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NASHVILLE NOTES

No constituencies for higher rates and bear markets

By Jeff K. Davis

Jeff Davis CFA is a veteran bank analyst. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of S&P Global Market Intelligence; Mercer Capital, where he is the managing director of the financial institutions group; or StillPoint Capital, where he is a registered representative.

One of the great reads about the global financial crisis is William Cohan's House of Cards. The book chronicles the hubris and eventual collapse of Bear Stearns, which was forced into a fire sale to JPMorgan Chase & Co. because of its inability to rollover short-term financing after investors lost confidence in the company's highly levered balance sheet.

While the characters Cohan writes about are colorful (ex-CEO Jimmy Cayne was a weed smoking, top-notch bridge player), there was nothing unique about Bear Stearns' collapse. Banks and other financial firms have failed throughout history because of too much leverage, inadequate liquidity and sometimes fraud. Greensill Capital (UK) Ltd. is one of the latest firms to fail due to possibly all three attributes. More will follow.

By chance, I heard a podcast with Cohan recently in which the host lamented the "everything bubble" that has seen asset prices skyrocket. In the host's view, the Federal Reserve is to blame through rock-bottom interest rates and open-ended bond purchases. Cohan had a great retort: there is no constituency for high rates and market crashes. I assume he would include generic bear markets, too.

Cohan's comment is insightful generally and is biting in the context of markets today, in which financial assets and most real assets are somewhere between richly valued and grossly over-valued. Digital assets may be cheap or expensive, but there is no history for cryptocurrencies and NFTs to make a call, in my view.

The Fed, I think, has painted itself in a corner in which it cannot tolerate markets that fall sharply. There is too much leverage supporting elevated asset prices and income-producing strategies in the developed world. A sustained fall in asset prices runs the risk of a 2008 or even an early 1930s scenario in which assets are liquidated to pay lenders. Social stability is iffy today, and probably would be an obvious casualty in such a scenario.

Cohan's view indirectly praises Paul Volcker, who served as Chairman of the Federal Reserve from 1979 through 1987. Volcker was appointed by Democrat Jimmy Carter when the political consensus was reached that more painful action had to be taken to bring inflation under control. Volcker did not flinch. The U.S. endured two back-to-back recessions in the early 1980s and short-term interest rates that rose to over 20%.

A wide swath of the U.S. was waylaid. Farmers who had borrowed heavily in the inflation of the 1970s held a tractor protest in Washington, where they circled the Federal Reserve's offices. Home builders were bankrupt. Corporate America, especially manufacturers, were forced to drastically reduce costs.

While Volcker is celebrated today as taming inflation, he was a controversial figure 40 years ago. In Japan, the head of the Bank of Japan was assassinated in 1936 due to policies that were unpopular with the military because he forced the government to reduce spending. His compliant successor oversaw high inflation.

So, what are we to make of news that two Fed presidents were trading equities in 2020 when the Fed dived deeply into the capital markets that included the purchase of corporate bonds?

We learned in early September that Robert Kaplan, the president of the Federal Reserve Bank of Dallas, had 22 trades of $1 million or more in 2020. Obviously, none were bank stocks, although a couple were Blackrock floating rate income products. Federal Reserve Bank of Boston president Eric Rosengren also traded a bit, including mortgage REIT Annaly Capital Management Inc. One policy the Fed implemented in the spring of 2020 that continues today is the purchase of $40 billion of Agency MBS each month.

While the holdings and trading complied with Fed regulations, the news strikes me as a big deal because much of Fed policy in my view is predicated upon market participant views of Fed credibility. Tiny Toto exposed the Wizard of Oz as a magnified voice behind a curtain. When Alan Greenspan was chairman of the Federal Reserve, his personal assets were mostly invested in U.S. Treasuries, particularly short-term bills.

Asset inflation has a constituency. Like me I assume everyone reading this post has benefitted from the spectacular run in stock prices and real estate since March 2020 when markets were on the ropes. I question whether the Fed will be able to back away from flooding the system with liquidity beyond maybe partially curtailing bond purchases — particularly Agency MBS. There is too much potential downside to take that risk, plus the U.S. government is running massive deficits that require someone to finance.

Bear Stearns (and Lehman Brothers among others) discovered the downside of not acting when they could. A former colleague was a relatively high-level Bear Stearns employee. When we first met in 2010, I told him I would not ask anything about what happened, but I had one open-ended question: Why? He said the company missed the window to raise a lot of liquidity when it could in the third quarter of 2007 by selling assets at a loss because the board and/or c-suite did not want to report a big quarterly loss.

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