

Moral Hazard

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Moral hazard is a concept that does not get talked about a lot in day to day investment commentaries but at Tacit we believe it is something that poses significant risks and therefore should be considered carefully.

In economics, moral hazard occurs when an entity has an incentive to increase its exposure to risk because it does not bear the full costs of that risk. For example, when a company is insured, it may take on higher risk knowing that its insurance will pay the associated costs. A moral hazard may occur where the actions of the risk-taking party change to the detriment of the cost-bearing party after a financial transaction has taken place.

Our current concerns about moral hazard in financial markets stem from an event which occurred in 1998. Twenty years ago, a little-known investment fund, Long-Term Capital Management (LTCM), lost 92 percent of the fund's capital suddenly and was deemed a risk to the stability of the global financial system. Within a month, the fund was bailed out by the New York Federal Reserve much to the astonishment of many market participants.

Why would the Federal Reserve use its money to bail out a fund that had taken bad decisions and lost a lot of client money? At the time, the Federal Reserve's intervention seemed limited: no government funds were used and no sanctions were imposed. But it was clear that the Fed needed the deal to happen as it deemed this a "Systemic risk." The Fed was worried that a fire sale of LTCM's highly leveraged assets would lead to widespread financial harm and result in economic consequences globally through tightened financial conditions.

Next came 2008. Twelve years ago, the financial crisis we all remember hit America, and the Federal Reserve and US Treasury used unconventional tools and government funds to bail out many companies as this was deemed a 'Systemic Risk'. AIG, Bear Stearns and many others were saved; Lehman Brothers was not.

Now, the authorities had bailed out entire financial industries before, such as in the savings and loan crisis of the late 1980s. But after LTCM, and diving in with the 2008 crisis, the US government established the dangerous precedent that it can examine any financial entity and decide whether to use taxpayer money to bail it out. This is a policy that is increasing the risks of moral hazard, and ultimately systemic fragility in the global economic system.

Moral hazard incites firms to take too many risks. With LTCM, the Fed exposed the possibility of bailouts to financial firms. Over the next decade, the firms therefore, rationally and steadily, increased the risks they took. While it worked, they reaped outsized profits. When it ultimately failed, as it always will, everyone suffered. It is sometimes referred to as privatising the profits and socialising the losses.

Systematic fragility follows inevitably whenever risks are artificially repressed. Like the subprime mortgage crisis or Japan's lost decade, or any vulnerable currency peg, hiding potential problems is the equivalent of pretending there's nothing wrong. Initially things appear calm, but the true risk is hiding, and when it reveals itself, it can cause far more damage.

The current Pandemic has seen another push into previously unheard of tools being utilised by central banks to manipulate risks: the purchase of High Yield, or Junk, bonds to limit the financial distress that would be caused by companies going bankrupt.

No one can argue that the intentions of the authorities are good, but the long-term impact of manipulating the risk/reward pay off of assets cannot be quantified today. At this stage, we remain concerned that the rise in US equity markets since March is being driven by a speculative trade that is based on the manipulation of financial assets by central banks.

Hopefully, whoever said 'the ends justify the means' will be proven right. If not, the price we could all end up paying may be considerable.

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