MEDALLION WEALTH MANAGEMENT

Mid-March Market 2023 Commentary

The Madness of Crowds

Messengers from brokerage houses crowd around a newspaper after the stock market crash on October 24, 1929.

"Money, again, has often been a cause of the delusion of the multitudes. Sober nations have all at once become desperate gamblers, and risked almost their existence upon the turn of a piece of paper." – Charles Mackay

I am often asked, though not as often as I used to be, what books I'd recommend on investing, and invariably one of my top five is always **"Extraordinary Popular Delusions and the Madness of Crowds".** Written by the Scottish author Charles Mackay in 1841, yes, 182 years ago and still relevant. Mackay wrote about the power of crowd psychology and the pitfalls of following the herd; beautifully enlightening us with examples of witch hunts, the Mississippi scheme, and Tulipmania.

What can we learn from these centuries-old tales of mania? Plenty. What have we learned? Nothing, it seems. Mankind is easily persuaded, and we engage in bubbles and their inevitable collapse somewhat frequently.

"Every age has its peculiar folly: Some scheme, project, or fantasy into which it plunges, spurred on by the love of gain, the necessity of excitement, or the force of imitation." – Charles Mackay

The recent collapse of Silvergate, Silicon Valley Bank, and Signature Bank all have a common thread: They grew rapidly during a period of excess liquidity and greed, risks were ignored due to hubris, and when confidence waned it evaporated quickly. Again, nothing new in 182 years.

I'm not going to go into detail about these specific collapses, there have been some excellent articles written dissecting their balance sheets, management teams, and regulatory oversight that there is little I can add. What I would like to comment on is another man-made problem, moral hazard.

Moral Hazard is defined as a lack of incentive to guard against risk, if one is protected from harm. The problem with the "madness of crowds" is that when things go terribly wrong, the crowd is looking for someone to blame. That blame is usually focused on politicians or regulators who should have protected us from our own folly. We want the pain to stop, we don't want to learn hard lessons, and we look to our elected/appointed officials to make it go away. It's why the Fed was created after the 1907 Financial Panic, and it's why they've consistently created one bailout package after another for over a century to try and protect us from ourselves.

Being from Pittsburgh, I was fortunate enough to listen to several presentations by the esteemed economist Allan Meltzer, who liked to say that "capitalism without failure is like religion without sin. It doesn't work." After the 2008 financial crisis, Meltzer worried that bank bailouts were actually undermining public support for capitalism. He feared that politicians would steer the financial system to ever more government regulation and away from market competition, and Americans would come to believe that only the state could protect them from the inherent instability that comes with economic freedom.

That's why I nearly fell off my chair laughing last week, when President Biden announced that **<u>all</u>** depositors of Silicon Valley Bank would be protected no matter their size. Even though those smart Silicon Valley depositors knew that the limit for deposit insurance protection was only $250,000, and over 80% of them had well in excess of $250,000 in the bank. The President went on to say, "Investors in the banks will not be protected, they knowingly took a risk and when the risk didn't pay off, the investors lose their money. That's how capitalism works." Cue hysterical laughter!

After he says that depositors who knew that their deposits over $250k **weren't protected**, who knowingly took that risk, would be lovingly bailed out, he had the gall to say **"that's how capitalism works."** Poor Allan Meltzer is rolling in his grave.

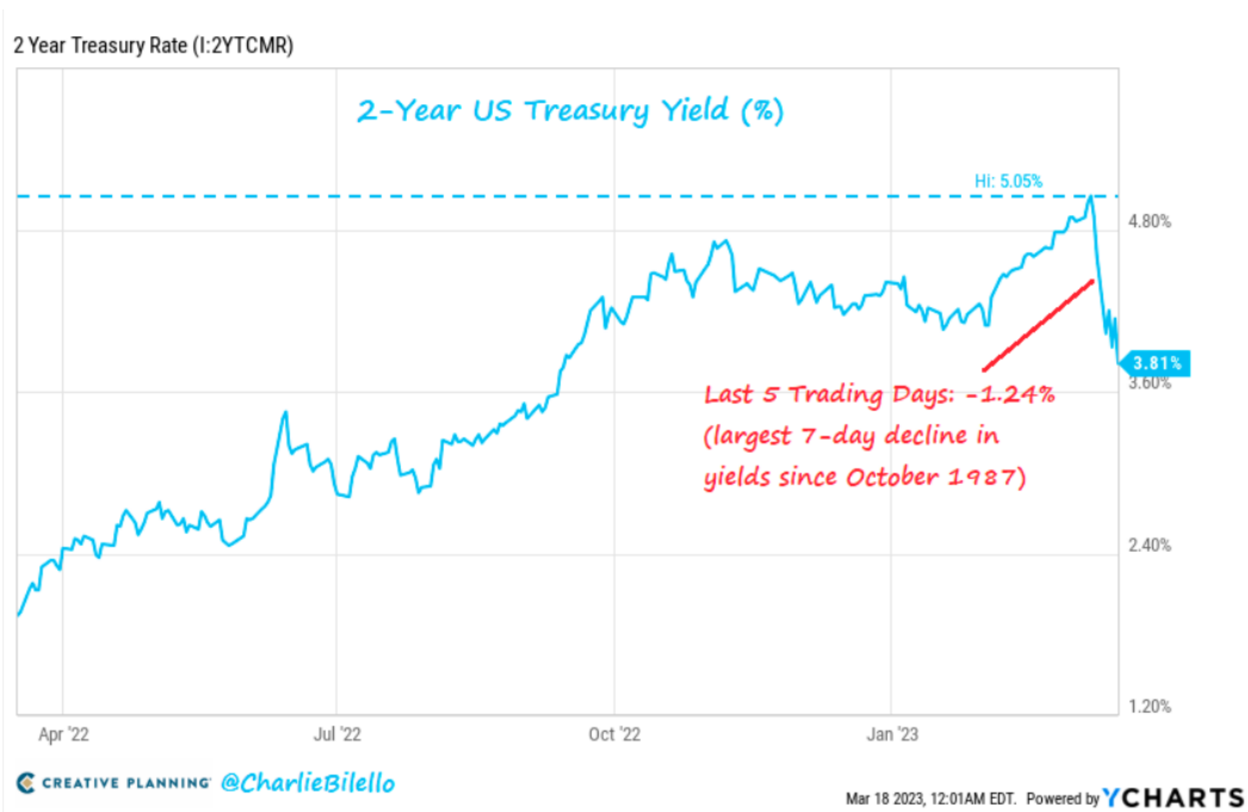
So, here we have the President of the United States telling us we have nothing to worry about. If we decide to park a few million dollars from our recent hyped-up IPO in our friendly neighborhood bank, and that friendly bank decides to loan it out or invest it in other equally hyped-up IPO's we're all protected. That's how capitalism works…

This is the sorry state of capitalism in the United States.

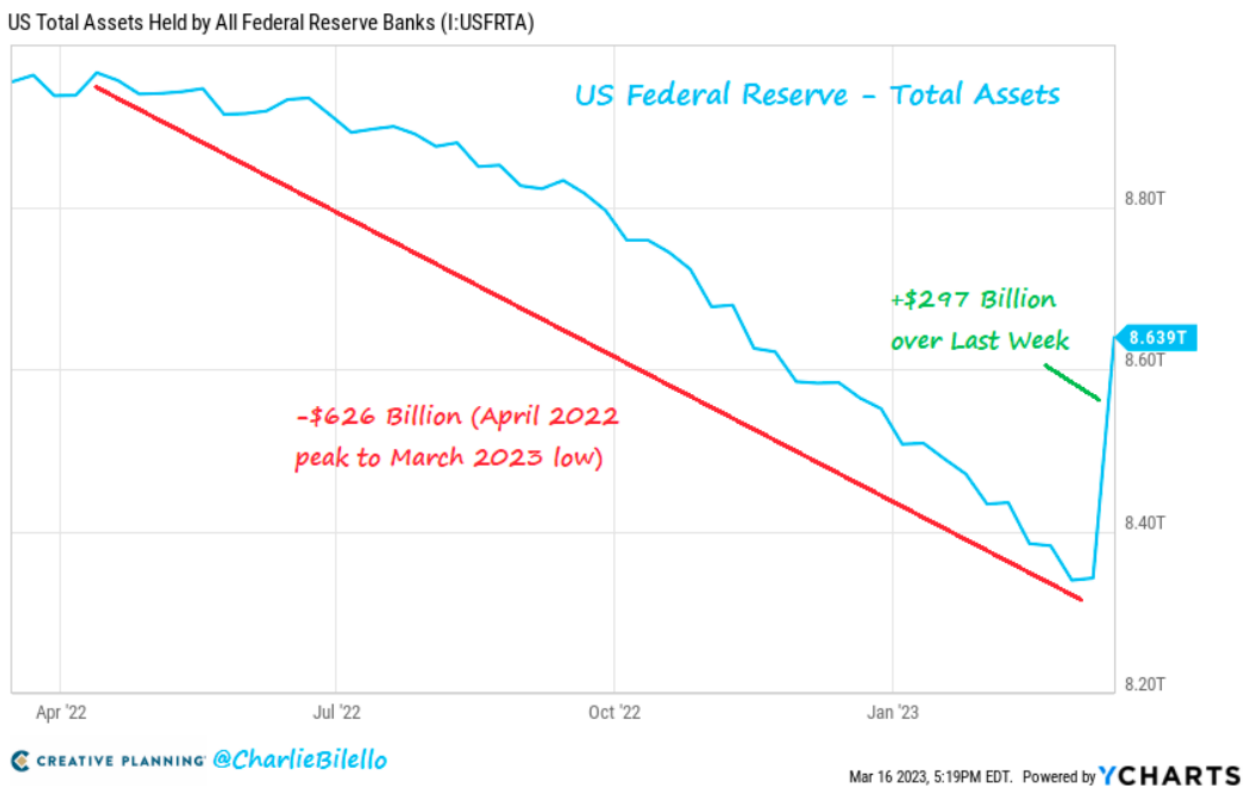
The banking sector is quickly coming to the realization that they are rapidly being forced into both consolidation and full government regulation. There will be a handful of national banks whose depositors will be fully protected, but in exchange for that protection their shareholder returns will be regulated like any other utility company. Regional banks will face an exodus of depositors, as the depositors realize that their deposits will not be fully backed by the government.

Investors are faced with the knowledge that regional banks will be allowed to fail, thereby wiping out their investments. Or, they can invest with the chosen few national banks, where their upside will be limited by government control. Because, that's how capitalism works…

In the broader market, we've seen a massive shift in interest rate sentiment away from "higher for longer" towards "that's high enough – haven't you broken enough things". We've just experienced the fastest decline in two-year yields since the October crash of 1987.



And, after a year of the Fed gradually unwinding it's Quantitative Easing programs, we've seen a stunningly rapid reversal. So much for reversing the excesses of easy money.



I know that many believe there is nothing wrong with a little moral hazard. What's wrong with taking risk, and if it doesn't work out, having the government come in and bail you out? Well, what's wrong with these government sponsored bailouts is that with each one you end up giving away more and more of your economic freedom. And with diminished economic freedom comes more government control, and with more government control comes less economic growth.

That's not how capitalism works.

"Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, and one by one." – Charles Mackay

Be careful out there,

Chris Wiles, CFA

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