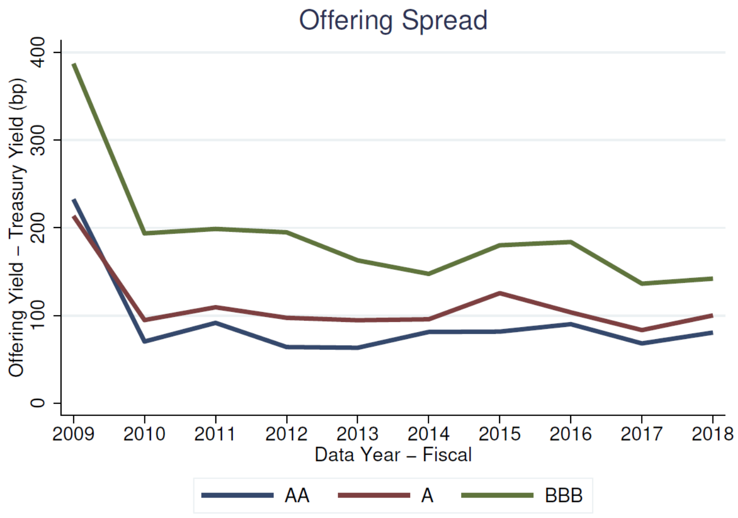
BBB market: deteriorating quality and lower yields

- Increasing debt-to-EBITDA ratio for BBB, but not for other IG, firms
- BBB offering spreads declined from 400 bps in 2009 to 105 bps in 2018, moving closer to AA and A spreads (no narrowing between A and AA spreads)

▸ Leverage evolution



Source: Compustat and Thomson Reuters



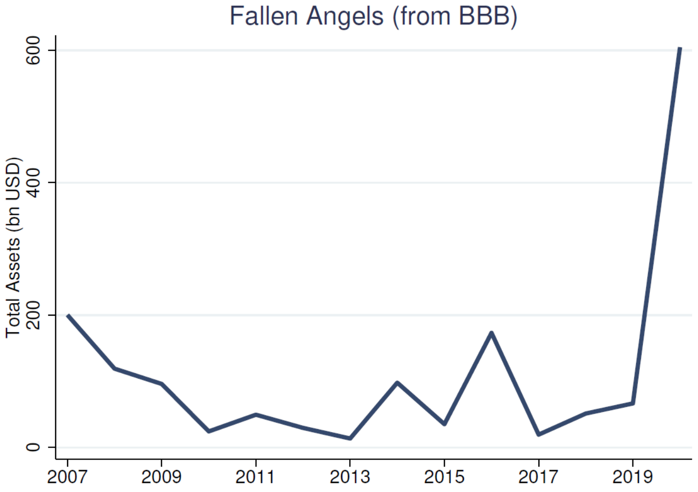
Source: Mergent and Thomson Reuters

Policy makers wary of risk posed by rise in corporate leverage

*"**Nonfinancial corporations** entered this [Covid] crisis with **enormous debt loads**, and that is a vulnerability. **They had borrowed excessively**. The borrowing spree happened because regulators had "few, if any tools to rein it in and because **low interest rates made it easier for companies to borrow.**"*

Janet Yellen, March 2020

Downgrade materialization during COVID

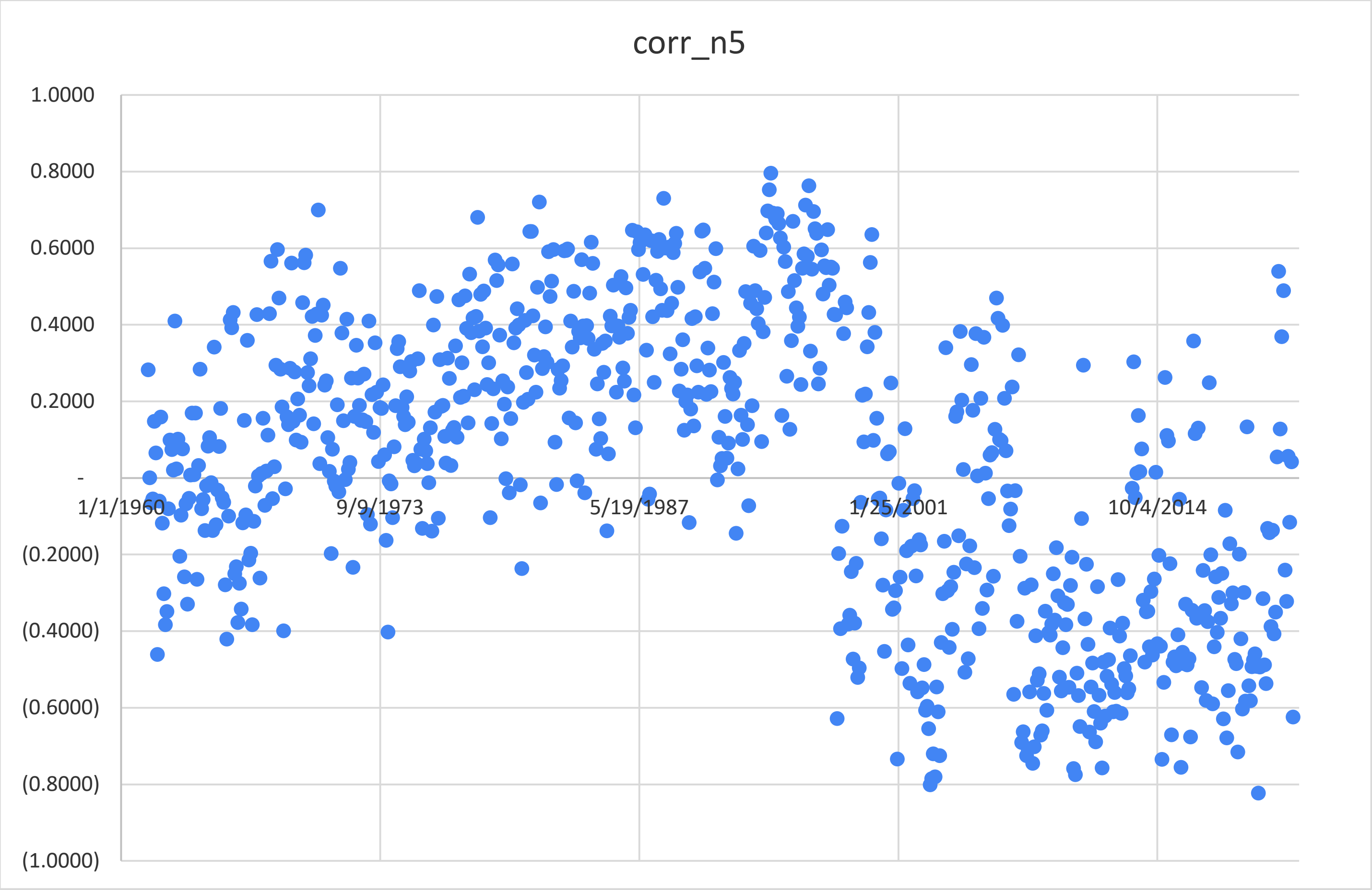


- Large price drop of IG corporate bonds at the onset of the COVID-19 (Haddad et al., 2021; Boyarchenko et al., 2021; Altman, 2020a; Acharya and Steffen, 2021)
- Including bonds from fallen angels Ford Motor and Macy's:

"The Federal Reserve is throwing a lifeline to some companies that have suddenly dropped into risky junk debt after ***expanding its corporate bond buying program to include fallen angels*** *[...] Bonds of* ***Ford Motor*** *and* ***Macy's*** *will be eligible for the program."* Bloomberg, 4/9/20

Stock and Treasury Return Correlations: Stagflation versus “Normal” times

(Joint work with Toomas Laarits, NYU Stern)

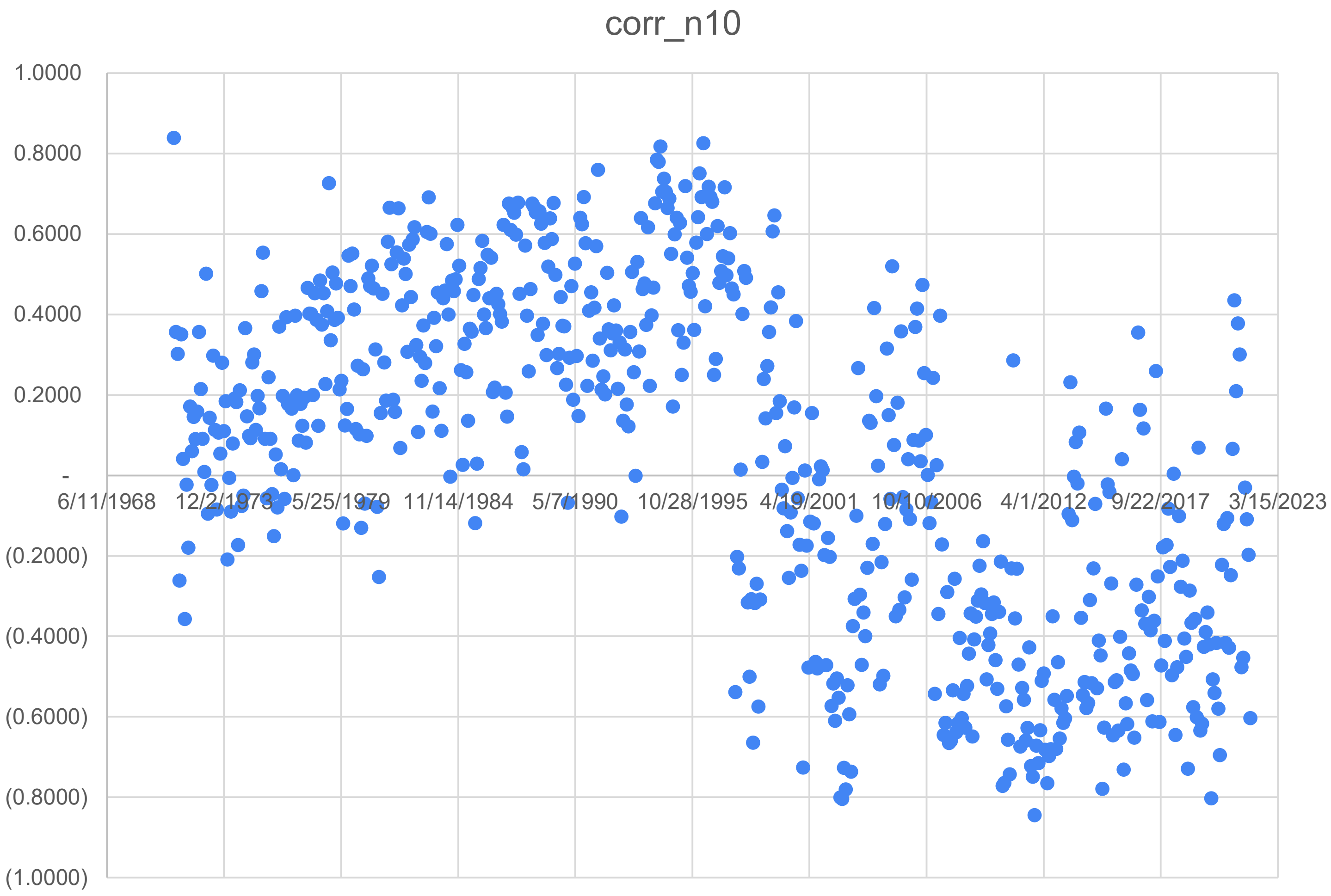


Daily returns

30-day rolling lookback windows

CRSP value weighted index return

5-year Treasury Bond returns based on Gurkaynack Sack and Wright fitted yield curve

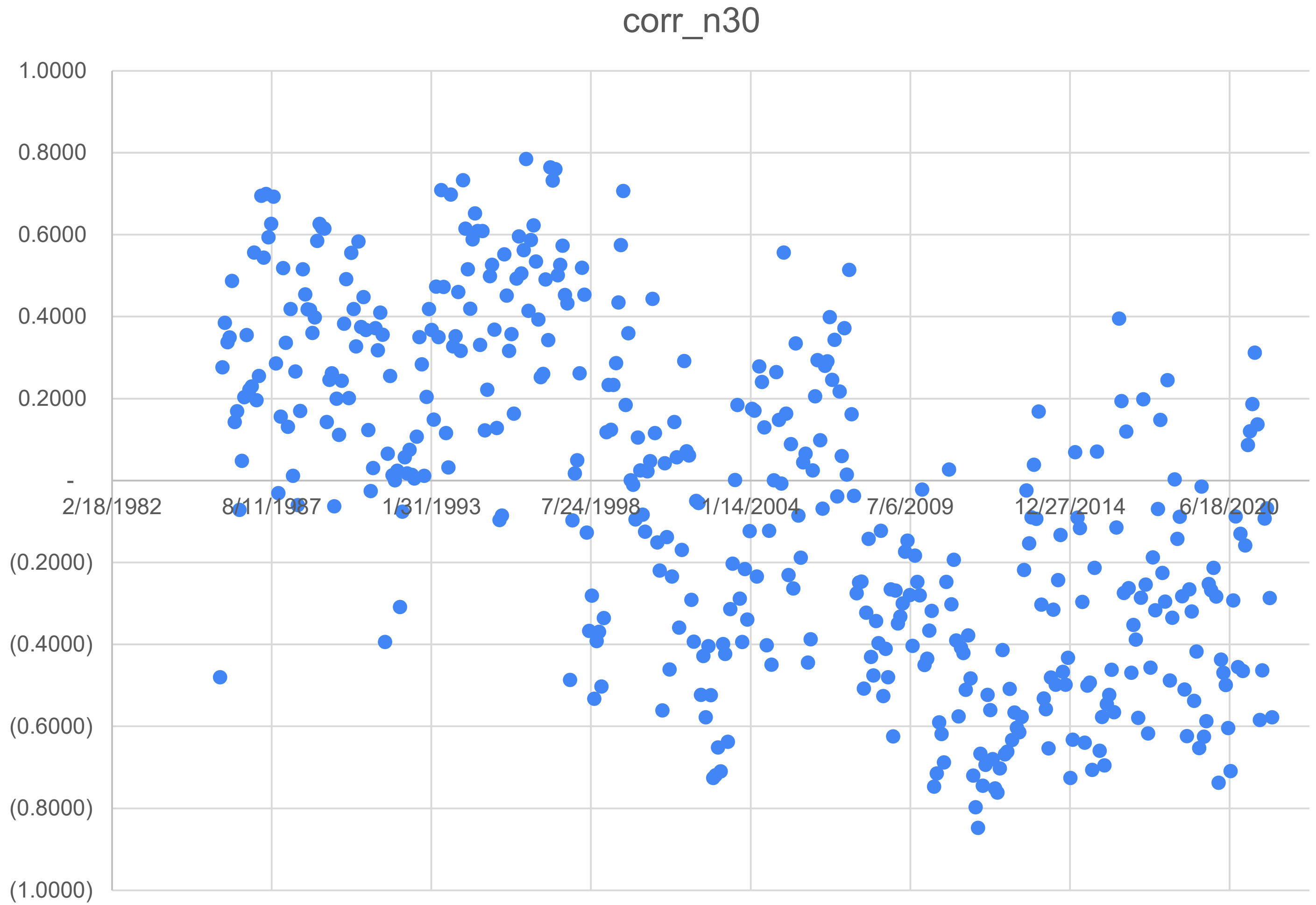


Daily returns

30-day rolling lookback windows

CRSP value weighted index return

10-year Treasury Bond returns based on Gurkaynack Sack and Wright fitted yield curve



Daily returns

30-day rolling lookback windows

CRSP value weighted index return

30-year Treasury Bond returns based on Gurkaynack Sack and Wright fitted yield curve

Fingers crossed… Thank you! ☺