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## Quarterly Market Commentary

January 2016

### A Report Card on the Federal Reserve Bank: The Panic of 2008 through 2015

The system is going to collapse in the next few days. I doubt that you will be able to open the banks on Monday. People are shorting financial institutions, they're withdrawing money from brokerage firms because they don't want to be the last people in - like in Lehman - which is going to lead to the collapse of Goldman and Morgan Stanley ... you have to do something.

Steve Schwarzman, Chairman, Blackstone Group to Henry Paulsen, Treasury Secretary, September 17, 2008, *Too Big to Fail*, Andrew Sorokin

When I was at the Federal Reserve, I occasionally observed that monetary policy is 98% talk and only 2% action.

Ben Bernanke's Blog, March 2015

In recent months, there have been two contributions to the history and legend of the Panic of 2008. One is the publication of Ben Bernanke's book, *The Courage to Act: A Memoir of a Crisis and its Aftermath*. The second is the release of the movie, *The Big Short*, based on Michael Lewis's bestselling book by the same name. Accordingly, this may be an opportune time to cast a backward glance at the steps taken by the Federal Reserve Bank (Fed) and the U.S. Treasury (Treasury) during the Panic and the Fed's monetary policy over the past seven years to judge how effective their policies have been - both during the crisis and since the Panic ended. Were the steps that the Fed and the Treasury took vital in countering what U.S. Treasury Secretary Paulsen called "the economic equivalent of 9/11"? How effective were Chairman Bernanke and the Fed in their policy of massive monetary expansion which lasted from late 2008 through most of 2015? And, what is the prognosis for the markets if Fed Chair Janet Yellen raises the Fed Funds rate several times in 2016?

The Panic of 2008 brought the U.S. to the brink of systemic financial collapse, and contrary to the above quote by Ben Bernanke, the Fed worked feverishly, in concert with the Treasury, Congress, and Presidents Bush and Obama in the fall of 2008 and the winter of 2009 to avoid the failure of the banking system and a depression reminiscent of the 1930s. Although this took place seven years ago, some of us remember the failure of large banks, the freezing of money market funds, the collapse in the commercial paper market, and the 57% decline in the S&P 500 Index as if it were yesterday. In fact, many stock market investors were so traumatized by the Panic of 2008 (which lasted until March, 2009) that they have still not put their money back into stocks, thereby missing a seven-year bull market. What were the origins of the crisis?

#### Origins of the Crisis of 2007 - 2009

In *The Courage to Act*, Bernanke ascribes the onset of the crisis to three factors: the rapid run-up and subsequent collapse of housing prices, a breakdown in discipline in mortgage lending (particularly in subprime lending) and risky lending to commercial real estate developers, and huge global demand for

financial assets perceived to be safe. Quite remarkably, there is not a word in his book about the role the U.S. government played in fueling the subprime lending debacle. During the Clinton Administration, HUD set annual targets for Fannie Mae and Freddie Mac's purchases of subprime mortgages, and by 1996, they mandated that 42% of all mortgages purchased by these Government Sponsored Enterprises (GSEs) must be subprime. By 2002, Fannie and Freddie had acquired \$1.2 trillion in subprime and other weak mortgages, and by February 1, 2006 when Bernanke became Fed Chairman, there was \$3.4 trillion on their balance sheets. 31 million loans - more than half of all U.S. mortgages - were subprime or otherwise problematic. 76% of those mortgages were on the books of GSEs - principally Fannie and Freddie. It was the government's drive to increase the percentage of homeowners in America, by weakening lending standards, which was the primary cause of the debacle. Rather than maintaining vital credit standards of requiring a down payment of 20% when purchasing a home (as Canada did, thereby escaping a financial crisis), mortgages were underwritten with as little as 3% down, and Alt-A loans, requiring no documentation verifying income and assets, were widespread. Another key factor in the crisis was the fact that Bernanke's predecessor at the Fed, Alan Greenspan, kept the Fed Funds rate below 2% for almost three years from 2002-2004. This helped to encourage the housing boom and its later collapse. Bernanke clearly did not wish to criticize his predecessor for the hand which Greenspan dealt him nor the politicians and government officials who helped cause this nightmare. Accordingly, his memoir comes across as rather shallow and insipid.

In the movie, *The Big Short*, Hollywood ascribes the origins of the crisis solely to the greed and fraudulent behavior of mortgage brokers, investment bankers, and the rating agencies - Moody's, Standard & Poor's, etc. Long rants in the movie indict the entire U.S. financial system as fixed against the man-on-the-street. At the conclusion of the movie, the narrator repeatedly intones that ultimately bankers and some politicians blamed the crisis on "the poor and the immigrants." It is unfortunate that the author of the book, Michael Lewis, allowed his highly insightful and amusing book to be turned into such a slick film, dominated by the theme of envy and class warfare. While mortgage brokers, bankers of all stripes, and rating agencies played their part in causing the crisis, there is ample blame to go around - including, of course, legions of borrowers who took on debt far above their capacity to repay and the government which mandated high quotas of weak mortgages in order to expand home ownership.

### **Key Steps Taken to Stem the Panic**

Central Bankers around the world invariably follow Walter Bagehot's rule of providing massive liquidity to the market in seeking to curb a financial panic. Bagehot, in his 19th century book, *Lombard Street*, approvingly summarized how the Bank of England stemmed the crisis of 1825 by quoting a senior Bank of England director: "We lent it (money) by every possible means and in modes we had never adopted before. We took in stock on security, we purchased Exchequer bills, we made advances on Exchequer bills ... in short, by every possible means consistent with the safety of the Bank [of England]." Fed Chairman Bernanke and Treasury Secretary Paulsen pursued exactly the same course, and it unquestionably prevented a systemic collapse in the United States and throughout most of the developed world. Here is a brief list of the steps that were undertaken between September 2008 and March 2009:

- The Fed initiated a program of Quantitative Easing (QE 1), tripling the Fed's balance sheet to \$2.8 trillion, thereby providing massive liquidity to the market

- The Treasury purchased commercial paper when even GE and American Express could find no buyers to buy their paper when it rolled over
- The Fed brought the Fed Funds rate to .25% or less by December, 2008
- The Treasury guaranteed money market funds and encouraged the FDIC to raise the guarantee on bank deposits up to \$250,000 per depositor
- The Fed pressured the SEC to ban shorting of financial stocks
- The Treasury assumed control of Fannie Mae and Freddie Mac through conservatorship
- The Treasury pumped almost \$188 billion into Fannie Mae and Freddie Mac to maintain their solvency
- The Fed and the Treasury jointly saved AIG, committing up to \$182 billion so AIG could meet its obligations
- The Fed played a major part in ensuring the solvency of key financial institutions such as Citibank, Bank of America, Goldman Sachs, and Morgan Stanley
- The Fed and the Treasury worked with President Bush and the Democratic leadership of the House and the Senate to pass TARP, providing \$700 billion in capital to banks and later Chrysler and General Motors
- The Fed created stress tests for the major banks with results publicly disclosed to restore sound capital ratios and help restore confidence in the banking system

### Was Taxpayer Money Used to “Bail Out” Wall Street Ultimately Repaid?

According to ProPublica, a total of \$618 billion of taxpayer money was disbursed to banks and other financial institutions, Fannie and Freddie, AIG, auto companies, and other entities during the crisis. Currently, \$681.1 billion has been received back by the U.S. government from these programs from repayments and capital gains, dividends and interest, resulting in a net gain to taxpayers of \$63.1 billion. As can be seen below, the only major shortfall in taxpayer money being repaid was in the case of the auto companies, which came up short by over \$20 billion.

Thus, we can cheerfully ignore the many politicians and demagogues who endlessly repeat the mantra of “Main Street bailing out Wall Street.” Yes, taxpayer money was used to curb the Panic, but the disbursements were structured wisely so that taxpayers have ultimately benefited from these programs.

	“Taxpayer Money” <u>Invested or Lent*</u>	<u>Money Repaid</u>
TARP (banks)	\$245.5 billion	\$275.4 billion
TARP (Chrysler & General Motors)	\$ 79.7 billion	\$ 57.9 billion
AIG	\$ 67.8 billion	\$ 90.5 billion
Fannie and Freddie	\$188.0 billion	\$228.0 billion

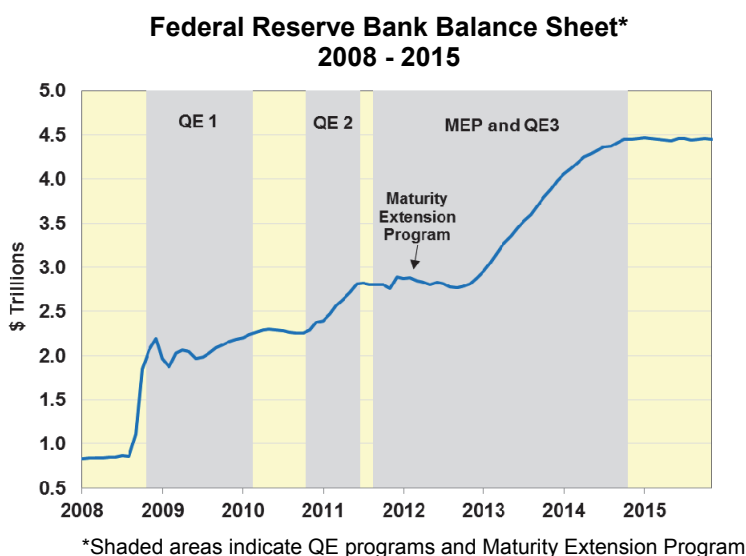
\*Does not include smaller programs

Based upon the record of what Ben Bernanke, in conjunction with Henry Paulsen and Tim Geithner, accomplished during the Panic of 2008, they deserve very high marks indeed.

## Federal Reserve from March 2009 - 2015

During the nearly seven years since the Panic ended in March, 2009, most of the burden of resuscitating the U.S. economy has fallen on the shoulders of the Fed. In order to produce a robust, healthy economy with annual real GDP growth above 3%, both sound fiscal and monetary steps needed to be taken. But fiscal policy has contributed little to the re-ignition of robust economic growth both in the U.S. and abroad. Rather than crafting pro-growth policies of tax reform, easing of regulatory policies, and structural reform in government welfare programs, the U.S. has moved in the opposite direction, imitating many of the social welfare programs of European nations. The result is that the U.S. has the lowest level of labor participation in its workforce since 1979. Since the “Great Recession” ended officially in the U.S. in June, 2009, the U.S. has experienced the weakest economic recovery since the Great Depression. Unfortunately, GDP growth in Europe and Japan has been even more anemic.

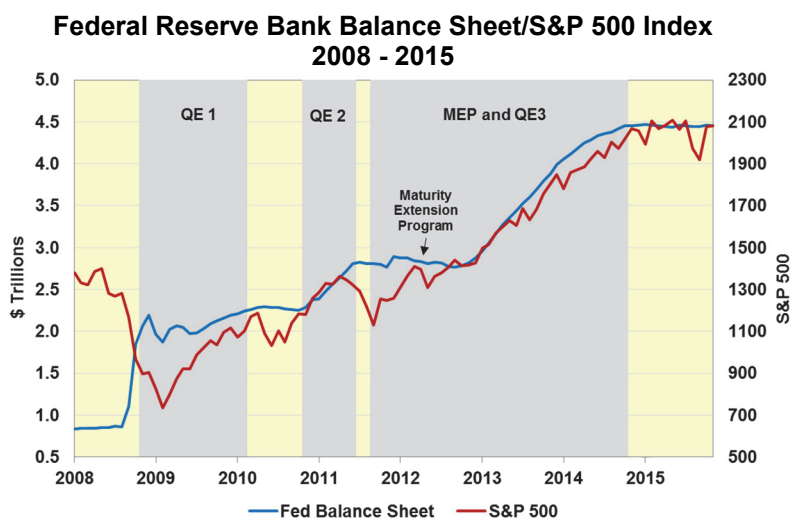
Thus, the monetary policies of the Fed were needed to prevent the scourge of deflation, lower the unemployment rate, promote economic growth, and maintain the value of the dollar without much help from the congressional or executive branches of government. The Fed has pursued these goals utilizing two intertwined strategies: keeping both short- and long-term interest rates at rock-bottom levels and implementing a program of extraordinary monetary liquidity. The first program of Quantitative Easing (QE1) commenced during the darkest days of the Panic in December, 2008 and lasted until March, 2010, with over \$1.3 trillion of mortgage-backed securities (MBS) and other debt instruments purchased by the Fed. QE2 was launched in November, 2010 and lasted until June 30, 2011, adding another \$600 billion to the balance sheet of the Fed. And QE3 began in September, 2012, with the Fed purchasing \$85 billion a month primarily of U.S. Treasuries and MBSs. Each of these programs injected large amounts of liquidity into the U.S. economy and caused the Fed’s balance sheet to expand dramatically as the chart below shows:



Sources: "Financial Crisis Timeline: Collapse and Bailout,"  
bankrate.com, 1/30/2013; and thechartstore.com, 2012

There appears to be a correlation between the path of the U.S. stock market and the Fed’s monetary policy. On several occasions, the U.S. stock market seemed to run out of steam but was reinvigorated with fresh injections of money by the Fed. This comes as no surprise. After all, liquidity and low interest

rates are two of the most important factors in the positive performance of the stock market. The chart below tracks the action of the S&P 500 Index alongside the growth in the balance sheet of the Fed:



Sources: "Financial Crisis Timeline: Collapse and Bailout," bankrate.com, 1/30/2013; and thechartstore.com, 2012

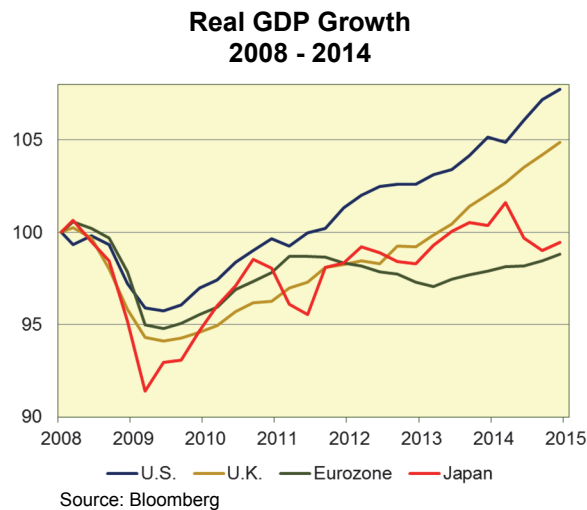
By leaving the heavy lifting of growing the economy to the Fed through its monetary policies, the current administration has produced the polar opposite of what it announced it was seeking to achieve – raising the wealth and income levels of the working and middle classes. The policies of higher taxation, greater regulation, and broader governmental control of various sectors of the economy have produced the weakest economic recovery in modern times with very little growth in wages and income. On the other hand, those households that had previously accumulated real estate, stocks, and bonds have seen their wealth rebound since the crisis and even increase, due in large part to the abnormally low interest rates, which had the effect of increasing the value of real assets. This is one of the main reasons for the high concentration of wealth in proportionately fewer hands. Also contributing to this disparity in income and wealth is America’s extremely generous immigration policy, through which more than 35 million immigrants have come to America since 1970, the great majority arriving with little education, modest earning power, and few financial assets. This wave of immigration, not to mention the 11 million or more illegal immigrants who live in America, represents more than 10% of the U.S. population and naturally accentuates income inequality in the short run.

### Federal Reserve Bank Report Card – Post Crisis 2009 - 2015

In assessing the performance of the Fed during this admittedly difficult economic period both here and abroad, we will begin with the positive, with the things that the Fed got right. First and foremost, the Fed’s policies of monetary easing on a scale heretofore unknown in economic history was largely responsible for preventing the global economy from descending into a destructive deflationary spiral. With Japan already experiencing deflation and Europe on the brink, Bernanke, whose academic expertise focused largely on deflation during the Great Depression, realized the economic, social, and political costs of deflation. In a speech in 2002, when Greenspan was still Fed Chairman, Bernanke said that the monetary authorities needed to do whatever was necessary to avoid deflation, including dropping money from a helicopter – a phrase that he borrowed from Milton Friedman who dubbed

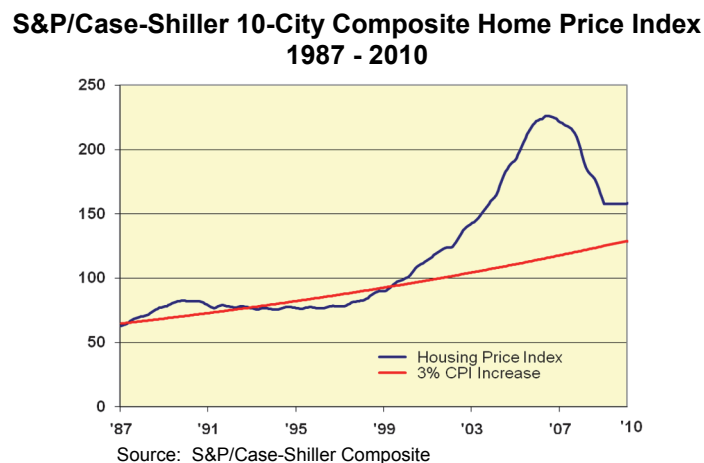
this approach a “helicopter drop.” Henceforth, Bernanke was known as Helicopter Ben, and indeed he flooded the economy with money and kept the Fed Funds rate at 0-.25% from 2008 until 2014 when he stepped down as Chairman of the Fed. And it worked; the U.S. experienced inflation of 1-2% for most of this period.

The Fed’s other major achievement was bringing the U.S. back from the brink of a terrible recession. During the crisis, U.S. GDP dropped 4%, which produced the term the “Great Recession.” However, by the third quarter of 2009, the U.S. economy reversed its decline and began to expand, and the economy continued to grow modestly over the next five years. In his book, Bernanke points to the fact that the U.S. output of goods and services at the end of 2014 was 8% higher than at the end of 2007, the pre-crisis peak. He admits that this growth over a seven-year period is “not great,” but points to the fact that it was better than the rest of the developed world, as the chart below demonstrates:



As indicated above, the U.S. economic recovery from the Panic was the weakest since the Great Depression, but the economy did recover and grow modestly, exceeding the growth rates of Germany and the U.K. For this, Bernanke deserves some credit.

On the negative side of the ledger, Bernanke and the Fed never appear to have understood the origins of the crisis. By the time Bernanke became Chairman in February, 2006, he was aware that a large housing bubble had developed, as the following chart demonstrates:



Although aware of this housing bubble – the largest in U.S. history – Bernanke and his team did not seem to understand the forces that caused it, as discussed earlier in this commentary. Peter Wallison wrote in a recent *Wall Street Journal* opinion-editorial piece that Mr. Bernanke famously told Congress in March, 2007 that “the impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained.” Appearing before the House Financial Services Committee with Paulsen in July, 2008, Bernanke still was unaware of the real causes of the crisis and writes that he testified that he was “eager to focus Congress on the gaps in financial regulation.” And with Bernanke’s blessing, the Democratic-controlled Congress passed the 2,139-page Dodd-Frank Act in 2010, which was named after two of the most vocal supporters of the very “affordable housing” policies which led the U.S. to near systemic financial collapse. The overreaching regulations of the Dodd-Frank Act are among the key contributors to the anemic growth rate of the U.S. economy in recent years. It has paralyzed many small and community banks with huge regulatory costs, and it has led to reduced lending to small firms and start-ups. It is axiomatic that job growth in the U.S. comes not from the largest 1,000 firms but from small businesses and start-ups, which rely on smaller banks for the credit needed to launch and expand their businesses.

Another questionable result of the Dodd-Frank Act was the establishment of the Consumer Financial Protection Bureau (CFPB) whose mission is to go after “bad actors” in the financial industry and protect consumers. But, as usual, the unintended consequences are hindering the flow of credit from auto lenders and others for fear of contravening CFPB rules and regulations.

Finally, Bernanke and the Fed have unquestionably harmed a large number of seniors by keeping interest rates so low for so long. Retirees and seniors, who saved their entire lives and planned to live off their fixed income investments, have been severely penalized. Instead of yields of 4-6% on bonds and other fixed income instruments, high-quality, intermediate-term bonds now yield 1-2.5%. This low interest rate policy has helped borrowers but not savers who have been penalized in their retirement.

In summary, balancing the positives and negatives during Bernanke’s chairmanship of the Fed, a grade of B- or C+ seems appropriate.

### **How Will This Experiment in Quantitative Easing End?**

There is no shortage of market strategists and pundits who predict that the Fed’s policies of zero interest rates and massive monetary expansion for the past seven years will end badly. On December 16, 2015, the Fed increased the new target range for the Fed Funds rate from 0-.25% to .25%-.50%. According to Fed Chair Yellen, the rate increase, approved unanimously by the voting Governors, was based on the improvement in the economy and the labor markets and the expectation of higher inflation in the U.S. Nevertheless, the Fed Funds rate is still at a very low level. (According to the St. Louis Fed using data extending back to 1954, the effective Fed Funds rate never dropped below .63% until 2008.)

Investors hate uncertainty even more than bad news, and there is much uncertainty about where the Fed Funds rate will be by year-end 2016 and beyond. The consensus of economists and market strategists is that the Fed Funds rate will gradually increase to 1.375% by the end of the year through three or four small Fed Funds interest rate hikes, but these are just guesses. Yellen has merely assured the public that the likely trajectory of rising interest rates will be modest.

In crafting monetary policy going forward, the Fed is caught between the rocks of Scylla and Charybdis. China has been one of the key drivers of global economic growth over the past decade, and the events in China over the past six months – the devaluation of the yuan, stock market plunge, and capital flight – clearly indicate an economic slowdown in the world’s second largest economy. These developments in China, together with no or low GDP growth in Japan and the Eurozone, will continue to create deflationary pressure globally – hence the policy of massive monetary expansion in the U.S. which has been followed in Europe and Japan. These factors militate against raising the Fed Funds rate much if at all in 2016, as the Fed’s policies over the past seven years have first and foremost been to avoid the destructive deflationary spiral which occurred in the 1930s.

On the other hand, zero interest rates and easy credit distort markets. They can create bubbles in the economy. Was the run-up in oil prices caused in part by energy producers dependent on cheap credit? Did zero interest rates cause investors to seek higher yields in junk bonds, which cratered last year? Are some of the huge mergers taking place only possible with quick and easy financing? And who knows what the next big problems will be? The Fed also has to consider the effect of higher interest rates on the U.S. dollar. U.S. interest rates are already higher than those in Japan and much of Europe, and as the Fed raises interest rates, money will likely flow into the U.S., thereby increasing the value of the U.S. dollar. A stronger U.S. dollar will hurt U.S. exports and cause market disruption abroad – especially in emerging markets.

In summary, one can only speculate about the ultimate results of the Fed’s past policies and how higher interest rates will affect U.S. markets. We are in uncharted territory. The main thing for investors to remember is that over the long run, stock prices correlate closely to earnings. And U.S. corporate earnings are forecast to rise this year. The U.S. economy has chugged along at a 2%+ pace over the past few years, and it seems likely that it will continue to do so in 2016. With dramatically lower energy prices, modest inflation, and higher earnings, we believe that the Fed should be able to increase short-term rates without causing a bear market in the U.S. stock market. So we advise investors not to get scared out of the market but to continue to invest in quality names for the long haul.

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