

Moral Hazard is my Middle Name

Fictional secret agent Austin “Danger” Powers, international man of mystery, has been the subject of three movies. In the real world, the pre-eminent man of mystery is the Federal Reserve chair. Pundits attribute movements in the markets to the inscrutable, secretive central bank he heads. The Fed supposedly wields tremendous power in unfathomable ways to assure that the American economy keeps growing and that markets remain stable. Some commentators on the Fed are so prone to conspiracy theories that you imagine them wearing a tin foil hat to keep out brain waves, nervously awaiting the black helicopters coming to punish them for revealing the Fed’s secrets.

Investors have such belief in this awesome but benign power of the Federal Reserve that they are more prone to take risks. Much financial market commentary interprets all news as good. If there is good news (e.g. the economy is growing), well, that is good news. If there is bad news, the Fed is more likely to cut interest rates to jump-start the economy, so that too is good news. If anyone worries about the explosion of debt in the economy or instability from the rise of hedge funds in the markets, the bullish answer is almost invariably that the Federal Reserve will protect us and save us from any crisis.

“Moral hazard” is the phrase that describes this increase in the propensity to take risks, depending on the Fed as a benevolent eraser of investor mistakes. The term describes unwanted changes in behavior due to a change in the reallocation of risk. For example, if you are a commercial bank that holds every 30-year mortgage you issue to maturity, you tend to be very careful about the financial status of the homeowner. On the other hand, if you can sell the mortgage without recourse to an investment pool of mortgage-backed securities three days after you issue it, you are likely to be much less fussy about the homeowner’s credit history.

We believe investors relying in this way on the Federal Reserve are confused about the real influence of the Fed. Decades ago, the U.S. primarily had an industrial economy financed by banks. The Federal Reserve led interest rate movements when they raised or lowered their discount rate. With the vast expansion of trading markets and dissemination of economic information, however, bond traders now determine interest rates; the Fed follows the markets rather than leads them.

“[The Fed Chairman is] Oz – working behind the curtains, leaning into the microphone, pressing buttons that blow smoke and fire, but not really having much power at all.”

~ John Hussman

Even if this were not the case, however, the policy instruments officially available to the Fed are blunt and inapplicable to the modern economy. The assumed power of the Fed relies on the premise that there is a significant and reliable connection between bank reserves, bank lending and the economy. There is not. The Federal Reserve now sets reserves only with respect to transactions

deposits (checking accounts), not savings accounts, CDs, money funds or bond mutual funds. The growth of alternative savings instruments has greatly reduced the effectiveness of Fed changes in interest rates or reserve requirements.

The old model of money supply and debt creation in economic textbooks is a dinosaur. Leverage now is created in a multitude of ways from a multitude of sources, many beyond the purview of any regulation or control from the Fed. Banks and various other financial market actors can design options, futures and derivatives that more closely resemble side bets than the textbook model of loans and money. There are no reserve requirements, cash interest payments or standard means of regulation – just the bets.

Finally, even if the Federal Reserve *really* had powerful and effective policy tools at its disposal, would it use them to defuse market bubbles? The Fed certainly did nothing to slow the frenzied boom of the late 1990s, nor did it protect investors from the brutal bear market of 2000 through 2002. People believe the Fed’s job is to control inflation, not prick bubbles. Investors like their stocks to go up; homeowners appreciate rising home values. The impact of any Fed action to slow a financial mania is likely to be increased unemployment and declining investor and homeowner wealth, both politically unpalatable in pursuit of a goal that is, at best, controversial.

Austin Power’s archenemy is Doctor Evil in his underground lair; the Federal Reserve’s enemy is aboveground conduct of investors. Investors, convinced by the Fed of its power, changed their behavior, altering outcomes, and increasing risk for everyone. If you would like investment help from someone who does not rely on the Federal Reserve to save investors from their mistakes, contact us at (503) 419-3938 or www.sigmainvestment.com. As an added benefit, Sigma’s staff speaks in plain, declaratory sentences rather than the fog you hear from Fed governors. By the time you call, we hope to have repulsed the black helicopters.