The Shifting Regulatory Landscape for Bond Investors

In my new book, *Bonds Are Not Forever; The Crisis Facing Fixed Income Investors*, I make the case that some big trends in the U.S. economy and Finance began shifting following the financial crisis of 2008, the consequences of which will include interest rates insufficient to compensate bond investors for inflation and taxes (hence the *Crisis*). The last few days have produced two news items of note which illustrate the altered economic and political landscape.

On Thursday, the Wall Street Journal reported that “Embattled J.P. Morgan” would be bulking up its oversight by spending an additional $4 billion and adding 5,000 employees to clean up risk and compliance problems. No doubt the company has been hit by a succession of issues from the huge loss in the office of the CIO to problems with mortgage underwriting standards and commodities trading. They’ve responded by deploying substantial amounts of money and people to resolve these problems and reduce the odds of new ones in the future.

I can imagine the stultifying impact these additional legions of compliance, regulatory and legal experts will have on many aspects of business. I worked at JPMorgan for 23 years and it’s a great company. I know from first hand experience that when additional layers of oversight are added whose job is to basically say “No” to any transaction or new line of business that carries a hint of the risks that have so bedeviled them in the past couple of years, it leads to a pretty frustrating environment. If you choose to make your career protecting a large bank from the sometimes questionable instincts of its revenue-generating employees, “Yes” is a word that carries career risk and limited upside. Many potential transactions and activities will now not occur, because they won’t pass muster with an increasingly vigorous compliance culture or because the weary revenue generators will steer clear of anything that is the least bit questionable. It will certainly make it a less fun place to work, and will hurt the top line while seeking to curb the Legal Expense line. It will make banking at JPMorgan more risk averse, less interesting and presumably more aligned with the public interest. If you hit a bank with enough $500 million fines, they do get the message.

The thing is, senior management will be well aware of the potential impact on revenues of rejecting all but the most anodyne transaction and will no doubt strive to maintain a profitable balance between the competing cultures of "No" and "Yes". They will be very sensitive to the new trade-off. And yet, they've still chosen to go down this road. The bank that most successfully navigated the financial crisis of 2008 has assessed the ongoing regulatory environment which must increasingly look as if they're every government lawyer's favorite target, and have adjusted their posture accordingly. The political mood has shifted against big banks and Big Finance after thirty years during which financial services grew its share of U.S. GDP. This is one manifestation of the altered landscape.

A second story of note is Larry Summers' withdrawal of consideration for the position of next Fed chairman. Interestingly, it was the lukewarm support from Democrats on the Senate Finance Committee that led to the calculation that Republican votes would be needed even to get the President's nominee to the full Senate for consideration. Summers is regarded by some as less enthusiastic about increased regulation than they might like, further reflecting the mood for a more tightly controlled banking sector. Listening to Senator Elizabeth Warren discuss the urgent need for ever more banking oversight may not reflect a balanced view, but it does once again reflect the new reality Finance faces.

Financial markets have this morning provided their input – bond yields are down and stocks are up, reflecting the view that a Fed Chairman Yellen will continue Quantitative Easing and low interest rates for longer than would a Chairman Summers.

Whether or not this is good public policy isn’t really the point – others may debate that. However, what both stories highlight is that a shift towards more banking regulation and dovish monetary policy pushes back the time when bond investors might expect to earn a decent yield on their savings. The market expects a Yellen Fed to continue to promote the interests of borrowers at the expense of savers through very low rates. The JPMorgan story illustrates that what’s good for Finance is clearly less important in Washington than what’s good for everyone else. So bond investors should conduct their affairs accordingly. Current interest rates are unattractive, and it will likely be a long time before bonds are a good deal.