

## SNL Blogs



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## Quarterly reports will not always be snoozers

By [Jeff K. Davis](#)

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In the larger scheme of the U.S. economy and our capital markets as a vehicle to efficiently allocate capital, the 90-day earnings cycle means little, in my view. I am not sure how it happened, but at some point over the past 25 years, quarterly earnings reports evolved into an elaborate game orchestrated by Wall Street and played by publicly traded companies regarding expectations, variances and revised expectations to be repeated in 90 days. I should add Microsoft has made one decided positive contribution to quarterly reports — the PowerPoint presentation that graphically summarizes results and trends that are described in a Microsoft Word document that sometimes has a Microsoft Excel attachment. Most of the Street likes a lot of detail; PowerPoint facilitates quick absorption of it.

Whether the reports are elaborate or brief, I think banks will live up the billing this quarter that they are supposed to be boring. Little changes quarter-to-quarter for most businesses absent an industry or broader economic inflection. It does not seem like the U.S. economy is at a decided inflection point, though there are signs that the current cycle is in the mid-to-late innings before considering central-bank-engineered extra innings.

A much discussed recent data point is the slowdown in commercial loan growth. The Fed's H.8 report indicates C&I loan growth stalled this summer after several years of strong growth. The slowdown corresponds with several banks guiding investors to the low end of their loan guidance range the past couple of months. Also, Thomson Reuters reports that syndicated loan originations fell 38% to \$372 billion, which consisted of an approximate 50% drop in investment-grade loans and a 14% reduction in leveraged loans.

Stalling commercial loan growth could imply a similar conclusion about the economy or maybe concern about the election as businesses await the outcome. Or maybe the slowdown is explained by liquidity flows — the ultimate arbiter for markets in the short run. My take is that commercial loan growth as measured by loans parked on bank balance sheets benefited during the fourth quarter of 2015 and first quarter of 2016 when high-yield credit markets froze due to widening credit spreads as fears about collapsing energy prices and multiple rate hikes incorrectly telegraphed by the Fed caused investors to withdraw capital. Banks like [JPMorgan Chase & Co.](#), [Citigroup Inc.](#) and other universal banks that can easily toggle borrowers between loans and debt issuances may have bridged client needs with on-balance-sheet financing. *The Wall Street Journal* ran an [article](#) recently that detailed how JPMorgan bought a private placement bond issue by the junk-rated Chicago school system when buyers were scarce. JPMorgan agreed to hold the issue for six weeks while the issuer got its ducks in a row. Markets wax and wane. The bank took credit and liquidity risk as a lender and made good money on a rebound in prices when the bonds were resold at a higher price, though the underlying tone of the article was that their hands were dirty for profiting. If the market tanked, then JPMorgan would have become an investor or absorbed the loss if it sold the bonds.

The same phenomenon may explain some of the slowdown in commercial loan growth, rather than a Zero Hedge narrative that the economy is collapsing. Leveraged loan and high yield bond markets have reopened since earlier this year as liquidity flowed back into the sector. Low prices (i.e., wide spreads) are the cure for illiquid markets. Higher prospective returns attract capital. High-yield bond prices have rallied such that the option-adjusted spread on the BofA Merrill Lynch High Yield index narrowed to 497 basis points as of Sept. 30 compared to 887 basis points on Feb. 11 at the height of the panic and around 670 basis points a year ago. Perhaps part of the disappointing commercial loan growth story can be explained by treasurers terming-out short-term bank borrowings in the bond market.

Likewise, auto loan growth credit may prove to be disappointing; however, after the opening of spigots to subprime borrowers for a few years "disappointing" volumes during the second half of 2016 and prospectively next year may not reflect economic weakness so much as lenders coming to their senses. After all, subprime infers nothing about character but a lot about ability to repay a loan.

Nor do I think investors will get much of a read on the always 800-pound gorilla in the room as it relates to community and regional banks — commercial real estate. As an illiquid asset that can masquerade as having a semblance of liquidity when packaged in CMBS or being the object of desire of institutional investors in a low rate environment, CRE has a propensity to blow up banks. Other than high-end condo projects in locales such as New York, Miami and apparently Vancouver, it does not seem as though investors are going to get much read on the sector beyond management teams professing they are closely monitoring CRE fundamentals.

As for the rate environment, the narrative at the margin may be better than expected. Technical issues related to new money market rules contributed to an increase in 30-day LIBOR of about 5 basis points between June 30 and Sept. 30. And, of course, the Fed has given investors hope that another 25-basis-point increase will be forthcoming in December. The potential overlay of better-than-expected NIMs with renewed cost-cutting efforts and rising oil prices may be sufficient to produce upside earnings surprises for [Comerica Inc.](#), [Hancock Holding Co.](#) and similarly situated banks.

Other business units should perform OK, too. Rising equity and debt markets are helpful to trust and asset management units. The drop in the yield of the 10-year U.S. Treasury during July should be constructive for mortgage banking gain on sale margins and origination volumes. Likewise, [Jefferies Group's](#) results for the quarter-ended Aug. 31 imply subdued capital market and investment banking revenues, but no disaster.

In summary, third-quarter results should be a snoozer. Another apocalypse has been avoided until the next 90-day reporting season, though perhaps the more relevant questions are (a) how long can central banks continue to prop up asset values? and (b) is [Deutsche Bank's](#) liquidity and capital position akin to Bear Stearns' and Lehman Brothers' weakened positions in 2007, only multiples bigger?

## Article

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