NASHVILLE NOTES

Eyes on the Deposit Door

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Fed Chair Jerome Powell gave a short 8-minute speech Aug. 26 at the annual central banker confab in Jackson Hole, Wyo. The gist of Powell's speech (link here) is that the Fed is solely focused on reducing inflation. Most would add the qualifier until a blowup in credit or major currency like the Euro forces the Fed to back off.

Powell's speech in 2021 discussed "transitory" inflation and the timing of when the Fed might begin to reduce its monthly purchase of $120 billion of Treasurys and Agency MBS. At the time consumer prices were then advancing around 5% vs. 9% now. In the fall of 2020, the Fed was rooting for much higher inflation (my interpretation).

Forward rates markets for Libor and Sofr priced in rates rising toward 4% next spring based upon Powell's comments. If so, the inverted U.S. Treasury curve prospectively will become more inverted if intermediate- and long-term rates do not rise much as has been the case immediately following his speech.

Inverted yield curves do not work well for the "carry" trade of leveraging capital with repo and other forms of short-term borrowings to fund fixed income portfolios or to carry inventory for market making. Nor do inverted curves work well for banks and thrifts that heavily rely upon wholesale funding.

However, for traditional commercial banks with substantial amounts of non-interest-bearing deposits and other low-cost deposits, rising short-term rates are mana as the spread for assets funded with these core deposits widen. There are many banks that fall into this category: Comerica Inc., Hancock Whitney Corp., Zions Bancorp. NA, and SVB Financial Group are just a few.

The inverted curve raises two issues separate from the NIM issue: credit costs and liquidity.

Since 1970, all recessions have been preceded by an inverted curve but not all inverted curves have been followed by a recession. The downturn in bank stocks this year reflects investor expectations about the potential impact a recession would have on credit costs next year; it is not at all about unrealized losses in bond portfolios in my view.

I know some investors are of the view that credit will be OK absent a deep economic downturn that meaningfully reduces employment or real estate values. That is a reasonable scenario to me for traditional credit, though not for money losing tech companies, sub and near prime consumer loans, and "new" forms of credit such as buy now, pay later championed by Affirm Holdings Inc. and others. There could be plenty of pockets of losses in an otherwise manageable downturn scenario.

The other issue is liquidity. Banks — especially community banks — for the most part remain reasonably liquid after the system was flooded with deposits the past two years.

But I wonder if liquidity could tighten by far more than has been the case since the 1994 rate hiking cycle when hikes were limited or predictable and gradual. The prospect of money markets that pay ~4% after years of deposits and money markets offering negligible yields other than 2018 and 2019 may suck deposits out of banks.

In effect, deposit betas may prove to be higher than usual — maybe much higher than usual — if the Fed really does raise short-term rates to ~4% and is not forced to backtrack because something blew up.

For banks with lots of excess liquidity, this may not be a problem; however, for those with little liquidity this will be a problem because securities would have to be sold at a loss or expensive wholesale money would have to be obtained to fund the runoff for institutions that choose not to raise deposit rates sufficiently high to stem the runoff.

Before liquidity becomes a big issue, the Powell Fed will have to keep hiking.

The record from the last cycle does not lead me to conclude the Fed can hike much or withstand the outcry from Wall Street and Washington when markets or the economy are in the ditch.

Nonetheless the setup for bank stocks is interesting, with many trading for 8-10x 2023 consensus estimates. There is no way to know if the benign scenario that

is reflected in consensus estimates will happen, in which rising rates drive spread revenues upward while not causing a downturn that spikes credit costs. Only risk-reward outcomes can be assessed with one of the key determinants being price paid. Lower is better all else equal.

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