2019 4th Quarter Stock Market Commentary

STRESS TRANSFER

"Before you judge a man, walk a mile in is shoes. After that
who cares? He's a mile away and you've got his shoes."
- Billy Connolly

In the 1960s archaeologists discovered artifacts in Northern Russia which showed that Stone Age humans were traveling on frozen tundra some 8,000 years ago using rudimentary skis. Cave drawings indicate that this activity was going on much earlier, 28,000 years ago during the last Ice Age. But downhill skiing as recreation dates to the mid-1800s. Equipment was primitive - flat wooden slats for skis, and leather ski boots resembling work boots, but with a wider toe to accommodate heavy socks.

Leather ski boots were not particularly warm, and frequently were not completely waterproof. But more importantly, the flexibility of leather provided little lateral stability. The result was an enormous number of broken ankles. Data shows that broken ankles accounted for more than 60% of all lower leg injuries among skiers in the 1950s and early 1960s.

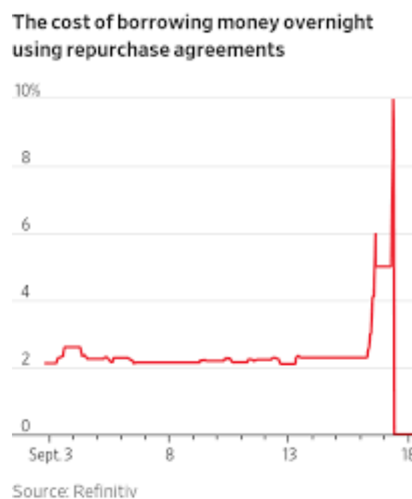
In 1965 Bob Lange introduced ski boots with rigid plastic shells. In addition to being waterproof, they provided much greater maneuverability for skiers, and virtually eliminated broken ankles as a risk. Fewer than 10% of lower leg injuries are now broken ankles. But, unfortunately, the inflexible boots shifted the forces involved in skiing from the ankle to the knee. More than 70% of lower leg injuries are now knee injuries, with the vast majority of those being ACL (anterior cruciate ligament) tears. Increased stability in one area created greater instability in another.

This same principle is why spinal fusion frequently fails to alleviate back pain. An L4-L5 fusion, for example, often results in increased stress at the L3-L4 level.

It would appear that a similar process is at work in the financial system. In the aftermath of the financial crisis of 2009, legislators and bank regulators crafted rules and regulations designed to make the banking system much more resilient in future crises. The most important and far-reaching change was the passage of Dodd-Frank in 2010. It included provisions to designate certain financial institutions as systemically important, and therefore subject to increased reserve requirements. It mandated that banks retain portions of loan securitizations, and forced banks to abandon or sharply modify proprietary trading and hedge fund activity (the so-called Volcker Rule). The law required banks to formulate Living Wills as a roadmap in the event of a bank

failure, and specified that banks must pass an annual “Stress Test” to demonstrate solvency under increasingly adverse macro-economic conditions. While critics of the law on the left argued it was too lenient, and failed to punish those responsible for the crisis, while those on the right argued it was yet another unwarranted expansion of governmental power, there is no doubt that the banking system is far more secure than it was prior to passage.

But evidence is mounting that other parts of the financial system, such as lending and securities trading, have come under increased stress from the additional requirements placed on the banking system. The graph below shows the startling spike in the interest rate on repo loans at the start of the quarter.



A repo (or repurchase agreement) is essentially a pawnshop loan for a financial institution. At a pawn shop a customer brings in some item of value as collateral – a piece of gold jewelry, or a musical instrument, for example. The pawn broker gives the customer cash based upon the value of the asset, who is then obligated to pay back the loan by a certain date. If the loan is not repaid on time, the collateral is forfeited. A repo works similarly, except that the borrower turns over a financial instrument, like a United States Treasury security (two-thirds of the time), a note issued by a government agency, or occasionally a mortgage-backed security, rather than a watch or guitar. Unlike a pawn shop loan, the borrower actually sells the security to the lender, who then agrees to buy it back later for a slightly higher price. Often the loan is repaid within a day or two, but repos generally last less than three months. The difference in the sale and re-purchase price represents the interest on the loan. Unlike a pawn shop loan, ownership of the security actually changes hands at the time of the loan, giving the lender greater security in the event of a default.

Repos first became popular during World War I, when Congress passed a tax on financial instruments to help finance the war effort. The tax threatened the health of banks, who suddenly had to pay the levy every time they borrowed money from the Federal Reserve, which had been created a few years earlier (1913) by President Woodrow Wilson. To circumvent the law and assist the banks in their tax avoidance efforts, the Fed agreed to buy securities from the banks, and then re-sell them at a higher price. This constituted a capital transaction, rather than a loan, and was thus not subject to the tax.

After the war the tax was repealed, and repos once again became a rarely used transaction. But then the Great Depression arrived, and the banking system once more found itself on the verge of collapse. Many observers felt that the crisis had been exacerbated by the recklessness of banks, who continued to offer interest to attract deposits, despite the fact that they no longer had the ability to prudently pay it. The Fed responded by issuing Regulation Q in 1933, which forbade banks from paying interest on demand deposits. This did not create additional problems when interest rates were low, but when the U.S. economy boomed after World War II interest rates started to rise. Corporations and municipalities were loathe to keep their cash in non-interest bearing accounts, and started entering into repo agreements with securities dealers who needed cash to fund their inventory of bonds. It was a win-win. Corporations earned more on their cash than they could in a bank account, while securities dealers financed their businesses more cheaply than the rate offered by banks. Once again, repos became a tool to circumvent regulation.

Today, the repo market is huge. On a typical day there are $2.2 trillion of repos outstanding in the United States. There are also active repo markets in the Eurozone, Japan, the United Kingdom and 40 other countries. They are viewed as an essential vehicle for stable short-term funding, and are often described as the “plumbing” of the financial system.

At the end of September several events coincided which caused the repo market to temporarily freeze up. For one, corporations were required to make their quarterly income tax payments. To do so, they withdraw cash from the money market funds where they were kept. This made money market funds, normally large repo lenders, temporarily unavailable. Second, there was a larger than usual auction of treasury securities to finance record deficit spending. This sucked reserves from the banking system at the same time securities dealers needed to borrow to finance the bond purchases. Third, in the aftermath of the banking crisis in 2009, banks are required to maintain higher levels of reserves. They have become reluctant to lend at the end of a quarter since they want to show regulators a pristine balance sheet.

The result of the confluence of these factors was a sharp spike in the rate that borrowers were forced to pay for short term loans. The current target range for the Fed Funds Rate (the rate at which banks lend to each other) is 1.75%-2.00%. Repo rates are usually slightly higher. Suddenly, though, rates surged to 10% amid a shortage of available funds in the financial system. In his third quarter conference call, JPMorgan Chase CEO Jamie Dimon noted that the bank had the cash and the willingness to calm the short-term funding markets when they stopped functioning normally, but regulations held it back. He noted that the bank maintains large reserves at the Fed that it would have gladly shifted into repos, since they could have earned more than four times what the Fed pays. It did not, because of regulatory mandates. JP Morgan Chase is one of the eight largest U.S. banks that are classified as “global systemically important” and therefore subject to stiffened capital requirements that penalize them for adding new loans. In the days following the jump in repo rates the Fed created a new repo facility of $75 billion to provide liquidity to the clogged market. Rates are now back down to slightly over 2%.

Historically, banks serve as intermediaries. They buy securities when others want to sell them and lend when others want to borrow. As banks have become safer, they have retreated from financial markets and made them more volatile.

The repo anomaly is not the only market swoon which has been blamed on the reluctance of intermediaries to serve as counterparties because of heightened regulation. In June 2018 there was a nearly 4% drop in bond prices in only a few days. Then in December of that year stocks plunged roughly 16%. Finally, in January 2019 there was a "flash crash" in the Japanese yen. In a report last Spring, the International Monetary Fund attributed all these instances of volatility to heightened risk aversion .

The part of the financial system most at risk because of this phenomenon is the bond market. The bond market is huge - $40 trillion in the U.S. alone, compared to $20 trillion for all publicly traded stocks. World-wide, the value of the bond market exceeds $100 trillion. This market has been rallying for more than 30 years, and many investors are heavily invested in this asset class. Moreover, most bond investors tend to be conservative. Several studies have shown that bond investors tend to withdraw from markets very rapidly when prices fall, and a relatively small sell-off can grow into an outsized drop in the market.

According to a Deutsche Bank report, bank inventories of corporate bonds are down a whopping 90% since 2001. With banks unable (or simply unwilling) to play the part of market maker, this means that prospective sellers will find it more difficult to find counteracting buyers. Steven Schwarzman, CEO of Blackstone Group, wrote an article for the Wall Street Journal in which he argued that stricter capital requirements will mean that there is no safety valve to catch rapidly falling security prices, a task normally undertaken by dealers at banks. This could potentially force market contractions that will subsequently induce layoffs, lower tax revenues and place greater stress on middle-class families.

Someday, maybe even in our lifetimes, the Federal Reserve will finally announces a series of rate hikes. At that time, investors may scramble to sell bonds, but there may simply not be buyers at a reasonable price. This is especially a possibility in less liquid markets – such as corporate, high-yield and municipal bonds – where there are a staggering number of unique bonds. Thus there are fewer buyers and sellers for each security. Without banks acting as market makers and buying up these bonds, investors may suffer devaluations on their bond portfolios.

Dodd-Frank was certainly successful in accomplishing its primary goal of buttressing the banking system. But it is worth remembering the phrase that "The road to hell is paved with good intentions." Many large-scale changes can produce unintended (and undesirable) consequences.