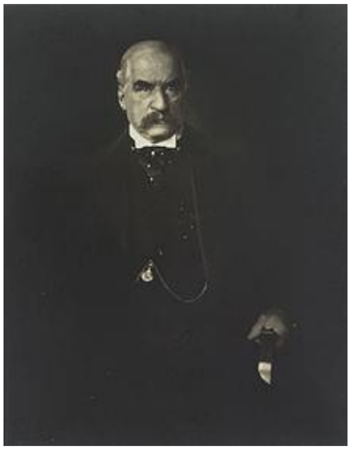
Lessons from the Panic of 1907

I have read *The Panic of 1907* (by Robert Bruner & Sean Carr) four or five times — I read it at every market crash.

The crash occurred more than 100 years ago and is one of many banking crises that beset the United States in the 19th and early 20th century. What made 1907 stand out is that the financial system was saved by the leadership of a private individual, John Pierpont Morgan, head of the banking firm that later became known as J.P. Morgan & Co. Without the 70-year old Morgan's force of will, the entire financial system would have imploded.



John Pierpont Morgan – source: Wikipedia

The crisis led to formation of the Federal Reserve Bank in 1913. The US had not had a central bank since President Andrew Jackson withdrew the charter for the second Bank of the United States in 1837. Bank clearing houses prior to 1913 were private arrangements created by syndicates of banks and were poorly-equipped to deal with the challenges of a banking crisis.

The lessons of 1907 are still relevant today. The authors of the book suggest that "financial crises result from a convergence of forces, a 'perfect storm' at work in financial markets."

They identify seven elements that converged to create a perfect storm in 1907:

1. **Complex Financial Architecture** makes it "difficult to know what is going on and establishes linkages that enable contagion of the crisis to spread."
2. **Buoyant Growth**. "Economic expansion creates rising demands for capital and liquidity and excessive mistakes that eventually must be corrected."
3. **Inadequate Safety Buffers**. "In the late stages of an economic expansion, borrowers and creditors overreach in their use of debt, lowering the margin of safety in the financial system."
4. **Adverse Leadership**. "Prominent people in the public and private spheres implement policies that raise uncertainty, which impairs confidence and elevates risk."
5. **Real Economic Shock**. "Unexpected events hit the economy and financial system, causing a sudden reversal in the outlook of investors and depositors."

6. **Undue Fear, Greed and other Behavioral Aberrations**. "….a shift from optimism to pessimism that creates a self-reinforcing downward spiral. The more bad news, the more behavior (erupts) that generates bad news."
7. **Failure of Collective Action**. "The best-intended responses by people on the scene prove inadequate to the challenge of the crisis."

Compare these seven elements to the current crisis in March 2020:

Complex Financial Systems

The global financial system is far more complex than the gold-based financial system of 1907. Regulation has not kept pace with the growth in complexity, with many products designed to avoid regulation and lower costs. The ability to build firebreaks to stop the spread of contagion in unregulated or lightly regulated areas of the financial system is severely limited. And that is where the fires tend to start.

In 1907 the fire started with poorly regulated trust companies that dominated the financial landscape: making loans, receiving deposits, and operating as an effective shadow-banking system. A run on trust companies threatened to engulf the entire financial system.

In 2020 it started with hedge funds leveraged to the hilt through repo markets but soon threatened to spread to other unregulated (or lightly regulated) areas of our shadow banking system:

- Leveraged hedge funds
- Risk parity funds
- International banks lending and taking deposits in the unregulated $6.5 trillion Eurodollar market (these banks are offshore and outside the Fed's jurisdiction).
- Money market funds
- Muni funds
- Commercial paper markets
- Leveraged credit
- Bond ETFs

Many of these offer the attraction of low costs and higher returns, often enhanced through leverage, but what investors are blind to (or choose to ignore) are the risks from lack of proper supervision and the lack of liquidity when money is tight.

Maturity mis-match is often used to boost returns. Short-term investors are channeled into long-term securities such as Treasuries, corporate bonds, munis or credit instruments, with the promise of easy sale or redemption when they require their funds. But this tends to fail when there is a liquidity squeeze, forcing a sell-off in the underlying securities and steeply falling prices.

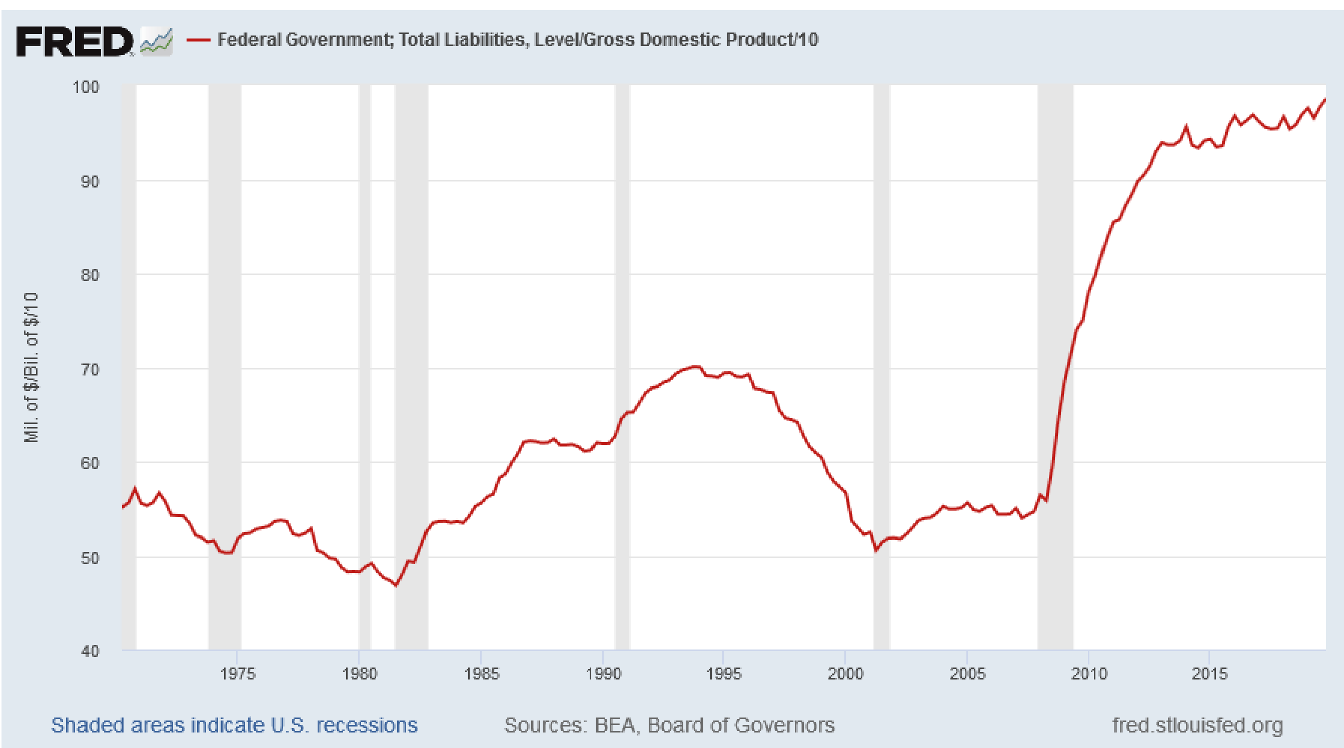
Rapid Growth

We all welcome strong economic growth but should beware of the attendant risks, especially when financial markets are administered *more stimulants than a Russian weightlifter* for purely political ends.

Excessive use of Debt

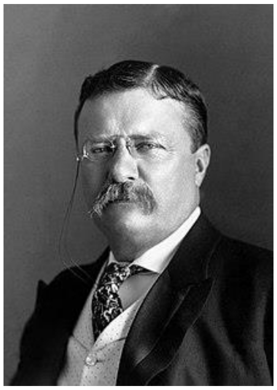
Corporate borrowings are far higher today and rising debt has warned of a coming recession for some time.

Public debt is growing even faster, with US federal debt at 98.6% of GDP.



Adverse Leadership

In the early 1900s, President Teddy Roosevelt led a populist drive to break the big money corporations through Anti-Trust prosecutions. This cast a shadow of uncertainty that fueled the sudden reversal in investor sentiment.

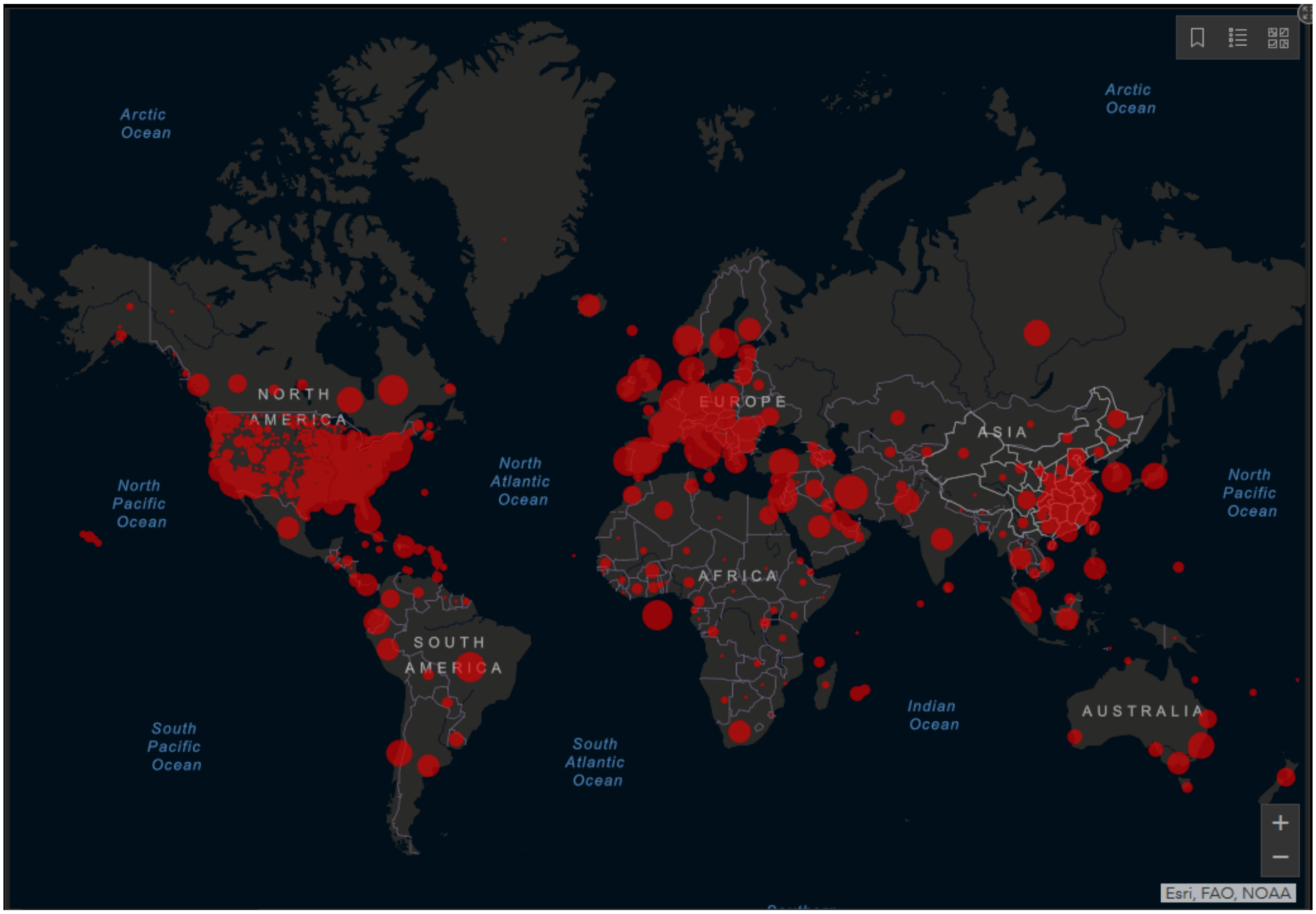


In 2020, we have another populist in the White House. Frequent changes in direction, spats with allies, imposition of trade tariffs, impeachment efforts by Congress, and a heavy-handed approach to trade negotiations have all elevated the level of uncertainty.

Economic Shock

The great San Francisco earthquake and fire of 1906 created an economic shock that was felt across the Atlantic. The earthquake ruptured gas mains, setting off fires, while fractured water mains hampered firefighting. Over 80% of the city was destroyed. Much of the insurance was carried in London and Europe and led to a sell-off of securities in order to meet claims. The Bank of England became increasingly concerned about the outflow of gold from the UK and hiked its benchmark interest rate from 3.5% to 6.0%. London was then the hub of global financial markets and money became tight.

In 2020 we have the coronavirus impact on global manufacturing, services and financial systems: the mother of all demand and supply shocks.



Undue Fear and Greed

Collapse of highly leveraged ventures in 1907 — with an attempted short squeeze on United Copper shares by connected corporations, banks and broking houses — stirred fears that a leading Trust company was going to fail. The panic soon spread and started a run on a number of trust companies.

A spike in the repo rate in September last year revealed that hedge funds had used repo to leverage their relatively meager capital into a rumored $650 billion exposure to US Treasuries. The Fed had to dive in with liquidity to settle the repo markets, lifeblood of short-term funding by primary dealers. But financial markets were on edge and concerns about funding difficulties in the unregulated $6.5 trillion offshore Eurodollar market and leveraged credit in the US started to grow. But the coronavirus outbreak in Europe and North America was the eventual spark that set off the conflagration.

Failure of Collective Action

Trust companies failed to organize an effective defense in 1907 against a run on their largest member, The Knickerbocker Trust Company, fueling a panic that threatened to engulf other trusts. Responding to appeals for help, J.P. Morgan intervened and marshaled the banking industry and surviving trusts to mount an effective defense.

Today that role falls to the Federal Reserve. Chairman Jay Powell moved quickly and purposefully to flood financial markets with liquidity, but the Fed was forced to reach far outside their normal ambit — increasing dollar swap lines with foreign central banks (to supply liquidity to international banks operating in the Eurodollar market) and providing liquidity to money market funds, muni funds, commercial paper markets, bond funds, hedge funds (through repo markets) and more. In effect, the Fed had to bail out the shadow banking system.

One thing that strikes me about financial crises is that each one is different, but some things never change:

- artificially low interest rates;
- rampant speculation;
- excessive use of debt;
- unregulated and highly leveraged shadow-banking with hidden linkages through the financial system;
- financial engineering (the latest examples are leveraged credit and covenant-lite loans, hedge funds running leveraged arbitrage, risk parity funds with targeted volatility, and management using stock buybacks to enhance earnings per share, support prices and boost their stock-based compensation);
- misuse of fiscal stimulus (to fund corporate tax cuts while running a $1.4 trillion fiscal deficit);
- misuse of monetary policy (cutting interest rates when unemployment was at record lows);
- yield curve inversion; and
- misallocation of investment (to fund unproductive assets)

Jim Grant (Grant's Interest Rate Observer) sums up the problem:

> *"The Fed has intervened at ever-closer intervals to suppress the symptoms of misallocation of resources and the mis-pricing of credit. These radical interventions have become ever-more drastic and the 'doctor-feel-goods' of our central banks have worked to destroy the pricing mechanism in credit.*
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> *….[credit and equity markets] have become administered government-set indicators, rather than sensitive- and information-rich prices… and we are paying the price for that through the misallocation of resources…..*
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> *Is there no salutary role for recessions and bear markets? …..they separate the sound from the unsound, they separate the well-financed from the over-leveraged and if we never have these episodes of economic pain, we will be much the worse for it."*

"The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist."
~ John Maynard Keynes (1936)

We haven't learned much at all in the last 100 years.