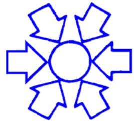 Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

DATE: March 28, 2022

In the midst of chaos, volatility always makes matters worse and this is very much the case with the commodities sector. This has led to growing speculation that central banks will step in should unprecedented price swings show signs of systemic impact. As we noted, we don't know a central banker that wants to bail out commodities. But none of them wanted to bail out anyone else either. If market stress turns systemic, then central banks will step in. Indeed, they may intervene even if stress seems manageable if they also believe that public welfare is at risk when core commodities go from pricey to prohibitive.

In the U.S., the Fed will resist calls to backstop commodities companies or traders for as long as it can by citing what it believes to be its limited mandate even as it argues that its anti-inflation policies will stabilize markets – just you wait. However, whatever the Fed is able to do about inflation will take time and whatever it does about its portfolio to address inflation will exacerbate commodity-market stress.

Three possible sources of extreme volatility are already on the horizon.

First, there's the liquidity stress sparked by CCP margin demands. This was the culprit in the letter from energy traders to the European Central Bank and it's at least as much of a factor in the U.S. The more commodity-market volatility, the higher clearinghouse initial and variation margin demands and the harder it is to post eligible assets already scarce in markets stressed by quantitative tightening combined with sanctions-driven market dislocations and the flight to safety sparked by the Ukraine crisis.

There are thus increasingly-worrisome signs of the dash for cash accelerated by margining highlighted in the FSB's analysis of the 2020 financial crisis along with the Fed's assessments of potential systemic risks. In the 2020 crisis, clearinghouses did fine, even though the market froze so hard that trillions of taxpayer dollars were mobilized. This could easily happen again. But, even if all that occurs now is a near-miss, another close call will propel the Fed and other U.S. regulators to go beyond studying margining and systemic-CCP regulation to quickly doing something about it.

The second severe risk resides on balance sheets all over the world mostly hidden from view. Eerily reminiscent of Long-Term Capital Management's systemic collapse, Archegos was an object lesson in how seemingly small exposure to leveraged speculators can cost serious money to systemic-scale banks. Even the most risk-willing behemoths are now better capitalized and more liquid than ever before, but commodities exposures to large, highly leveraged traders are still likely to be both big and concentrated regardless of the post-crisis limits on single-counterparty exposures. Regulators are talking about better disclosures to address LTCM/Archegos risk, but commodity-related problems could pressure them quickly to go beyond disclosure to another round of still more stringent exposure limits.

2101 L Street, N.W. – Suite 300
Washington, DC 20037
Phone: 202.589.0880

E-mail: info@fedfin.com
Website: www.fedfin.com

The third risk resides directly on big-bank balance sheets. The risk-based capital framework for market risk dates back to 1996. Regulators then and even now rely on value-at-risk (VaR) to decide how much capital banks must hold against their trading-book exposures even though VaR fails to factor extreme-stress events. CCAR assumptions baked into the stress capital buffer measure some market risks, but none approaches the price volatility experienced in core commodity markets in the course of this crisis nor its downstream credit risk.

Where risk was once housed in proprietary trading – much of that is gone due to the Volcker Rule – but not all big banks are under the Volcker Rule and the VaR remedy Basel crafted in (see FSM Report **CAPITAL211**) or something better has yet to be implemented pretty much anywhere, the U.S. included.

Clearly, this is a lot of stress for a financial system in the midst of a geopolitical crisis unseen since 1962, for which no one was prepared militarily, let alone financially. Any additional market disruptions that even approach the systemic thresholds sketched out here will have profound and adverse impact on public welfare. Millions in most countries may find it impossible to prevent their children from going still hungrier and their ability to get to the work – something essential for economic stability – will be even more challenging. Millions more will reduce spending to handle basic consumption, cutting back to the bone given the thin margin of financial error on which all but the wealthiest Americans sadly perch. Acute financial-market strain, even if it isn't systemic, will have far-reaching social- and public-welfare costs, costs with even graver political consequences for governments and central banks that seem to look the other way.

Will the Fed seek shelter under its dual mandate and inflation-fighting assurances, doggedly clocking careful rate hikes along with cautious QT as all around it disintegrates into macroeconomic collapse and political fury? No.

Another emergency liquidity facility and still more moral hazard will seem a small price to pay for even a bit less macroeconomic pain and political peril. Commodity markets grew so speculative in part because central banks have been so acquiescent. More backstops mean more moral hazard. But more hunger, want, and economic inequality means acute damage to social welfare, stagflation, and profound political discontent. As with inflation escalation beyond Fed control, commodity speculation is partly of the Fed's making by virtue of years in which rescues saved financial markets but only the largest banks were meaningfully regulated to prevent recidivism. We must figure out better ways to ensure macroeconomic and financial stability, but a geopolitical crisis isn't the time to give it a go.