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INSIGHT

TRADING SECRETS

Our Destiny of Self-Deception

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Ten years ago, the U.S. home ownership rate eclipsed 69% and hovered at that historical level for years to come. It was the fruit of a bipartisan effort over the preceding decade beginning with a National Homeownership Strategy and later the Ownership Society agenda to both expand the absolute level of homeownership and narrow the gap amongst various ethnic and socioeconomic groups. While the intention was compassionate, the true benefits of a high homeownership rate are debatable, and, with hindsight, the methods by which that level was achieved were flawed. Today, we believe a combination of regulatory and monetary policy has created an unintended consequence that has again put our financial system at risk.

In the years leading up to the financial crisis, Fannie Mae, Freddie Mac, and the Federal Housing Authority (FHA) were continuously pressed to outright relax underwriting standards or creatively expand existing ones. It was a political pipedream of public-private partnership that laid the faulty foundation upon which home prices rose. Ultimately, it was pushed beyond the brink by Wall Street's "originate-to-distribute" mortgage lending model, as well as blind risk-taking by global investors more worried about near-term relative performance than protecting long-term value.

The evidence was all around us, yet most, including politicians, Wall Street, the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC), had convinced themselves that the economy was on strong footing and, more importantly, that the financial framework under which this historical achievement was reached was sound. The consequence was a ruinous chain of events beginning with early payment mortgage defaults followed by subprime mortgage originator bankruptcies leading to hedge funds collapsing, all culminating in the largest bankruptcy filing in U.S. history on September 15, 2008. In response to that economic and financial collapse, we witnessed an unprecedented use of monetary tools intended to both save, and then heal, the economy concurrent with a regulatory overhaul of the banking and broker-dealer business of a magnitude not seen for generations. The monetary and regulatory agendas were a package of acute, chronic, and preventative treatments for an economy recovering from a leverage binge. It was a coordinated program intended to heal the wounds and ensure that our global markets and economies would never again be susceptible to the vulnerabilities of a "shadow" financial system.

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Six years removed from the crisis, a cursory checkup paints a picture of improving economic growth along with a far less levered and more stable banking system. Yet dig a little bit deeper and you'll find a fault line masked only by a thin veneer of stability. Six years of aggressive monetary and regulatory work hasn't reduced as much systemic risk as it might appear. Rather, they have simply substituted one destabilizing force for another. Explicit and contingent leverage and liabilities are now a fraction of what they once were but so is, to our great misfortune, liquidity. Like the risks that negative amortization and no documentation mortgage loans should have been years ago, the liquidity risk to the market today is unmistakable.

Liquidity is the life blood for our system. It informs investors of the price at which a security can be traded, allows those investors to determine their opinion of value based upon that price, and then gives them the ability to transact in a timely manner consistent with that price. These trades allow some investors to pay insurance claims, others to satisfy bank account withdrawals, and still others to meet the working capital and infrastructure demands of their business. Regrettably, history will most likely have to repeat itself by living through the next crisis before we attempt to fix the very cause of it.

Over the past four years the Federal Reserve's balance sheet has almost doubled while the targeted federal funds rate has stayed within the committee's 0.0%-0.25% band. This unprecedented policy has been the driving force behind the U.S. equity bull market and the extraordinary expansion of the most credit-sensitive fixed income markets. Since 2010, the global leveraged finance market has grown by over 50% while the investable emerging market debt universe has swelled by over 60%. With paltry risk-free interest rates and compressed high quality asset spreads, both institutional and retail portfolios have ventured into these higher risk segments of the market in an effort to maintain some semblance of income from their bond allocations. This reach has fueled almost 50% growth in fixed income mutual and exchange-traded funds.

Coincident with the rapid expansion of these asset classes and proliferation of investment products to access them has been a transforming combination of international and domestic banking regulation. Basel III accords set the stage for significantly more stringent capital, leverage, and liquidity requirements enforced by federal banking regulators. An even higher bar has been set for systemically important financial institutions through provisions of the Dodd-Frank Act. The Volcker Rule, another section of the Dodd-Frank act, prohibits banks from proprietary trading, limits investments in hedge funds and private equity, and significantly enhances oversight of trading and market-making activities. While the merit of each individual rule can be debated, what is indisputable is that collectively these rules have transformed the banking and broker-dealer business model. Nowhere is that more evident than in the trail of declining trading assets and risk on the books of the largest banks.

A recent research piece from Credit Suisse tracks the reductions in both assets and risk (measured by interest rate value at risk, or VaR) since the credit crisis at these banks. As one might expect, both metrics dropped precipitously from mid-2008 through all of 2009. However, what we find most interesting is the continued descent of risk taking from the post-crisis peaks in trading assets from the fourth quarter of 2010 through the third quarter of 2014. Nowhere was more risk reduced over this time period than from the fixed income, currency, and commodity (FICC) trading books. Over that time period FICC assets dropped by 26% while VaR declined by over 56%. This halving of risk took place over a time period beginning two years after the bloat of the pre-crisis era, and is likely almost entirely attributable to new regulations.

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While the reduction in the depth of liquidity is alarming in its own right, the pace at which the tide of liquidity retreats is equally important to note. Over the past few years, these large banks have demonstrated that as realized volatility increases, the pace of risk reduction accelerates exponentially, which further exacerbates market moves. Look no further than the "taper tantrum" in June 2013 to see just how quickly the mirage of liquidity evaporated when rising U.S. Treasury yields began to gap higher and quickly infected credit assets as broker-dealers had no appetite to position any type of risk. Prices were dropping rapidly while fund outflows picked up steam, and left managers of these investment vehicles in a precarious position of trying to match daily liquidity redemptions by selling assets that couldn't offer the same liquidity in return. Had the Fed not been so quick with a generous dose of forward guidance, the volatility and price declines may have been far more severe. This was hardly the healthy market it appeared to be for the first five months of that year.

Consider a hypothetical transportation bill intended to improve suburban mobility through tax incentives to promote automobile ownership while funding that bill through a permanent closure of half of local roads and highways. For good measure, the entire traffic lighting systems would convert to flashing red during peak hours to ensure safety due to the increase in car volume. The result would be an obvious reduction in mobility as more cars compete for less roadway space that only intensifies when they need it most, at rush hour. You might assume these diametrically opposed features of the same bill would be laughed right out of consideration. However, over the past four years have monetary and regulatory polices looked any different? Have we not inflated asset values, vastly expanded the investor base for some of the riskiest assets, all while greatly debilitating the infrastructure for which those assets transact?

You can't have it both ways. If financial market stability is the foundation for which monetary policy seeks to inflate asset prices and ignite a wealth effect upon, regulators (including the Fed itself) cannot simultaneously strip down that foundation. The result is merely an illusion of liquidity dependent upon a "Fed Put" and a financial system unable to support itself. These two powerful forces cannot eternally coexist. Hope for improved liquidity and transparency through electronic trading platforms and unregulated institutions such as hedge funds filling the market-making void are just that. They merely augment the façade by painting a picture of buy-side-to-buy-side trading during good times only to see it vanish at a mere hint of a storm. It is neither their business nor fiduciary duty to supply competitors with bids and offers. Nor should investors rely upon the hedge fund community to provide reliable markets and promote stability. If anything, these institutions relish volatility. And without the traditional broker-dealers to stand in their way, they could very well drive prices toward their desired outcomes faster and more profitably than before.

We advise investors to brace their portfolios for flashes of unexpected volatility at best and at worst, a far more damaging wake-up call than 2013's "taper tantrum." By looking beyond a window dressing of liquidity and entering bouts of volatility well-prepared, investors will be better positioned to take advantage of inevitable opportunities. ■

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