It Ain't Over Until the Banks Cry Uncle

By Vineer Bhansali| October 06, 2022

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I would like to thank the New York Fed for inviting the public (virtually) to the conference last Friday on financial stability considerations for monetary policy, not the least because it allowed the masses to hear the "state of the art" on the interaction of markets and monetary policy. With two of the three of the FOMC's holy trinity attending (Lael Brainard and John Williams), I assume that the opinions of the researchers who spoke at the conference matter a little to the policymaking class.

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As I have written previously, we are probably morphing from inflation as the primary objective of the Fed to financial stability (or instability) as the most immediate consideration. Recent actions of the Bank of England and the Reserve Bank of Australia show they are already in the middle of a soft pivot toward easier policy. Others are likely to follow when the banks squeal in pain.

Here are some high-level takeaways and then some action items for investors.

The first paper presented at the conference concluded that optimal monetary policy should always pay consideration to financial vulnerability in addition to the "classic" economic variables such as output gap, inflation, and the natural rate of interest. Of course markets

already know this, but thankfully economic researchers can now incorporate what is known as an obvious fact into optimal monetary policy. Better late than never. The paper notably ignores the feedback mechanism between markets and policy, focusing on banks' risk constraints. It also ignores the importance of other entities, such as pensions, who might be running levered "hedges", as we recently found out in the UK.

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We are probably still a few steps away from an explicit incorporation of financial stability into the rules of monetary policy, but I am sure there are researchers who have already been working on "Taylor" rules with financial stability and tail risk as variables. I know I have fruitfully used my own crude version of a non-linear "asymmetric" Taylor rule for investment decision making (see this paper from an econ journal a few years ago).

Let us talk about Taylor rules for another moment and the concept of "r*". r* is the ethereal "natural rate of interest", at which actual GDP equals its potential in the absence of shocks. This has been the topic of much debate in ivory tower policy circles, and indeed is one of NY Fed President Williams' claims to fame. The second paper at the conference introduced a shiny new concept called "r double star" (r**). This is the threshold above which there is an increased likelihood of financial instability. The historical analysis in the paper confirms (again known to market participants for a long time), that if real interest rates are kept too low for too long, this instability threshold falls. As Minsky said: "financial stability begets financial instability". In other words, if you keep financial conditions too easy for too long, the market gets addicted to it and there is excessive levered risk taking, and this results in increased vulnerability when rates start to rise again.

Here is the punchline – r** can be much less than r* when the markets are vulnerable, because any large shock can result in banks' net worth falling below zero, and thus constraining them from providing credit. While I could not obtain the latest reading on the

value of r**, eyeballing the charts in the paper it seems like this rate is probably right around 0%. So if we are already in one of these unstable regimes (feels like it) then real rates as measured by TIPS (at 2% or so real yields on the shortest maturities) are already above the point where financial instability should set in.

As an aside, I am seriously thinking of writing a paper introducing the concept of "r***" (r triple star), at which stock markets, especially banking stocks, start to fall out of bed. I think I can prove with some math the obvious fact that r*** is less than r** and r*, and real rates are already way above my r***.

The final paper in the conference dealt with the cost-benefit tradeoff from monetary policy "leaning against the wind" versus macro-prudential policy (i.e., regulation). The paper concludes (though it was based on data that does not incorporate the recent inflation shock) that while macro-prudential policy can result in better outcomes, monetary policy is less effective in doing so.

So what does this all mean for investment?

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Let us first note that the Fed is technically a "bank" of banks. I was not surprised that all of the papers narrowly focused on the banking channel as the key to stability and instability. Central bank academics like to use banks' role as intermediaries to derive nice formulas for the kind of papers discussed in this conference and, unfortunately, this ignores the impact of "helicopter money" that was showered on citizens over the last few years (much of which ended up in Vegas slot machines and on now-crumbling SPACs). That point aside, banks are much more than intermediaries. Commercial banks are the ones who actually create credit, and the Fed simply controls the price of credit through interest rates and asset purchases. Yes, the Fed can create a lot of reserves, but unless the reserves create more lending to the economy, no stability or instability is generated. If the banks use the reserves to speculate, leverage, and buy assets then we could have a problem. And when banks are in survival mode, the markets

crater. The incredible illiquidity of the US Treasury bond market is just one sign of it. The financial crisis of 2008 was another memorable example.

What all of this means is that the impending signs of the Fed's pivot will likely show up first in the price of bank stocks. Banks profited enormously front-running the Fed when it was buying assets (because the banks naturally marked them up and sold them to the Fed), and banks will likely get a whiff of changing Fed winds before the common public does because in the academic halls of the Fed, banks are the main medium through which money flows through the system.

As of this writing, the yield curve is sharply inverted, and since bank profits depend on lending long and borrowing short, this is like throwing sand in the working of banks. As short-term interest rates rise, investors have chosen to move deposits away from bank checking accounts to US Treasury bills and notes and the rapidly ballooning Fed reverse repo facility. These provide a relatively hefty 3% plus yield, compared to nothing on bank deposits.

We might be getting close to a banking sector capitulation. Depending on which category of banks and financial services sectors we look at, the last 12 months have resulted in a wide range of outcomes for banks and financials. For example, the 12-month total return on the financial services ETF IYG is -25% , JPM is -33%, GS is -20%, MS is -16%, C is – 37% (Source: Bloomberg). European banks have fared much worse.

At some point the banks will cry uncle, and that is the point at which the Fed will pivot. Be ready.

Important Disclosures

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