Zanetti Monday Missive 2023.07.10

Federal Home Loan Bank

“I believe that banking institutions are more dangerous to our liberties than standing armies.”
~ Thomas Jefferson

Hello Everyone,

When?

That is the question so many investors ask.

“Greg, I know something is wrong, but nothing has happened. When?”

Thanks to Kathryn George over at The American Prospect, I may have an answer for you. At least an answer with respect to the next banking crisis. And, yes, I believe the second wave is coming.

But when?

We may know the “when” if we follow what is happening in an obscure corner of the financial system. The Federal Home Loan Banking system (FHLB).

Stay with me. You are going to like this. Really. Maybe. :>)

The FHLB was established in 1932 to help “the little guy” qualify for a mortgage during the Great Depression. It was a good idea. But like most government “good ideas” it has grown dramatically and really serves the interests of the “big guys” now. I know. Shocking.

Some call the FHLB the second-to-last lender of last resort. The ultimate lender of last resort being the Federal Reserve. Think of the FHLB as a possible pit stop on the way to insolvency for troubled banks.

Let me explain.

Let’s pretend you are Banker Bob. Your bank is stressed. You need cash. Stat! Where do you get it?

- You can go to the marketplace and try to raise cash. But the marketplace has very sophisticated investors. They will likely look at you and say, “You are in deep trouble Banker Bob. I can’t lend to you. I don’t think I’ll get my money back.”

- Your next stop is then the FHLB. Think of it as a Payday Loan office for banks. The quasi-governmental FHLB will loan you money---but the interest rates are high (currently 4.5%-5.7%) and the terms are dear. Everything in the contract favors them. But you'll likely get the cash you need…to a point.

So, why would Banker Bob do this? Well, besides being desperate, money that comes from the FHLB doesn't send up alarm signals. Most people will assume you went to the FHLB to get funds so you could make more home loans to regular Janes and Joes.

But what if you are not making loans? What if you are just pocketing the FHLB dough because your bank needs cash?

This is what happened in 2007. And this was well before the Lehman Brothers debacle---and the subsequent Great Financial Crisis---of 2008.

In the early 2000's, banks had made horrible loans to people who could never pay them back. Defaults ensued. Suddenly, banks needed cash. They tried to raise money from the marketplace. No dice. They then went to the FHLB. Not for cash to create loans for more mortgages. But rather to patch the holes in their balance sheets.

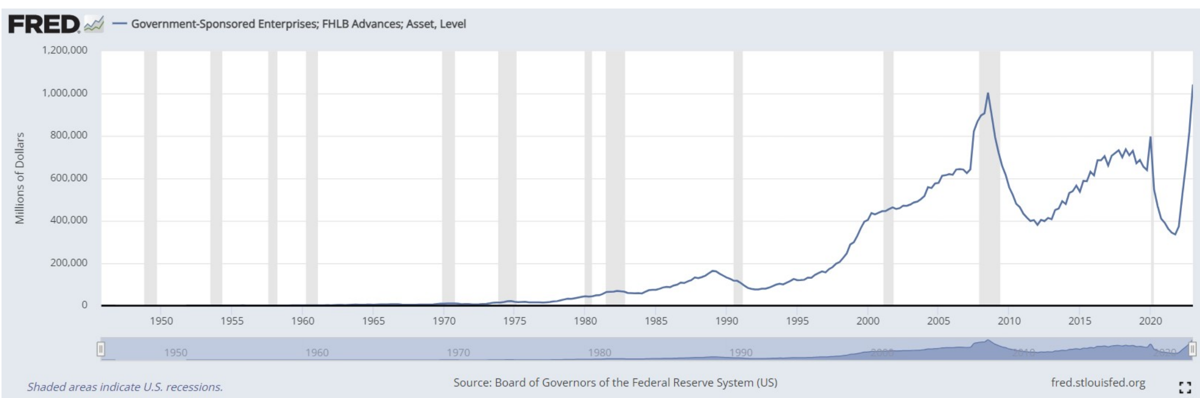
Thus, the FHLB money really functioned as a stealth bailout.

Look at the below chart. The first spike you see starts in 2007. That spike represents banks going to the FHLB…16-18 months before (!) the collapse of Lehman. Oh, and remember, Bear Sterns, AIG, and Century all collapsed 6-7 months before Lehmann fell apart.

Then look at the second spike on the chart. That spike started its upward trajectory in the first quarter of 2022---- and continues to today. Oh, and it is parabolic. Hmmmm.

Thus, we are seeing a similar pattern to 2007-2008 when AIG and Bear fell first.   Today, the draw of FHLB funds preceded the collapse of Silicon Valley Bank, Signature Bank, and First Republic Bank earlier this year.

Hmmm again.



OK, but that is only one data point. Is there a confirming signal? Or, two?

Let’s go back to Banker Bob.

Let’s say Banker Bob’s bank is under so much stress that even the FHLB will no longer loan to him. And yes, that happens. Where would he go next?

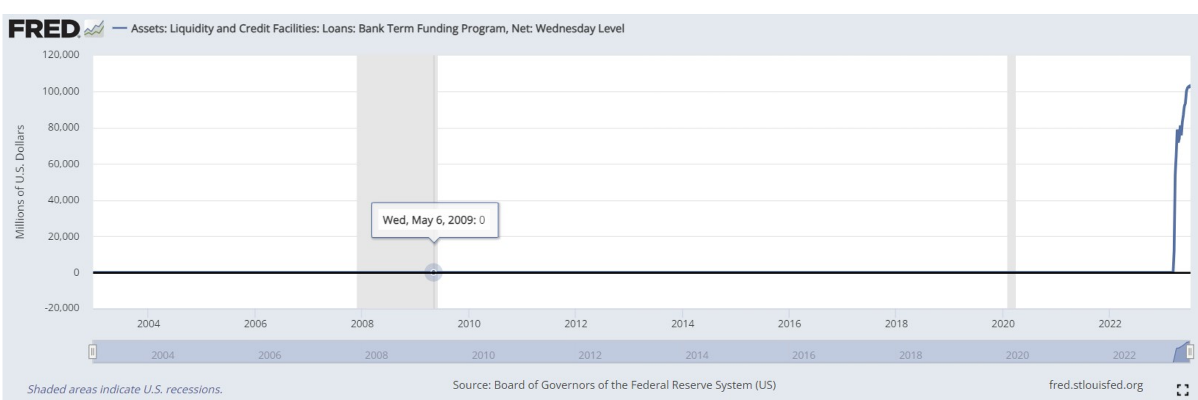
Now he must go to the bank of last resort, the Federal Reserve itself. And the Fed does not want failing banks.

Therefore, in the aftermath of the Silicon Valley Bank collapse this past spring, the Fed established something called the Bank Term Funding Program (BTFD). It is a purposely opaque name...IMHO.

Anyway, the BTFD is an emergency pool of cash that Banker Bob can access for up to one year. Think of it as a super short-term Payday loan. Of course, Banker Bob must post collateral and pay interest. But, hey, he needs the cash.

The problem with BTFD money is that it signals to the world that you are in deep trouble. Eyebrows are raised. Funds start transferring out. Electronic bank runs are possible. Reassuring words from Banker Bob do not always calm the depositors down.

So, let's look at the chart of the BTFD. Look to the far right on the chart. Of course, the BTFD is new, thus the flat line until 2022. But it too, is showing banks accessing cash at an alarming rate. And draws on the BTFD are not coming down.



Moving on…

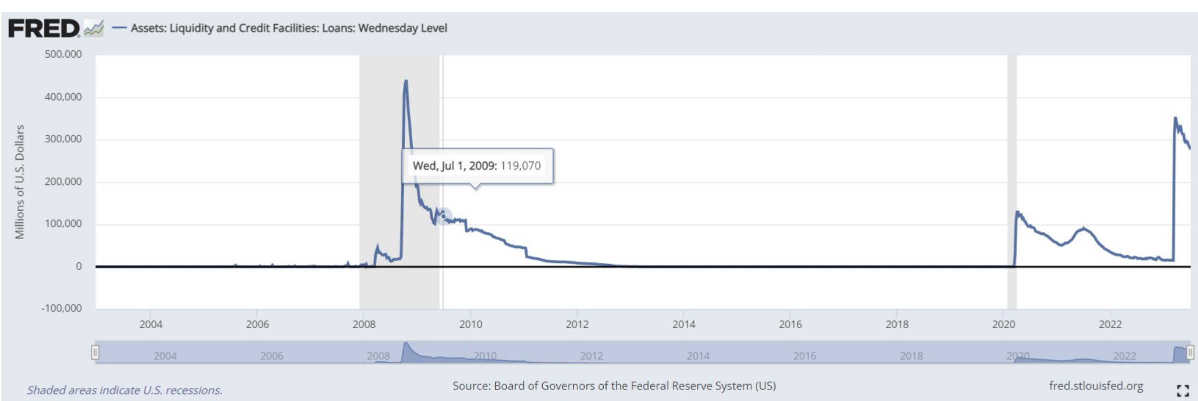
Let’s say that even after accessing BTFD funds to the limit, Banker Bob is still stressed. His bank is circling the drain. Is there one last hope? Yes.

The Fed has something called the “discount window.” The discount window is the safety valve of last-last-last resort. These are overnight (!) funds. “Just let me survive until tomorrow! Maybe a miracle will happen!” The discount window can be used for individual banks like Banker Bob’s, or for the banking system as a whole. Think the contagion effect of Lehmann 15 years ago.

If Banker Bob must go to the discount window, he’s done. Put a fork in his bank. Liquidation is probably the next step.

So, let’s look at that chart. The first spike occurs in 2008 when Lehmann falls apart. The second spike occurs right around the time of the Silicon Valley Bank + Signature + New Republic + Credit Suisse failures. Like 2008, banks were tapping the discount window like crazy.

Since then, draws from the discount window have calmed down and are starting to return to normal. That’s good news.



The points are these:

- If you put together draws on the FHLB system + draws on the BTFD + emergency draws on discount window, you can be pretty sure a significant banking issue is at the doorstep.
- Currency, two of the three charts (the FHLB and BTFD charts) show continued stress. We at Zanetti Financial would love to see a reversal here. But so far, that is not happening.
- If the discount window chart starts to spike again, it is time to duck and cover. That would mean the second wave of the banking crisis will likely be upon us…stat.

So, that is the answer to your "when" question regarding when things will unravel. Because if the banks struggle again, you can be assured the stock and bond markets will not be far behind.

Rest assured, we are watching this closely.

Signed, Your Why-Is-It-If-I-Lie-To-The-Government-It's-A-Felony-But-If-The Government-Lies-To-Me-It's-Politics? Financial Advisor,

Greg

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Our mailing address is:

5130 San Francisco Rd NE
Suite A

Albuquerque, NM 87109

505-858-3303