



Ch-Ch-Ch-Changes

RISKS AND STRUCTURAL CHANGES IN THE GLOBAL MARKETPLACE

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A new mandate has emerged for central bankers that requires more active involvement in the capital markets.

Today is a fantastic time to be an investment professional. Dynamic modeling is throwing conventional asset allocation programs on their edges and raising questions about what we have long assumed. The speed of innovation, due to technological advances in processing and analytics, has improved information flow and risk management. Demographic trends in healthcare and the advancement of the middle class in emerging economies have expanded the consumer economies of the world. Market interconnectedness has increased, and the speed and ease of capital flows have improved. We are in the midst of the information revolution and it is all very exciting.

But, with advancement comes significant change. Advancements often outpace the market's ability to respond, increasing structural risks and creating market inefficiencies. Market inefficiencies occur episodically, transcending geographies, asset classes and structures. Some are market driven, such as those driven by irrational exuberance, and others are related to legislative actions. This discussion will address some current and potential inefficiencies resulting from structural changes in today's global markets.

THE MEN (AND WOMEN) WHO SOLD THE WORLD

In the wake of the Global Financial Crisis, a new mandate emerged for central bankers that required more active involvement in the capital markets. Central bankers must now focus on financial market stability as much as on unemployment and price stability. In fact, in many economies, both emerging and developed, central banks have become permanent, significant, and large market participants, whose impact is observed across diverse markets, including bank and non-bank lending activities and residential and commercial real estate pricing.

It has been nearly 30 years since the 1987 stock market crash and the initial foray of the moral hazard then dubbed the "Greenspan Put". However, this radical injection of capital into the markets to salve panic and stave off disaster has been used by the Federal Reserve multiple times since then, including in the wake of the currency crises of the late 1990s to halt the "Asian Contagion", and in the early 2000s during



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the explosion of the “dot-com bubble”. More recently, central bank activities have included direct injections of capital into banks during the Global Financial Crisis, and rounds upon rounds of asset purchasing activities masked by the term “quantitative easing”, in an effort to manage market volatility.

It is apparent to market makers and investment professionals that central bankers will act if called upon, akin to calling the Dark Knight when all else fails. However, the moral hazard of this “put option” is very real and incentivizes greater risk-taking today, with the expectation of a rescue tomorrow. As the perception of danger decreases, compensation for engaging in risky activities decreases to a point where risk and returns are no longer in concert.

DANCING IN THE DARK

At the same time as the world’s central bankers increased their participation in the market, a long period of loose regulation came to a halt. Prior to the Global Financial Crisis, Wall Street experienced a long period of relaxing rules, culminating in the late 1990s with the reversal of the Glass-Steagall Act. After witnessing the effect of letting banks become “too big to fail”, politicians attempted to prevent another crisis through legislation. Although the implementation of the Volcker rule of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Basel III and the Solvency II Directive is incomplete, those governed by these and other regulatory acts have been guided to conservatism, which impacts traditional lending activities and market liquidity.

As we all know, in response to the excesses of the roaring 2000s, global regulatory bodies are, and will continue to be, suspicious of the market’s ability to exhibit self-control. The proposed guidelines, however, are opaque, and clear and consistent interpretations do not currently exist. Regulations are putting market participants in the dark, as we remain uncertain of other contributors, their roles and the rules of the dance.

With this type of uncertainty comes great opportunity. So far, we’ve seen the further development of the shadow market for lending. A growing portion of corporate lending activity is managed by non-bank institutions that are not governed by regulators and, therefore, are permitted to lend to whomever they want, under whatever terms they want. Historically, lending has been a long-term commitment between borrower and lender; a relationship that begins as an economic agreement but transcends this financial transaction to become a broader partnership. Under the current regime, the focus is primarily on the economic benefit to the lender. Therefore, borrowers’ long-term planning activities may be impaired as the viability of the long-term relationship may be at risk under differing scenarios.

The perceived result of increased regulatory oversight is greater stability and a safer marketplace. Although that may be true in part, the perception of safety will be proven when dancers remain standing even when the music changes or stops.

UNDER PRESSURE

The rise of shadow banking, an unregulated and undefined capital source, is a minor indicator of market inefficiencies. The expansion of Collateralized Loan Obligations (CLOs) and Exchange Traded Funds (ETFs) has allowed institutional and retail investors to access capital markets that have historically been difficult to manage. The involvement of the average person in these traditionally complex markets could have a devastating impact.

CLOs are structured investment vehicles that contain a diversified pool of corporate loans and allocate risk across a series of horizontal tranches determined by ratings characteristics and market demand. The structure is created with rating agency guidelines and provides access to specific tranches of risk for individual investors. The CLO manager’s incentive is to manage the underlying collateral pool such that

the vehicle remains intact throughout its life and performs as expected. These are locked up vehicles with minimal rights to collapse the structure and unwind early. However, in difficult markets, structural protections may become strained and active management may require sales of individual loans at inopportune times to maintain credit worthiness. Such sales may be made in environments of minimal liquidity, and at fire sale prices, resulting in huge losses for investors.

Similarly, ETFs are structured vehicles that provide access to a market or market basket. Historically, ETFs targeted highly liquid assets, like listed equities, but have increasingly ventured into less liquid products, such as investment grade and even non-investment grade corporate debt. ETFs have daily liquidity triggers, which can result in a mismatch with the liquidity profile of the underlying or referenced portfolio. In addition, ETFs are often created using synthetic collateral pools, which introduces counterparty risk to the structure. In the case of a liquidity mismatch or counterparty default, the resulting ripple effect could have catastrophic consequences.

Finally, the market interpretation of the Volcker rule has been that banks may not operate proprietary trading activities. Regulators do not want financial institutions risking customer deposits on their own investment activities. Here, we insert the law of unintended consequences. Most fixed income trading operations, including non-investment grade debt, are over-the-counter businesses, meaning that the market between buyer and seller is discrete. Historically, investment banks acted as principal and acted as the counterparty for buyers without sellers, and vice versa. Essentially, investment bank trading desks provided liquidity to the market, which was particularly important in volatile markets. Unfortunately, market makers that serve this function are rare today, as very few are not regulated by the Volcker rule or are capitalized to take risk.

In highly volatile markets, when the stabilizing force of a well-capitalized institution is most needed to provide a backstop, market makers and market participants that historically provided liquidity are absent. It is in these periods of extreme volatility that CLOs and ETFs are likely to flood the market with sell orders. This combination could make for a highly combustible cocktail.

GOLDEN YEARS

Geopolitical interdependence and interconnectedness have contributed to momentary rises in volatility and higher frequency of “black swan” events. As the occurrence of episodic volatility has increased, the reliance of capital on liquidity has also increased. Retail capital flows impact underlying pricing and valuations across asset classes. Over-the-counter, “less liquid” products, such as bonds and loans, form the basis of liquid investment vehicles, creating an imbalance in capital markets. Concurrent with this increasing reliance on liquidity, regulations that limit the ability of broker/dealers to carry inventory may unintentionally result in decreased market-making activities by broker/dealers when volatility spikes.

Despite significant reductions in private capital leverage, lending activity and velocity of capital remains historically high, which implies high market liquidity. On the other hand, as capital velocity slows, as it does in highly volatile markets, the flow of capital becomes more viscous, market structure breaks down, and the ability to finance operations and assets declines.

The combination of increasing volatility and decreasing liquidity in a market that increasingly requires “normal” behavior and measurable risk, contributes to periodic inefficiencies and investment opportunities.

So, here we are in a market with new, large players who have different mandates and expectations, contending with opaque rules and structural impediments for liquidity and stability when we might need them the most. Pretty soon, it will be time to turn and face the strain.

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