John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday May 27, 2020

It was close, very close. The pessimists almost had a victory. Here are the headlines from an article by Justin Baer in the *Wall Street Journal* on May 20:

"The Day Coronavirus Nearly Broke the Financial Markets.

The March 16 stock crash was part of broader liquidity crisis that threatened the viability of America's companies and municipalities."

The article is both informative and scary. The drivers of the near catastrophe were fear, intensified by a surprise easing in monetary policy by the Federal Reserve and overregulation of the banks by the Dodd Frank, post 2009 crisis, legislation.

On Sunday March 15 at 5:00 PM the Federal Reserve surprised traders, investors, and economists by announcing a plan to slash interest rates and buy $700 billion in bonds. In ordinary times that announcement would have been greeted with a cheer. In March it had the opposite effect. The Federal Reserve was not expected to announce anything that Sunday because there was a planned meeting on Wednesday March 18.

"Rather than take comfort in the Fed's actions, many companies, governments, bankers and investors viewed the decision as reason to prepare for the worst possible outcome from the coronavirus pandemic. A downdraft in bonds was now a rout."

Here is more of Justin's story of what happened when the futures market reacted to the Fed's surprise.

"An urgent call reached Ronald O'Hanley, State Street Corp.'s chief executive, as he sat in his office in downtown Boston. It was 8:00 AM on Monday, March 16.

A senior deputy told him corporate treasurers and pension managers, panicked by the growing economic damage from the COVID-19 pandemic, were pulling billions of dollars from certain money-market funds. This was forcing the funds to try to sell some of the bonds they held.

But there were almost no buyers. Everybody was suddenly desperate for cash.

He and the deputy, asset-management executive Cyrus Taraporevala, had spoken the night before, wrestling with how investors would respond to an emergency interest-rate cut from the Federal Reserve.

Now they had their answer. In his 34 years in finance, Mr. O'Hanley had weathered plenty of meltdowns, but never one like this.

"The market is fearing the worst," Mr. O'Hanley told him.

March 16 was the day a microscopic virus brought the financial system to the brink. Few realized how close it came to going over the edge entirely."

Money-market funds are familiar financial vehicles. Individuals use them to hold cash because they are safe and usually pay a slightly higher interest rate than a bank deposit. But few realize that money-market funds play a much larger role in keeping the economy liquid. Companies have long relied on money-market funds that invest in short-term corporate and municipal bonds, considered safe and liquid enough to be classified as "cash equivalents." They are used by companies like checking accounts, storing money temporarily for payrolls, office leases and other necessary expenses.

On Monday March 16, investors no longer saw certain money-market funds as "cash like." They suddenly pulled out billions of dollars. Money-market mangers struggled to raise enough cash to meet redemptions.

"In theory, there should have been some give in the system. U.S. regulators had rewritten the rules on money funds in the wake of the 2008 financial crisis, replacing their fixed $1 price with a floating one that moved with the value of their holdings. The changes headed off the panic that could ensue when a fund's price "breaks the buck," as one prominent fund had in 2008. But the rules couldn't stop a panicked assault like this one.

This was bad news for not only those funds and their investors, but also for the thousands of companies and communities dependent on short-term loan markets to pay their employees." (Justin Baer)

The Sunday Fed surprise dealt another unwanted shock to financial markets. Companies had taken advantage of super low interest rates by selling long-term bonds and using them as collateral for bank loans. When interest rates were pushed further down by the Federal Reserve, the prices on all those bonds fell sharply, meaning that more collateral was required. But the banks couldn't take on more collateral because of risk limits imposed by the Dodd Frank rules and regulations. In other words, capital rules intended to make the financial system safer were draining badly needed liquidity from the markets.

Mortgage-backed bonds were also crushed. The Fed's Sunday surprise included $200 billion for mortgage-backed bond purchases. But that turned out to be nowhere near enough. "On that first day, the Fed got completely run over by the market," said Dan Ivascyn, manger of one of the world's biggest bond funds.

As Justin Baer explains, state and local communities were also threatened by the Monday bond rout: "Terrified investors ditched municipal debt at fire-sale prices,

underwriters canceled billions of dollars worth of deals and new borrowing stopped. There was less bond issuance in the week of March 16 than at any point during the 2008 crisis, the 2001 terrorist attacks or the week of 1987's Black Monday, according to Refinitiv data, adjusted for inflation."

States and local communities rely on short-term municipal debt to cover every day operating expenses including payrolls. Bond dealers buy the debt and then resell the bonds to investors. On Tuesday March 17 billions of dollars worth of that kind of municipal debt went up for sale. Interest rates on municipal bonds had been hovering around 1.28%. But Tuesday morning it looked as if those interest rates were going to soar to 6%, if the bonds even then could be sold. At the same time banks and other municipal bond dealers were cancelling billions of dollars worth of deals. In other words, many state and local governments were about to run out of cash.

The Federal Reserve did come to the rescue of the bond markets including the municipal bond market. But it wasn't until March 30 that the municipal bond market became fully liquid again.

To its credit the Federal Reserve did respond quickly to the crisis, pumping more than a trillion dollars into the bond markets. As one trader said, the Fed brought us back from the brink of depression.

Still there were losses. JD Capital Management said that the firm's Tempo Volatility Fund lost 75% or more for the month of March.

Allianz Global Investors, a division of the giant German insurance company said on March 25 that two of its funds worth nearly $2.3 billion would be liquidated and that one of the funds was down about 97%.

We can all breathe a sigh of relief and send a thank you to the Federal Reserve. The unintended consequences from the Dodd Frank bill should be a lesson to our politicians. But listening to the rhetoric as we head for November elections, I am afraid that the politicians have learned nothing from this near catastrophe. If anything, many want to impose more regulations on banks and other players in our financial markets. That would, of course, lead to more unintended consequences in a future crisis. Hopefully, voters will be critical and dismiss the worst of the political lot.

I will have the next market review and update one week from today on Wednesday June 3, 2020.

All the best,

John Dessauer

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