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Joseph Lavorgna, Chief US Economist | 212.610.1741 | joseph.lavorgna@smbcnikko-si.com

Easy Financial Conditions Mask Historic Tightening

The Fed is miscalculating the current stance of monetary policy because traditional measures of financial conditions have not shown much tightening. In fact, **the Chicago Fed National Financial Conditions Index (NFCI) shows a dramatic easing in financial conditions since last October to a level not seen since the Fed first began raising interest rates in March 2022**. Financial condition indices effectively mask an historic increase in household borrowing costs, which is not unusual.

As we can see in the chart below, **the Chicago Fed NFCI series almost never shows any tightening in financial conditions**, demarcated by a reading over zero. Strange. In fact, the index showed easy financial conditions before the onset of the 2001 recession despite a plunge in stock prices. And the NFCI eased further during the recession.

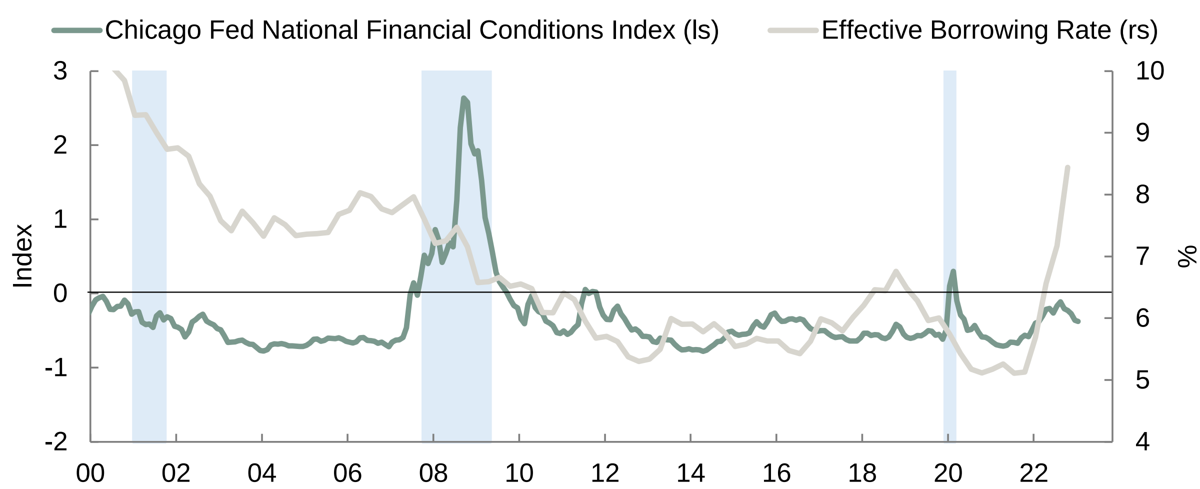
Moreover, since the 2008-09 financial crisis, the NFCI has rarely shown any tightening either. For example, there were marginally tight conditions from September 2011 to December 2011 following the fallout of the debt ceiling debacle and ensuing US government downgrade.

A reason for the unusual behavior of the NFCI could be an overengineering of the series which uses approximately 100 variables in its construction. But whatever the reason, we have found that "financial conditions" for a large subset of the economy, namely the consumer, have massively tightened. This is apparent from our effective household borrowing rate, which is shown alongside the Chicago Fed NFCI.

Our series is a weighted average of household debt with the weights determined by their respective share of total consumer borrowing. Mortgages (65%) have the largest weight, followed by personal loans (20%), then auto loans (8%) and finally credit cards (7%).

Unlike the Chicago Fed NFCI, effective household borrowing costs have tightened dramatically since the Fed began raising rates, soaring to the highest reading in two decades. This explains the current deep recession in the housing market. In general, the longer household borrowing rates remain high—and they are likely to go up more with further fed hikes—the greater the likelihood we see a capitulation in consumption.

It would be prudent for Fed policymakers to scrap "traditional" measures of financial conditions, such as the Chicago NFCI, because they do not accurately capture what is going on in the real economy. Sadly, there is nothing to suggest this is going to happen, at least not until the unemployment rate begins to move sharply higher.



Sources: Chicago Fed, NY Fed, FRB, Freddie Mac, Haver, SMBC Nikko

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