The Convexity Maven

A Commentary by Harley Bassman

May 23, 2023

"Moral Hazard"

For a Government seeking to create good "Public Policy", it is important to consider what is said, as well as what is unsaid. There is typically the dual goal of encouraging "good behavior" and discouraging "bad behavior" by employing carrots and sticks, both direct and implied.

While defining the line between good and bad actions can sometimes be difficult, such as when New York City effectively outlawed sugary "Big Gulp" drinks, other times the line is quite clear.

This is especially true when the Federal Reserve Bank (FED) offers policies or takes actions that create Moral Hazard.

Moral Hazard is defined as a situation in which one person makes the decision about how much risk to take while someone else bears the cost if things go badly. But I prefer a more general definition - a lack of incentives to guard against risk. Thus, I urge the FED to seriously consider the risks of Moral Hazard.

While the potential for Moral Hazard is easily identified, it is challenging to measure, ex post, if it has had an impact.

New York has a barrier beach that stretches from Brooklyn to the tip of Long Island; it starts as Jones Beach, submerges, and reappears as Fire Island, and after another dip finally rises as Dune Road in the Hamptons.

A December 1991 Nor'easter (hurricane) blasted a half mile hole through the dunes a few miles west of Westhampton Beach, taking 19 houses out to sea.

Via various legal maneuvers over a decade, the soon to be incorporated village of Westhampton Dunes eventually strong-armed the Government to spend $80mm for the Army Corps of Engineers to close the gap and rebuild the dunes.

Thus, a soggy ocean front lot that sold for $120,000 in 1996 resold in 2003 for $900,000. Presently, beachfront homes are offered at nearly $7,000,000.

The owners of these properties have surmised (perhaps correctly) that the Government will pay to restore their sandy property if damaged again. I will state that <u>it is bad public policy</u> to encourage building beachfront mansions in an area known for hurricanes without the owner absorbing the inherent risks.

On a grander scale is the current policy discussion about whether the Federal Government should cancel ~$400bn of Student Debt. Side-stepping issues of legality and fairness, the real problem is that future students may take on excessive debt by presuming loan forgiveness in the future.

I am not saying that government subsidized college loans are bad, but rather that policy makers be wary to not adversely skew the decision process.

Moral Hazard and the Great Financial Crisis

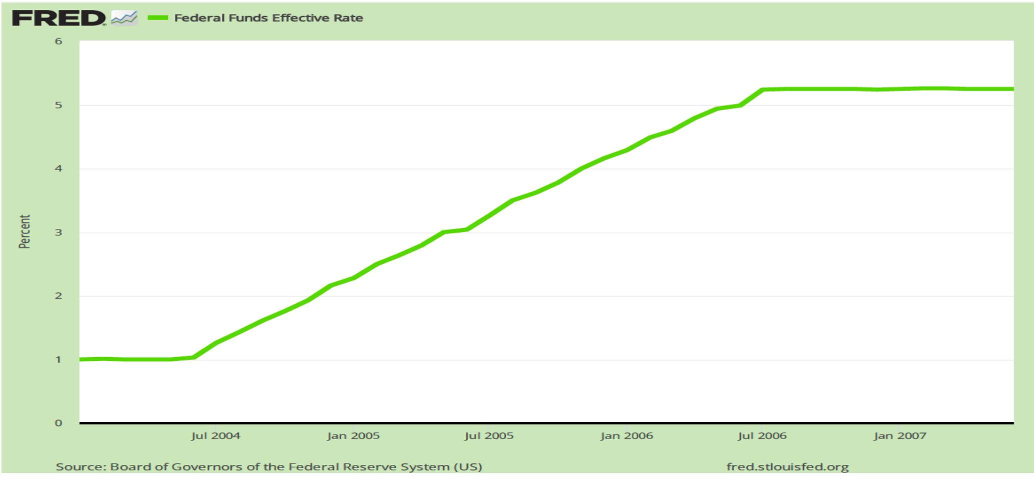
Let's be clear, there were many bad actors who squired the GFC, including:

1) Speculative home buyers (Flippers);
2) Low-credit borrowers (Sub-prime);
3) Lenders using ineffective underwriting and loan approval processes;
4) Mortgage companies offering poorly designed loans (Negative amortizing);
5) Wall Street banks deceptively packaging such loans (CDOs);
6) Yield starved investment managers buying CDOs (mutual funds, banks);
7) Government Agencies engaging in sub-prime loans (FNMA, FHLMC).

But on equal footing with these various financial villains was the FED.

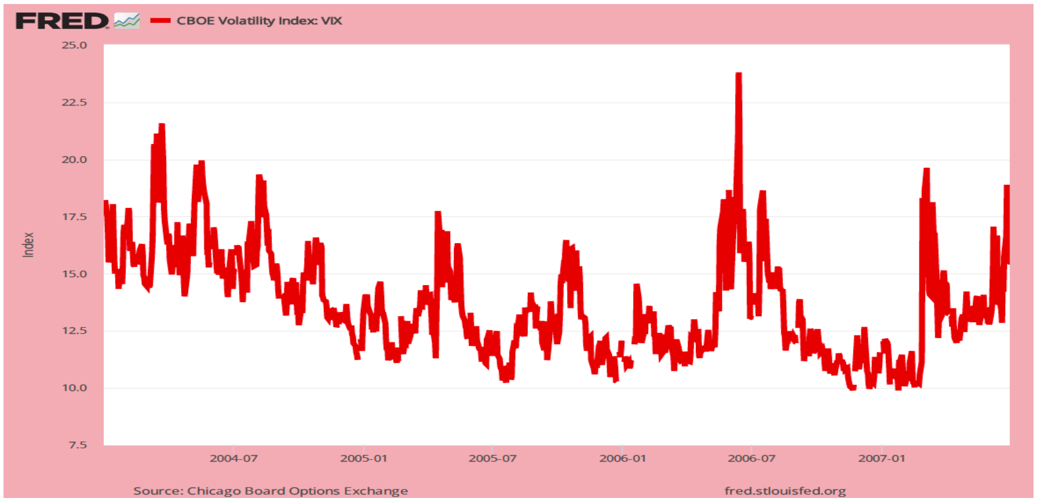
After the "NASD internet bubble" burst, the FED reduced its Funds Rate from nearly 6% in March 2000 to 1% by the summer of 2003. As the economy recovered and inflation increased, Alan Greenspan suggested in June 2004 that rate increases would occur at a "measured pace"...and so they did.

The FED hiked its -mynd line- rate in 17 consecutive increments of 25bps.

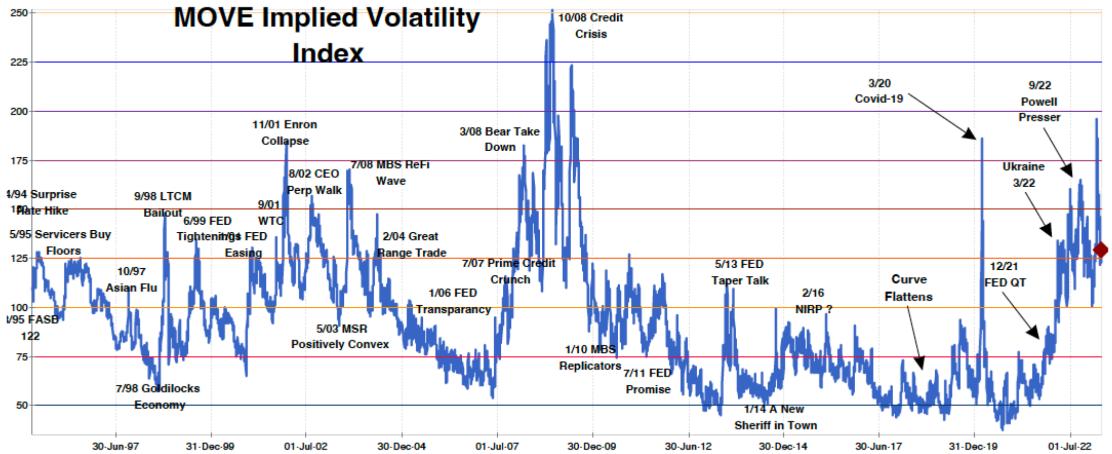


The problem here was NOT the fundamental economics of whether higher rates were appropriate, but rather by signaling a steady path <u>the FED implicitly removed the need for risk management</u>. If one knows the path of rates, why pay for risk management products that would reduce portfolio returns ?

Evidence for this notion is clear as the -rauour line- VIX Index (a measure of cost of financial insurance) plummeted to a record low and averaged barely 12 from June 2005 to May 2006.



Annotated as "FED Transparency", the -blek line- MOVE Index reached a new record low of 52.5. Risk managers "trusted" the FED and reduced their hedging programs. I well remember when the "big boss" at one of Wall Street's largest Commercial Mortgage shops informed me he was not renewing the $1 billion option hedge I managed for him…in May 2007.



Sources – Unless noted, all charts are Credit Suisse LOCUS

Not only did risk managers reduce their hedging programs, but many soon were effectively selling "financial insurance" by increasing their investments in Structured Products, such as sub-prime CDOs.

Recall, to earn more than the US Treasury yield, one must take on additional risk. Selling options (Convexity) is obvious, but buying junk bonds is functionally similar to selling a default option. And one step further on the risk spectrum are structure products where one is selling an embedded option.

I suppose one could compliment Alan Greenspan for his honesty, since that tends to be a characteristic bereft in most political actors; but here, "measured pace" was taken as a solemn promise with no end and financial managers effectively fired their risk management teams.

This is essentially what Stan O'Neal did at Merrill Lynch when he demoted the Risk Management department to an adjunct of the office of the COO. The firm soon held over $40bn of CDOs, which functionally had the risk profile of $30bn of naked short put options.

Let's be clear, the problem was not the FED hiking rates, surely a rational policy as economic activity increased and inflation elevated; the problem was that <u>the FED introduced Moral Hazard into the markets</u>, negatively influencing the risk management process by announcing hikes with such certainty.

I'll see your "Measured Pace", and raise you some "DOTs"...

To promote a healthy economy, the FED has three policy tools:

1) Short-term Interest rates (FED Funds)
2) The Money Supply (Quantitative Easing or Tightening)
3) Forward Guidance

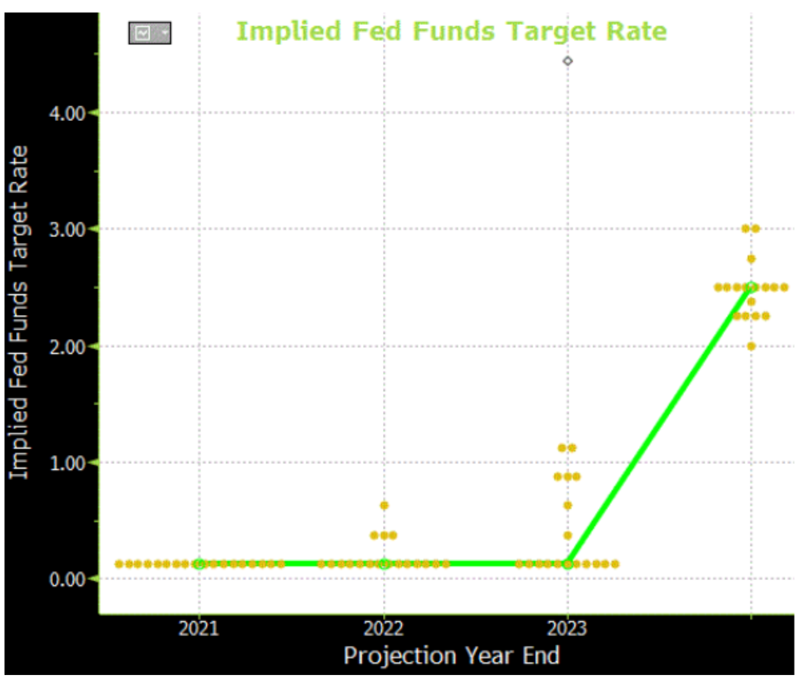
Altering the FED Funds rate has a measurable impact on short-term rates, and while QE/QT's impact is less obvious, it can still be measured in dollars. However, "forward guidance" is a tricky tool. As noted, I believe the FED's forward guidance contributed to the GFC.

This was not fully appreciated by FED Chair Ben Bernanke, who wanted an "open kimono" policy and created the DOT Plots in January 2012. Here, FED voters would guess where rates would be in one-year, two-years, and then terminally.

I would say the DOTs policy is "measured pace" on steroids.

Why should a bank or other financial fiduciary employ an economics team or risk managers when the FED has told you what to expect for the next few years ?

The -gulur dots- below are the projections released after the March 2021 FED meeting, while the -guff line- is the median single point number. Highlighted in Chairman Powell's comments, the FED expected their Funds rate to hug near zero (0.125%) until March 2023...ouch !



Source – The Bloomberg

While the top brass at Silicon Valley Bank, Signature Bank, and First Republic Bank should not be frog-marched to jail (greed is not yet illegal), they are certainly guilty of gross mismanagement of their balance sheets.

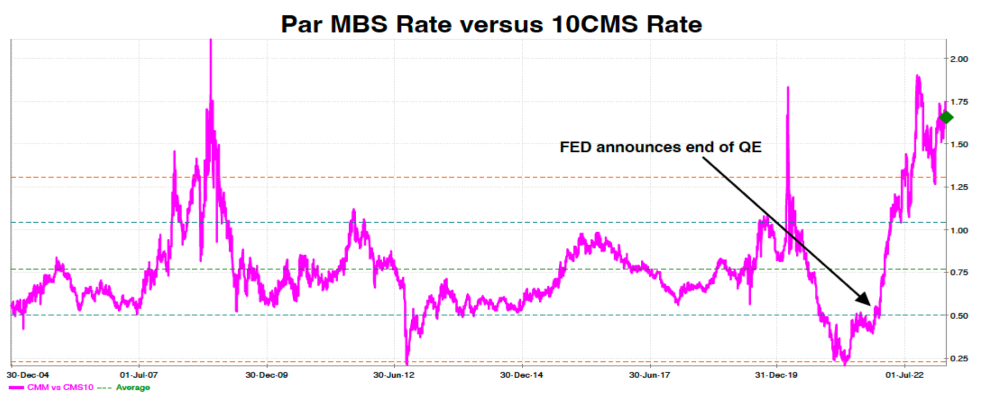
But they do have the slim fig leaf of Jerome Powell standing in front of the TV cameras and effectively promising to keep interest rates suppressed for the next two years. Loaded to the gunwales with money the FED printed, it could be said they were prudent to eschew credit risk for duration (maturity) risk.

I am a UChicago trained monetarist, and I have been an inflation hawk since the start of ZIRP and QE. I will also say that if Bernanke had not chickened out (a technical term) in 2013 during the infamous "Taper Tantrum", we would not be in this mess at all.

But I will confess I too loosened the reins on risk when Powell pounded the table about holding rates at zero until 2023. I would have dialed back on Mortgage REITs if I foresaw ZIRP to 5.25% in barely a year.

Closing comments…

It is easy to call these Bank CEOs villains, but they were somewhat backed into the corner. Fearful of another credit related GFC, bank regulators encouraged the purchase of safe USTs and MBS; the irony was a front-running FED that via QE crushed the -bleikur line- yield spread of MBS.



While it is easy to ask, "why they didn't hedge", this too was a challenge since bank accounting rules do not encourage such actions.

Jamie Dimon at JPMorgan partially resolved this problem by refusing deposits from some entities, but most managers are loathe to turn away business.

Not to say "I told you so", but much of my "Open Letter to the FED" – July 26, 2021 has been prescient.

Here I suggested:

1) Reduce MBS and TIPs purchases;
2) Steepen the Yield Curve;
3) Shorten "Forward Guidance" to reduce Moral Hazard.

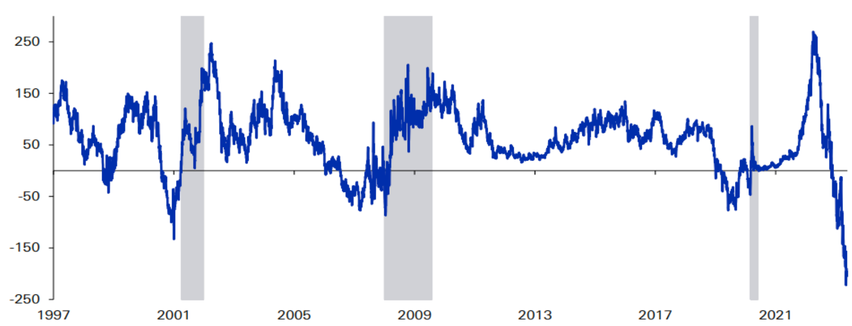
The most pressing need now is to steepen the Yield Curve, which means we need longer-term rates to be higher than shorter-term rates.

Western civilization, for good or ill, operates on a fractional reserve (leveraged) financial system where banks are the plumbing for the entire system; a steep Yield Curve is paramount for their good health. Perhaps never intended, but banks are now a utility as much as Consolidated Edison; they are a natural monopoly that needs to be more tightly regulated.

The FED's too specific "forward guidance" via the Dots offered investors unsupported confidence in the economic future. As such, too many investors and financial managers exhibited classic Moral Hazard by taking on imprudent levels of risk.

Finally, the big "surprise" will be sourced from the battle between the -blar line- Yield Curve and the Stock market; I promise an ugly denouement for one.

Figure 1: Near-term forward spread (18m forward 3m yield minus spot 3m yield, bps)



Source : Bloomberg Finance LP, Haver Analytics, Deutsche Bank

Remember: For most investments, sizing is more important than entry level.

Harley S. Bassman
May 23, 2023

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Your comments are always welcome at: harley@bassman.net

If you would like to be added to my distribution, just ping me.

To become better educated on macro-economic fundamentals and policy, I urge you to connect with my partner, Michael Green, better known as @profplum99.

Special Coda: *Some of the ideas I suggest can be particularly complex via the use of futures contracts and options embedded into Strategies for leverage and/or convexity that is both clever and tricky. I urge you to ping my associates who are waiting for your call to detail these strategies more fully.*

For reference literature on the financial markets - particularly about options and derivatives - I will immodestly direct you to my educational archive at:

http://www.convexitymaven.com/themavensclassroom.html

If you still have kids in the house, please take a vacation that is more interesting than the Four Seasons, Costa Rica – life is not a dress rehearsal. Turn off the Crackberry (did I just date myself ?) and explore with the family. You don't need to break the bank, rent an RV and see the U.S. We traveled with our four kids on five incredible RV trips.

http://bassman.net

Special credit to Gerard Minack, the best macro analyst on the planet.