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Voices What a difference a crisis makes: This time, the financial system is working

By John Taft, April 17, 2020



The Fearless Girl statue stands across from the New York Stock Exchange in New York on March 30, 2020. *Bloomberg News*

The most dangerous words in finance are “this time is different.” But this time really *is* different.

The financial market sell-off and accompanying volatility since February has raised for many individual investors, business owners and corporate executives the all-too-traumatic specter of the financial crisis of 2008-2009. But there are important distinctions between 2020 and that meltdown 10 years ago.

In 2008-2009, excesses in financial markets and over-lever-

aged and under-capitalized financial services companies *were* the problem. This time, the problem is a public health black swan (the coronavirus pandemic) and the financial markets are victims of collateral damage.

Using a medical analogy, here’s how macro-research firm Strategas, a Baird company, describes the differences between what’s going on today and what happened in the financial crisis:

“In 2008, the central nervous system of the U.S. economy, the

financial system, was infected. Today, the U.S. economy's central nervous system [financial markets] is beginning to show signs of infection, but the infection began elsewhere. [U]nlike in 2008, the Federal Reserve Board's job today is to protect the financial system from damage while the body (the economy) fights off the infection."

In 2008-2009, the "infection" in the financial system was so severe that a broad range of financial securities stopped working the way they were intended to work. Money market funds broke the buck and suspended redemptions, threatening investor confidence and the ability of corporations to access the short-term markets as needed to stay solvent. Auction-rate preferred stocks were unable to find buyers for their securities, no matter how high their interest rates. Leveraged residential and commercial mortgage-backed securities and related derivatives lost up to 100% of their value. Numerous financial institutions — Bear Stearns, Lehman Brothers, AIG, Countrywide Mortgage, Washington Mutual, Wachovia Bank, Merrill Lynch — failed or teetered on the brink of failure.

In contrast, during this new bear market, no major financial institutions have failed. No class of financial instruments has stopped working. ETFs, for example, which had been stamped with a "caution" label after their exponential growth in recent years, have continued to function more or less as expected. There are some areas of concern in the bond markets, like municipal credit, where a lack of liquidity has led to odd price behavior, or high-yield corporate bonds, where distressed debt quadrupled in the past few weeks and default rates are expected to soar, or commercial mortgage-backed securities, where the impact of the upcoming recession is likely to be most severe and forbearance provisions in the CARES Act is causing borrowers to invoke "force majeure" provisions to stop making loan payments.

But unlike 2008-2009, policy makers this time were able to quickly reactivate an alphabet soup array of market intervention tools that were created during the last financial crisis. The Federal Reserve has grown its balance sheet to over \$5 trillion with the purchase of U.S. Treasuries and mortgage-backed securities, and with legislation approved last week by Congress the Fed will be able to deploy its firepower to purchase an unprecedented range of corporate bonds, municipal securities and even ETFs in the months ahead.

In 2008, it took months and several legislative failures of nerve for predecessor versions of these programs to be designed and

implemented. The response time-to-market in 2020 has been much faster.

Under the real life, real time stress test we're experiencing, it appears that the post-crisis reforms in financial regulations — in particular, increased capital requirements at major financial institutions — are in fact working. JP Morgan CEO Jamie Dimon recently wrote to shareholders that his bank could withstand "an extremely adverse scenario" that assumes a 35% drop in GDP lasting through the end of the year and a 14% unemployment rate. Excesses in risky assets, to the extent they exist, have moved to unregulated or more lightly regulated sectors of the financial system (the shadow banking system) where taxpayers are at least not directly on the hook for losses.

By no means are we out of the woods yet. While Congress may have approved the CARES Act — the largest fiscal stimulus, economic and emergency aid package in history — the implementation and logistical challenges of supporting our economy are massive. Under the most optimistic scenarios, it will take weeks and perhaps months for meaningful money to reach the intended beneficiaries of the bill.

It's also worth remembering that the 2008-2009 financial crisis came in several waves. It was a full year between the time Bear Stearns was driven into JP Morgan's arms and the U.S. stock market hit its low point.

This time, there may not be simply one lockdown, but two or three or rolling lockdowns.

Still, the nature of socioeconomic disease in 2020 is vastly different than it was in 2008-2009, and the monetary, fiscal and regulatory treatment we are using to fight it is far superior to what we used the last time around.

This time really is different.

John Taft Vice Chairman, Baird



There are important distinctions between 2020 and the meltdown 10 years ago, writes John Taft, vice chairman of Baird.