The Long & Short of It
Quarterly Newsletter
First Quarter 2023

History Does Not Repeat. It Rhymes.

Pushing back on all the claims that this is another 2008 crisis or nothing like the 2008 crisis, we would like to say, “The future is uncertain.” Here we offer some perspective regarding the passage of time. Prior to 2008, the Fed began raising the federal funds rate in July 2004 and stopped in July 2006. Roughly a year later in August 2007, the Fed pivoted and implemented a series of cuts to the federal funds rate. It took until early 2008 for the market to begin discounting the problems to come and until late 2009 before the economy exhibited the full impact.

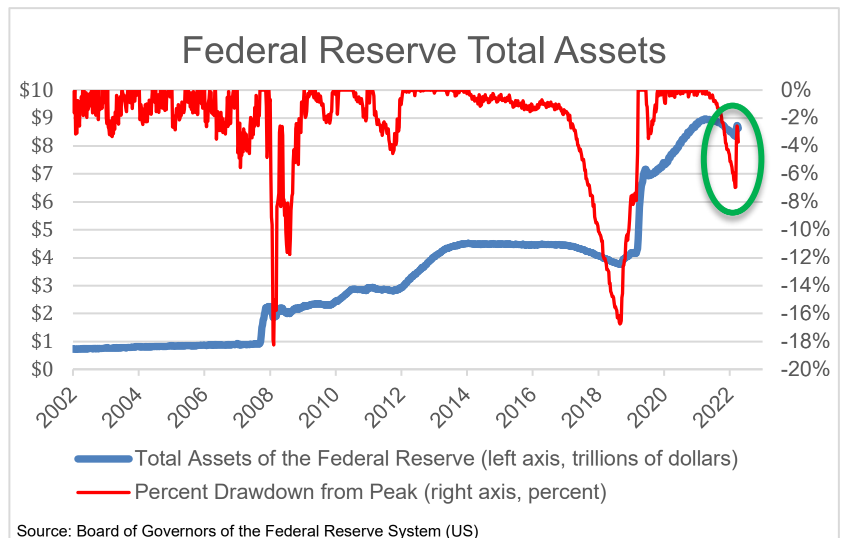
On March 16, 2008, seven months after the 2007 pivot, the first large failure took place (i.e., Bear Stearns, $395B in assets). That summer, IndyMac ($40B) and eight smaller banks failed. Then in September, six months after Bear Stearns and more than a year after the pivot, Lehman Brothers failed ($600B), followed by Washington Mutual Bank ($307B). By the end of 2008 a total of 25 banks had failed. In 2009, 140 more banks failed. In 2010, another 157 and in 2011, another 92. The number of failures continued to decline until 2018 when no banks failed. 2019 and 2020 each saw 4 bank failures. 2021 and 2022 again saw none. Easy money floats underperforming banks. Tight money sinks them, usually with a long lag.

The vast majority of failing banks were notably small. Deposits generally fled to the perceived safety of larger banks. The concept of “too big to fail’ has long been an unwritten part of Fed policy, but the colossal mess of Lehman Brothers resulted in its formalization. With the passage of the Emergency Economic Stabilization Act of 2008, the government was subsequently required to declare some banks and corporations "too big to fail" and provide rescue measures to ensure their continued operation.

As we anticipate how the prior cycle compares to the current, note that the federal funds rate began to increase in March 2022. Recent events suggest the Fed may have ceased or will soon cease raising the federal funds rate. It has been only 12 months but in early March 2023 (one might ask, “What is it about March and September?”), Silvergate Bank ($16B), Silicon Valley Bank ($209B), and Signature Bank ($118B) failed. There is no immediate crisis; we think the word is overused and not very helpful. Yet are the troubles really all behind us? Count us among the doubters. We expect more to come in markets over the summer and early fall. Perhaps a September to remember?

Financial Innovation

Recent innovations in monetary policy such as the “facilities” announced after each blowup appear to fall short of the benign goal of lasting stability. Most unsettling is the Fed’s growing inability to reduce/normalize its balance sheet without another financial crisis erupting. The economy and markets are addicted to the Fed’s elixir, always needing more. To avoid bad outcomes, the Fed accommodates (what else can a committee do?) but the direction does not feel good. With each cycle and each outsized budget deficit, our monetary system feels more and more fragile.



Source: Board of Governors of the Federal Reserve System (US)

From the Fed's founding in 1913 to September 2008, total assets had only reached $0.9T. By December 2008 assets had risen to $2.25T. After an 18% decline from 2010 to 2012, the Fed was forced to raise assets again from 2013 to 2015 where they stablized at $4.5T. From 2015 to 2019, Jerome Powell reduced asset levels by 16% before the overnight cash market began to malfunction in fall 2019. During the pandemic, Fed assets peaked at $9.0T, representing approximately one third of all treasuries outstanding. Last month, after a modest decrease of 7%, renewed financial stress yielded still another round of expansion of the Fed's balance sheet (as shown by the spike circled above).

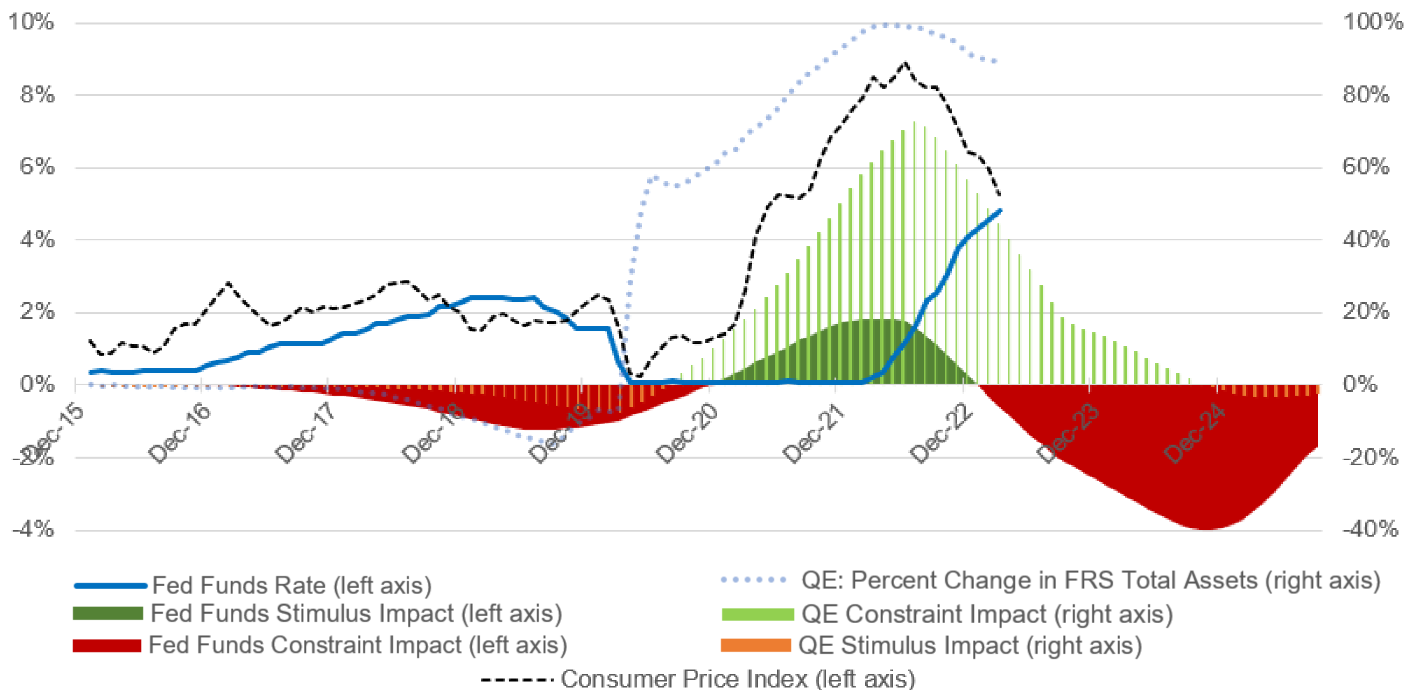
The Fed uses repurchase and reverse repurchase facililties to keep overnight cash markets from pushing the fed funds rate out of its desired range (currently 4.75-5.00%). From the Fed's online "Policy Tools" section describing the "Overnight Reverse Repurchase Agreement Facility," is this helpful description:

> *"In the Policy Normalization Principles and Plans announced on September 17, 2014, the Federal Open Market Committee (FOMC) indicated that it intended to use an overnight reverse repurchase agreement (ON RRP) facility as needed as a supplementary policy tool to help control the federal funds rate and keep it in the target range set by the FOMC. The Committee stated that it would use an ON RRP facility only to the extent necessary and will phase it out when it is no longer needed to help control the funds rate."*

After growing to $0.4T at the end of 2014, the ON RRP dropped off to near zero from 2018 through the end of 2020. Today the ON RRP sits at $2.4T, demonstrating the increasing challenges faced by the Fed to maintain market stability.

Refrain: Lag, Lag, Lag

Last quarter we presented a visual depiction of monetary policy lags and their actual and projected impacts. (See last quarter's letter.) We have updated it here and will continue to track it through this economic cycle.



Sources: U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items in U.S. City Average Seasonally Adjusted [CPIAUCSL], Board of Governors of the Federal Reserve System (US), Assets: Total Assets: Total Assets (Less Eliminations from Consolidation): Wednesday Level [WALCL], and Federal Funds Target Range - Lower Limit [DFEDTARL], all retrieved from FRED, Federal Reserve Bank of St. Louis.

The slowing of inflation remains on track with much more to come. Many other economic indicators are turning lower as well. This cycle is similar yet different, and it is still early. Given the Fed's rapid tightening over summer 2022 and the expected lag, more stress seems unavoidable. Since inflation has yet to be defeated, the Fed may be slow to pivot or may leave rates unchanged while waiting, painfully, for a more definitive drop in inflation.

The Next Chapter

Throughout the Fed's 110-year history, its green eyeshade-wearing PhDs were seen as slow to react. They were often frustratingly cautious and late to solve problems. They worried about long lags and protecting the reputation of the Federal Reserve from excessive intervention. Yet today those tendencies seem preferable to current leadership. Instead of the risk of a slow Fed amid a growing problem, there is the risk of current management making the institution itself the cause of the problem. In doing so, they put not only the reputation and existence of the Fed but also the sustainability of the US dollar in jeopardy—it would not be a good legacy for Mr. Powell.

As we have for over 25 years, we will continue to monitor the impact of these policies on clients' portfolios and the investment markets. We take our fiduciary responsibility very seriously and are humbled by the trust placed in us by our clients and readers. Thank you!

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