Is The Fed Falling Behind?

May 1, 2012

On April 25, the Federal Open Market Committee affirmed its intention to keep short-term interest rates near zero until late in 2014. Should members rely on this "promise," or should they begin to add duration to their funding?

A recent article in the *Wall Street Journal* indicated that two thirds of the economists who participated in the latest monthly survey felt that the Fed would be inviting higher levels of inflation if it kept short-term interest rates near zero until late 2014. If we see stronger labor and housing markets in the foreseeable future, the Fed might be forced to tighten or risk an overheated economy and a pickup in inflation.

The February 2012 release of the six-month forecast of state leading indexes by the Federal Reserve Bank of Philadelphia shows that 47 state indexes are projected to grow over the next six months, while only three are expected to decline — a significant improvement since last June and July when only 34 states were projected to grow. The index looks at levels of employment, unemployment, wages, and hours worked in manufacturing to produce a current state index. The model then incorporates other leading indicators such as housing permits, initial unemployment claims, manufacturing delivery times, and the spread between three-month and 10-year Treasurys to predict the six-month growth rate of the state indexes.

Financial institutions faced with earnings pressure may now be holding long-term mortgages that may have been sold in the past. Mortgages with coupons at these levels could have minimal prepayments and turn out to be very long assets. Booking long-term advances can reduce the interest-rate risk associated with holding long-term assets and lock in spread. The Bank has financial strategists who can assist you in developing funding alternatives for these loans. (Please contact them at strategies@fhlbboston.com if you're interested.)

Is your asset/liability model demonstrating that you are approaching interest-rate risk limits in rising rate scenarios? If that is the case, you should begin to have discussions at ALCO about lengthening your funding. Even if your model indicates you are still in compliance with your limits, how you handle the recent "surge" in core deposits could have a huge impact on the results. If you maintain the current balance of core deposits, you are likely under reporting your exposure to rising interest rates. Many of the balances you've picked up since the financial crisis started are likely just parked and awaiting higher returns either within or outside your institution. These balances will exhibit greater sensitivity to changes in interest rates than those that simply remain in your core deposits.

Whether the Fed is behind the curve or, structurally, your balance sheet needs longer-term funding to reduce interest-rate risk, now is an opportune time to book long-term advances as advance rates of five and seven years remain at or near historical lows. Extending overnight or other short-term advances to terms of one year or longer will also help stabilize your cost of funds if the Fed begins to tighten before the end of 2014.

For current advance rates, please contact your relationship manager or the Money Desk at 1-800-357-3452.