Quarterly Point of View
Third Mandate? A Less Conspicuous Fed

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Equity prices in the Unites States posted large gains in the first quarter, recovering from declines suffered in the last months of 2018. The rapid rally in prices appears to be fueled, at least in large part, by bets that central banks have now turned 'dovish' and will hold rates steady at low levels. This is contrary to the prior consensus view, even as late as December, that more rate hikes were in store for 2019 and shrinking of the Fed's balance sheet was on schedule. On the surface it would seem to be news to celebrate, but for investors more concerned with long-term economic and market stability, it may not be. We've discussed in the past our view of the Fed's role, but it's time to take another look. It continues to appear as if the Federal Reserve is so concerned about asset markets that it is straying from its mandates, fostering a corrosive environment of moral hazard.

A Little Central Bank History[1]

After the American Revolutionary War, the U.S. government attempted to create a central bank. Dealing with war-time debts and seeking financial stability, the Bank of the United States (now referred to as the First Bank), championed by the Secretary of the Treasury, Alexander Hamilton, was established in 1791. Despite general success in financing the new government and stimulating the economy, a vocal contingency, led by then Secretary of State Thomas Jefferson, united to oppose it. This opposition, worried about increasing federal power that could undermine the new democracy, questioned the Bank's constitutionality and opposed renewal of its charter, which was due to expire in 1811. In that year, by a narrow vote in the House and Senate, the First Bank's charter was not renewed.

Soon after the First Bank was dissolved, economic instability brought on primarily by the impact from British Naval blockades during the War of 1812 necessitated the establishment of the Second Bank of the United States. Once again though - this time under the premise the bank had overextended credit and favored a small group of economic elite - the charter was allowed to expire in 1836. For roughly the next eight decades, the United States would operate without a central bank.

After a series of financial panics, most notably the Panic of 1907 (sometimes referred to as the "Banker Panic" or "Knickerbocker Crisis"), in which a loss of confidence among depositors prompted a run on banks and trust companies, there was again momentum to seek fundamental banking and currency reform. The National Monetary Commission was created a year later to study potential solutions (mainly those that were in use in Europe) that could be implemented in the U.S. The Commission's ultimate findings established the basis for the Federal Reserve Act, which was signed into law by President

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Woodrow Wilson in 1913. The Federal Reserve Act's purpose was to provide the nation with a safer, more stable monetary system by establishing functions for check clearing and collection to all members of the Federal Reserve. All nationally chartered banks were now required to become members. Additionally, member banks were now entitled to have access to loans at the 'discount window,' which helped relieve liquidity strains and provide a reliable source of backup funding. Though there were subsequent amendments to the Act, including the creation of the Federal Open Market Committee (FOMC), which acts as the Fed's monetary policymaking body, nothing altered its essential purpose - that of a safe and stable monetary system. This remained the Fed's only mandate for the next 64 years.

During the 1970's stagflation took hold, a macroeconomic condition by which high unemployment was coupled with high inflation. In response, Congress passed the Federal Reserve Reform Act in 1977 resolving, "to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." Since this point, the Federal Reserve has been viewed to have a dual mandate, that of maximum employment (newly defined in the 1977 Act) and a safe and stable monetary system, the 1913 Act's original intent.

The Current Central Bank

You might be wondering why we are bothering you with this background, but we think it's fundamental to understand the origins and mandate of the Federal Reserve, so that we can view their current workings considering their historical charter. Despite some early positive indications in the tenure of Fed Chairman Jerome Powell, who has been in his post a bit over a year, it again seems as if the Fed operates straying outside of the stated mandates. Since the turn of the century, and particularly today, it has played a role Congress never explicitly granted – the conceptual role of 'risk manager,' under the cloak of 'macroprudential regulation.' In other words, attempting to manage and reduce systemic risks through regulating collective financial system behavior. In outlining the purpose of the Federal Reserve, the Fed's website now includes "maintaining the stability of the financial system and containing systemic risk that may arise in financial markets," as a responsibility. This gray area role could have far reaching, significant consequences.

Giving this risk manager role the benefit of the doubt for a second, the intent is probably well meaning, that "maintaining the stability of the financial system" is congruent with their goal of a safe and stable monetary system. The problem, however, lies with "containing systemic risk." Firstly, the systemic risk they seek to contain is cultivated, in large part, by their own decisions as the all-powerful body able to set the price of money. Holding interest rates at essentially zero for many years attempting to attain one goal, and then in turn trying to police the impact of those rate decisions through other means, is a difficult, if not impossible proposition. Going a step further though, it's the Fed's propensity to identify any material pullback in asset prices as systemic risk that could cause lasting problems.

Let's review some recent events that illustrate the issue. Most stock indices had peaked last September before starting to weaken over trade war concerns, or possibly for no other reason than bull market fatigue. In either case, the Fed continued to be set on its plan to raise rates, even as President Trump broke precedent and complained loudly about Chairman Powell, and that more hikes would hurt the economy (The politicization risk of this institution may be a topic for a future letter). The Fed's statement posted after its December 2018 FOMC meeting noted, "Some further gradual increases in the target range for the fed funds rate will be consistent with sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective." Then, in his press conference after the meeting, Chairman Powell said, regarding normalization of the Fed's bloated balance sheet, "So we thought carefully about this, on how to normalize policy, and came to the view that we would effectively have the balance sheet runoff on automatic pilot and use monetary

policy, rate policy, to adjust to incoming data. And I think that has been a good decision. I think the runoff of the balance sheet has been smooth and has served its purpose. And I don't see us changing that."

In our view, this was a very positive sign, a Fed Chair continuing to normalize rates and shrinking the balance sheet, even in the face of traders (and the President) screaming 'no' as asset prices fell. To us, normalization of rates, after years of anything but normal, was constructive. The market viewed this action differently, however, accelerating its decline in the days after Powell's comments, to finish with a loss of 9% for the month of December, concluding the quarter down 13.52%.

Instead of sticking to its guns and letting the markets be markets, where price discovery between buyers and sellers based on company fundamentals is left to do its indispensable work, the Fed decided, (though not explicitly stated of course), the rough December for stocks posed 'systemic risk.' The January 30th FOMC statement contained the following regarding rate hikes, "In light of global economic and financial developments and muted inflation pressures, the Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate." And with regard to balance sheet normalization it read, "The Committee is prepared to adjust any of the details for completing balance sheet normalization in light of economic and financial developments. Moreover, the Committee would be prepared to use its full range of tools, including altering the size and composition of its balance sheet." Then in February, in his semiannual congressional testimony on Capitol Hill, Powell stated, "Financial markets became more volatile toward year-end, and financial conditions are now less supportive of growth than they were earlier last year."

By all accounts this is just a stunning reversal, all in a month and a half. The about face only makes sense if their mandate is to support asset prices at all costs, but we clearly know their congressional charter states nothing of the sort. Ironically, the mere fact this seems to be the unspoken 3rd mandate of the Fed actually poses much more danger to assets prices over the longer term than leaving markets to function on their own. Why is that? The concept of moral hazard.

Moral Hazard

As we outlined several years ago in our letter "Undermined Incentive for Responsibility,"

> *The concept of moral hazard centers on the premise that people insulated from risk behave differently than people exposed to risk. Insurance companies are well aware, requiring policy deductibles, in part, to promote a shared responsibility by the insured. The term applies to many areas beyond insurance, notably finance and economics, referring to undue risks individuals or institutions are apt to take if they don't bear the consequences of their decisions. The consequences of moral hazard are impossible to quantify, but that doesn't make them any less real. Albert Einstein once said, "Not everything that counts can be counted and not everything that can be counted counts." Moral hazard certainly fits in the 'not everything that counts can be counted' category.*

Our concern is that markets have become so dependent on the Fed they act as if they are insensitive to price, valuation and fundamentals. Over time, as this dependency gets conditioned (and in our opinion we are years into this conditioning), it nurtures instability and misallocation of capital. The very attempts to 'help' the system (i.e. markets) in the short term, end up creating conditions for catastrophic events. It's analogous to the concept of controlled burns, which have a long history in forest management, whereby small burns are intentionally conducted as a hazard reduction technique. A series of small fires allowed to burn in cooler months, will reduce 'fuel' build up in the forest. These are clearly preferable

to larger, hotter fires that cause massive devastation. Allowing small fires reduces the likelihood of large fires. If the market is not allowed 'small fires,' which frankly is all the 4th quarter of 2018 seemed to be, then the Fed is unwittingly creating conditions for a large fire.

Risk of loss is fundamental to a healthy system, it forces prudent decision making, which is diminished by moral hazard. The Federal Reserve needs to do what successful investors do, focus on the longer term, and not 'tinker' from meeting to meeting in constant reaction to the capital markets. Being data dependent as they claim to be is fine, if the data provides a long-term signal, not just short-term noise. On an ever-increasing basis the Fed seemingly reacts to markets, but it would be much healthier for the system if it focused exclusively on its historical mandates of stable prices and full employment. By doing so, it would make itself much less conspicuous – which would be a worthy third mandate.

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Respectfully,

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1. Federal Reserve History, Federal Reserve Bank of Richmond, www.federalreservehistory.org

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