Weekly Market Flash

Bankers Behaving Badly

October 22, 2021

Back in September there was a mini-kerfuffle involving two regional Federal Reserve presidents – Eric Rosengren of the Boston Fed and Robert Kaplan of the Dallas Fed. The scandal involved the active trading in individual securities by both men – both of whom are closely involved in the Fed's deliberations on monetary policy – throughout the pandemic in 2020.

As you will no doubt recall, the Fed was at the absolute epicenter of the economic response to the pandemic. On one day – March 23, 2020 – the Fed announced its decision to step in and bail out just about every conceivable form of credit security in the middle of a panic that was even affecting US Treasury securities. That announcement sent just about every asset class under the sun into a V-shaped recovery that persisted even while the real economy itself was in the ICU and millions of Americans were losing their jobs. Being at the table where these decisions were made would have been just about the most potent inside information anyone could imagine.

Fed Buys Mortgages, So Does Rosengren

A particularly egregious example of these individuals' active trades involved mortgage REITs, which were prominent in Eric Rosengren's account. These REITs hold the very same mortgage-backed securities that the Fed itself buys as part of its quantitative easing program – currently to the tune of $40 billion every month. To make matters worse, Rosengren (like many Fed officials) was a prominent speaker at many of those events where journalists and investors eagerly translate "Fedspeak" into articles and trading strategies. Rosengren was known for talking up the mortgage and real estate market at these events, creating at least the appearance of a blatant conflict of interest.

What Do you Say, Jay?

Rosengren and Kaplan resigned their positions after the scandal made headlines in September. But since then it has become clear that the problem of Fed officials actively trading their accounts while making official policy decisions that will very directly affect the value of those accounts runs deep…it runs, in fact, right up to Fed chair Jay Powell as well as the vice-chair Richard Clarida. Both men were actively moving between bonds and equities at notable times during the pandemic (for example, a shift of $5 million by Clarida from a bond fund to a stock fund during the market downturn last year a couple weeks before the Fed moved to stabilize conditions).

These revelations have led to some damage control measures by the Fed to shore up its credibility: Fed members will now be prohibited from trading in individual stock, bond and agency securities. There are also new requirements for officials to obtain approval by ethics officers prior to a transaction, as well as a blackout period for trading during times of market turmoil (like the March 2020 environment).

Why This Matters

The problem here goes beyond the fact of individual bankers with access to information likely to move markets trading actively for their own accounts. The problem is that the Fed itself is arguably the one major institution in this country that has managed to maintain its reputational credibility – and that credibility is absolutely crucial to the health of the global economy. Ever since the financial meltdown and deep recession of 2008, the central bank has been the one institution capable of taking active measures to prevent economic freefall. The fallout from the 2008 crisis and from the 2020 pandemic would almost invariably have been deeper and potentially calamitous without the Fed's intervention and continual monetary support.

Now, some aspects of this support have been counterproductive – the idea that Job Number One is to bail out asset markets has contributed to the widening inequality gulf that is one of our most pressing problems as a society. It has also provided the groundwork for moral hazard that brought us to a world of meme stocks, cryptocurrencies and other get-rich-quick manias where the question of risk doesn't seem to even enter the conversation. The alternative, though, of not doing anything to stabilize markets would most likely have left everyone worse off – rich, poor and middle class alike.

So when we see news reports where the highest officials within the central bank seem to be acting like Robinhood punters, it diminishes that all-important reputational credibility. For one thing, the scandal has led to higher uncertainty about whether Powell will even be renominated for a second term – a decision President Biden will have to make very soon. That in and of itself could weigh heavily on markets, and this at a time when the specter of more durable inflation is haunting the economy. The 10-year and 5-year breakeven rates – measures of inflationary expectations – are at their highest levels in more than a decade. Fedspeak these days is largely devoid of the "transitory" language of a few months back.

Perhaps even more than at the outset of the pandemic, the Fed is going to need every ounce of credibility to guide a jittery market through this period. Asked what is the greatest risk in the market today, the answer given by many investors is "the day we wake up and the Fed can't solve whatever major problem is at hand." Policy matters for this. Appearances matter, too.

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