Investors Face Tough Walk on Easy Street

By Justin Lahart

Summertime, and financial markets are looking easy.

The Federal Reserve Bank of Chicago on Wednesday reported that its financial conditions index, with over 100 measures ranging from debt issuance to consumer surveys on credit conditions, showed America last week faced its easiest financial conditions in 20 years. Indeed, the last time the measure was so loose was in early February 1994, the point at which the Federal Reserve began a series of rate increases that would give stock and bond investors fits for the remainder of that year.

The Fed doesn't feel anywhere near the same urgency to tighten as back then. Indeed, a separate index from the Chicago Fed suggests financial conditions aren't especially easy after factoring in the recent performance of the economy. There will need to be more labor-market improvement, and probably higher inflation readings, before the central bank begins the process of raising its target for overnight rates.

Moreover, the easy readings on financial conditions aren't translating into wide credit availability. Mortgage rates are extremely low, for example, but the bar that first-time home buyers must clear to secure a loan remains very high. So, although some Fed policy makers worry the financial environment could lead to credit excesses, there are scant signs that is actually happening.

But while the Fed can afford to be sanguine about financial conditions, investors may want to be a bit more careful. The prices they have been paying are in many cases high. Yale economist
Robert Shiller's cyclically adjusted price/earnings ratio shows stocks are nearly as expensive as they were at their 2007 peak. Meanwhile, the spread between junk-bond yields and comparable Treasurys has narrowed to 2007 levels.

The case for prices going higher is tantamount to a case for either financial conditions getting even easier or the economy getting much better. The former seems improbable, while the latter would give the Fed cause to tighten.