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This Time Isn't Different

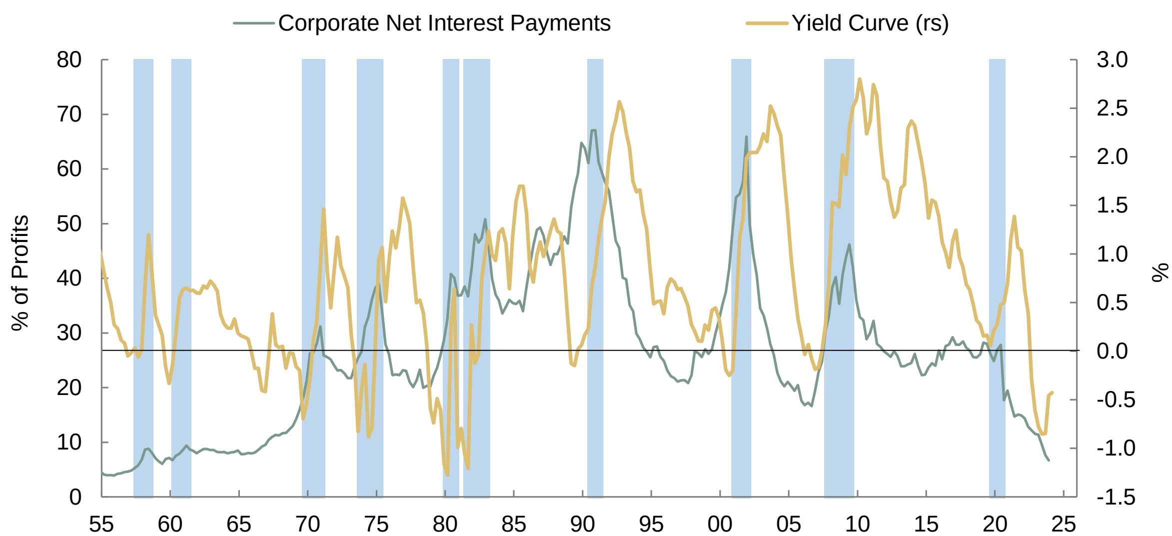
This has been the only economic cycle where a tightening of monetary policy has not led to corporate interest expense rising too. When the Fed began raising rates in March 2022, corporate net interest payments as a share of profits was almost 30%, as illustrated in the chart below. As the Fed funds rate continued to increase, net interest payments continued to fall. Presently, they are under 10%, which is the lowest share since the mid-1960s. This has never happened before and is clearly a factor explaining why the economy has not slowed as much as a substantial increase in the funds rate would imply a priori. What happened?

Given the severity of the 2020 recession which resulted in both a zero percent fed funds rate and firm Fed guidance that rates would remain low, many companies locked in historically cheap debt. Corporate bond issuance grew by nearly $800 billion in Q2 2020 from four quarters earlier, a record amount that was $300 billion above the previous all-time mark. This meant that many companies were inoculated from higher interest rates well before the Fed began tightening.

Then as the Fed began raising rates, companies began earning more interest on their institutional money market and treasury accounts. In effect, the inverted yield curve (defined as the spread between 2- and 10-year Treasury yields) has been net *stimulative* to the corporate sector because it is earning interest above what it is paying out in interest to its bondholders. Notice how the net interest expense as a share of profits has continued to decline while the curve remains inverted. The dampening effects of higher fed funds have been blunted. **But this does not mean that monetary policy is ineffective or that it will not ultimately slow the economy.**

Corporate debt will eventually need to be refinanced but more importantly, household borrowing costs are at a two-decade high. Elevated automobile, credit card, mortgage and personal loan rates may be starting to pinch consumers, which is evident from the latest Federal Reserve Bank of New York data for Q1. Automobile loans and credit card delinquencies are at their highest readings since 2011. This is troubling considering that the unemployment rate is under 4% compared to 8.9% in 2011. What happens if the labor market softens in the months ahead?

Absent a sharp decline in interest rates, the upward trajectory in household delinquencies may continue with obvious negative implications for future consumption. In this regard, the "no landing" and "soft landing" enthusiasts should not become overly confident that monetary policy does not have potency or that this time is different.



Source: BEA, Federal Reserve, Haver, SMBC Nikko

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