INVESTMENT UPDATE

Next month will mark the tenth anniversary of the collapse of Lehman Brothers, the flash point of the 2008 financial crisis. Much has changed since then, so we thought we'd get ahead of the pack a month early and discuss where we stand now, and how the bond market has changed since the dark days of 2008.

We can't talk about the financial crisis and its aftermath without discussing the Federal Reserve. Since we have recently covered the impact of the Fed's balance sheet (and those of other central banks) on the bond market, we'll skip monetary policy and instead talk about the Fed's other major role: regulation. The Fed has come under plenty of criticism for not doing more to help tamp down some of the excesses that allowed this particular economic recession to turn into a near-catastrophe for the global financial system. In particular, we would point to a lax regulatory environment (a shared responsibility with other agencies, including the Comptroller of the Currency and the FDIC) that failed to properly supervise bank operations. Chief among these lax regulations was the inadequate capital that banks were required to keep on their books relative to the size of the risky assets that they held. Former New York Fed Governor Bill Dudley, in a 2016 speech, admitted as much, stating that "the regulatory community did not fully grasp the vulnerability of the financial system. In particular, critical financial institutions were not resilient enough to cope with large scale disruptions without assistance, and problems in one institution quickly spread to others."

Since the crisis, the Fed has implemented a host of new regulations, including stiffer capital and liquidity requirements. To the dismay of those in the executive suites of large banks, these institutions must now undergo annual "stress tests" designed to ensure their institution's ability to survive under adverse economic scenarios—even more severe than those experienced in 2008. The Fed, in fact, has an entire new branch, the Office of Financial Stability, charged with taking a wide-angle view of the US banking system from a risk management standpoint.

In addition to the Fed, there has been a host of additional regulations passed, all designed to protect consumers and help keep the government (and thus, taxpayers) from bearing the costs of future bank bailouts. While a full discussion of these regulations isn't possible in a couple of paragraphs, the so-called "Dodd-Frank Act" is the most prominent. Consumer activists applaud it; bankers and many other financial professionals hate it; consultants who help institutions comply with it are getting rich from it. We try to see it from all sides, and acknowledge that good regulations that are properly implemented help to keep our economy healthy, but with the added caveat that there should be a balance between the benefits from regulation and the costs of complying with those regulations.

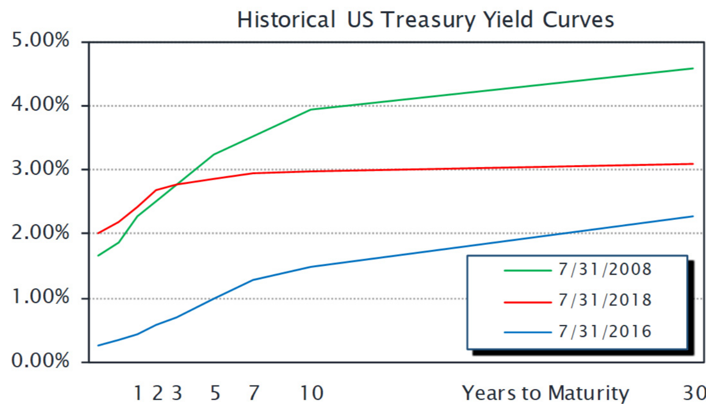
One of the more controversial features of Dodd-Frank is the Volcker Rule, named after ex-Fed Chair Paul Volcker, which was designed to limit banks' proprietary trading activities. Policymakers, in the wake of the crisis, wanted to dial back the systematic risk of the banking system, as bond trading activities (including the re-packaging and re-selling of risky mortgage securities) had begun to resemble a dressed-up casino operation. Large banks have bitterly criticized these regulations, claiming that the Volcker Rule has impaired their ability to "make markets" and hurt market liquidity. The Trump administration has ordered the relevant agencies to revise the guidelines, and those revisions, which will allow greater flexibility in banks' trading operations (while still ostensibly prohibiting "proprietary trading"), are expected to be implemented over the next few years.

Our opinion, based on Agincourt's day-to-day trading activity, is that market liquidity—our ability to buy and sell bonds for our clients' portfolios at favorable prices—has never been better. When we talk about changes to the bond market over the past decade, the emergence of electronic trading platforms, and the transparency that these new systems provide, might be the most important development of all. In addition, the expansion of the TRACE system (which supplies price information on secondary corporate bond trades) since the early 2000s has leveled the playing field between Wall Street firms and investment managers. Naturally, the dealer community is opposed to these developments, and continues to claim (against evidence to the contrary) that transparency is hurting the liquidity of the modern bond market; in fact, all that's been hurt is their ability to extract excess profits from investors who previously had to scramble to find out what bonds were trading and for what price. While it's true that trading volume is down from ten years ago, that's a direct result of the Volcker Rule limiting dealers' proprietary trading operations, which often involved taking massive positions with tiny margins, which neither increased market liquidity nor served clients' needs.

While we're on the topic of the US bond market, it's instructive to take a look at the path that interest rates have traveled during the past decade, and what that means going forward. As the chart on top of the next page shows, ten years ago, the benchmark Treasury yield curve was characterized by relatively

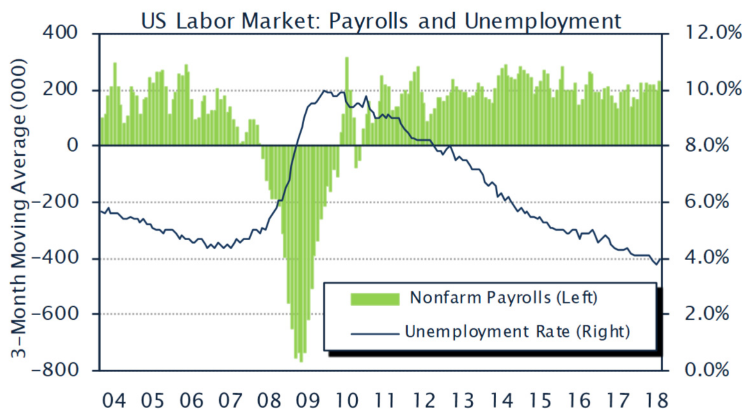
low (sub-2%) short-term rates and much higher long rates, with 30-year Treasuries yielding more than 4.5%. At the time, the Fed had begun to lower the funds rates in response to an already-shaky housing market and growing stress in the banking system. Longer rates remained high, though, as it was wrongly assumed that the weakness would be contained to the subprime mortgage market; just how widespread the problems actually were would soon be revealed.

By 2016, after the Fed had flooded the economy with easy money with no uptick in inflation, long Treasury rates fell to multi-generational lows. Rolling the clock ahead just two years, we see the impact of a slightly stronger US economy and (especially) the Fed's efforts to normalize policy by pushing up the funds rate, which now sits above its level from a decade ago. The relatively flat shape of the current yield curve reflects both the Fed's efforts in pushing up short rates, as well as one of the more perplexing aspects of this recovery—the lack of current inflation, and the absence of much of a yield premium for the risk of future inflation.



Along with the significant changes in the yield curve over the past decade, the corporate bond sector has seen big swings as well. Today, the extra yield demanded by investors to own high-grade corporates has come essentially all the way back from the relatively tight levels seen before the crisis began. This should come as no surprise, since high-grade corporate yield spreads (the incremental yield over like-maturity Treasuries) are highly "mean reverting;" in plain talk, that means that when corporate bond yields get very wide (or narrow) compared to Treasuries, they tend to snap back towards their long-term average. During the crisis, we witnessed investment-grade corporate yield spreads widen to more than 500 basis points, levels not seen since the Great Depression, as risk-averse investors dumped corporate bonds. Yield spreads came back to earth quickly, and since 2012, have traded in a range of roughly 100 to 150 basis points above Treasuries. Further, "all in" yields for high-grade corporates are nudging back up above 4% for the first time in eight years. That's very good news for pension plans and insurance companies, which have been starved for high-quality yield for years.

Finally, let's briefly touch on the economy (a topic regular readers are pretty familiar with). Specifically, there are two main indicators—housing and the labor market—which demonstrate pretty dramatically how far we fell and how much we've recovered since the crisis. The second chart shows both the unemployment rate and the net monthly change in US payrolls before, during, and since the financial crisis. It's easy to forget just how bad the labor market was in the months following Lehman's collapse. The net number of workers added to US payrolls turned slightly negative in early 2008, but by the fourth quarter we were losing more than 700,000 jobs per month, and unemployment spiked, peaking at 10% in October 2009. The loss of jobs was more severe than the US economy had ever witnessed, and it took six and a half years to get those lost jobs back, longer than in any recovery since the Great Depression. As the chart shows, today the labor market continues to plug along, as employers have been adding an average of 200,000 new jobs every month for the past three years, strong numbers roughly nine years into a recovery. Likewise, we have an unemployment rate that hit 3.8% in May, the lowest rate since 1969.



The catalyst for all this trouble ten years ago was the US housing market, which, after seeing spectacular price gains, cracked under the strain of poor underwriting, an overbuilt market, and rank speculation. Home prices, which were previously seen as unassailable, sank like a lead balloon after peaking in mid-2006. Within three years, average US home prices were down 30%, and they stayed at depressed levels for another three years, hitting a trough in early 2012. Home prices were so slow to recover that it wasn't until earlier this year that home prices finally got back to the levels of the previous 2006 peak—a full 12 years. These are national averages; prices are well above the previous peaks in some markets (Dallas, Denver) while in others (Las Vegas, Phoenix) home prices are still 20-25% below the previous highs.

So that's a quick update on the US bond market's recovery from the abyss (fortunately for you we only had two pages to work with!). And on this occasion, we'd like to wish Ben Bernanke, Tim Geithner, and "Hammerin' Hank" Paulson a happy 10th anniversary—and a good retirement to all three!