NASHVILLE NOTES

Friedman Can Forecast

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By Jeff K. Davis

Jeff Davis CFA is a veteran bank analyst. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of S&P Global Market Intelligence; Mercer Capital, where he is the managing director of the financial institutions group; or StillPoint Capital, where he is a registered representative.

Legend has it that some citizens of Rome unlocked the city gates in 410 A.D. before the Visigoths sacked the city to get the inevitable looting and pillaging over. As someone said to me once, bad news does not get better with time.

I think a majority of investors had the same sentiment about the Federal Reserve's rate hikes to deal with inflation that the central bank and Washington created by dumping trillions of dollars into the economy and financial markets.

None of us should be surprised that exiting what Jim Grant calls a "hall of mirrors" interest rate policy is proving to be messy when central banks take their fingers off the scale. In fact, I am amazed that we did not see unruly markets until late September after the Fed implemented its second 75-basis-point hike in short-term policy rates.

So far, the most notable disruption has been in the U.K. where (maybe) bad policy and the absence of central bank bond buying, until midweek, created a crisis as bonds, called gilts, crashed when levered investors could not meet margin calls. It is always too much leverage that creates issues.

As for Main Street, data points on a slowing economy are piling up beyond the widely recognized slowing in what was a white-hot housing sector fueled by obscenely low mortgage rates and herd behavior.

FedEx Corp. focused Wall Street's attention on the likelihood of at least a profit recession occurring, if it is not already underway, when it withdrew guidance for the fiscal year ending May 31, 2023, in mid-September. Shares of Nike Inc., Rent-A-Center Inc. and Carnival Corp. & PLC fell sharply in late September after posting disappointing results.

Last spring, RH CEO Gary Friedman got a lot of attention when he hosted a conference call and made a number of dire predictions about the state of consumers and supply chains. I listened to a replay of the call and could not decide if Friedman was just being hyperbolic or really was freaked out. Then again, not everyone can afford $10,000 sofas.

The most recent report that may sum up the economy is CarMax Inc., which saw its shares drop nearly 25% on Sept. 29 following results for the second quarter ended Aug. 31, obviously falling short of Street expectations.

After reviewing the results, I am surprised that Wall Street was surprised, because inflation is overwhelming consumers. The average selling price for a used vehicle was $28,657, up 9.6% from the same quarter of 2021, and up 39% from the August 2019 quarter. Net sales only rose 2.0% from the year-ago quarter, while the number of units sold declined 6.4%. As it relates to consumer banking, the provision for loan losses within the finance unit roughly doubled to $76 million from $36 million in the year-ago quarter.

Inflation is obviously weighing on the economy, especially the consumer. Telling, I think, is the roughly 20% year-over-year increase in domestic card balances, as of both June 30 and Aug. 31 at Capital One Financial Corp.

Bank stocks have declined with the broader markets that have shifted from pricing an open-ended boom a year ago to a recession today that with luck will prove to be a "profit" recession rather than one that has big job losses too.

Illiquidity and leverage are dangerous combinations. The U.S. markets might see forced selling if price declines increase. Banks presumably would not be immune, notwithstanding the 25% reduction in the S&P U.S. BMI Banks index year-to-date through Sept. 29.

That said, what is different for banks entering an apparent recession is that net interest income is poised to strongly improve at least for several more quarters given the rate backdrop. While the pace of improvement will slow as banks have to become more competitive in pricing given alternative rates available from money markets and Treasury bills, higher core revenues provide the means to absorb higher credit costs.

Fed Chairman Jerome Powell is not Visigoth King Alaric, and I do not think he is a reincarnation of Paul Volcker. However, Powell was forthright in saying the Fed was solely focused on bringing inflation down and that in doing so losses would be incurred and there would be pain.

The unanswered question is whether the Fed will be able to withstand pain as investors expect the Fed to eventually pivot, too.

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