NASHVILLE NOTES

Jettison the Losers

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Two market adages come to mind on the eve of second-quarter earnings: "Bought right is half-right" and "There are no bad bonds, only bad prices."

Banks, insurance companies and other fixed-income investors bought a lot of bonds in 2021 and early 2022 at the wrong price. The same can be said for low coupon mortgages that were originated to be held rather than sold. For an unlevered investor, bad purchases are painful in the form of unrealized loss in the value of the assets and the nominal amount of interest income the assets produce. For levered investors such as banks, the purchases are a trifecta of negatives, because the cost to carry bonds that yield nearly 2% is less than the marginal cost of funds that is above 5% today and could go higher if the Federal Reserve hikes further.

Either capital is expended today to sell bonds at a loss to reduce expensive funding and/or build liquidity that for now yields 5%, or the bonds are held to maturity to preserve capital today though the negative carry slowly erodes capital.

The Wall Street Journal provides some unintentional levity to the situation in its recent report that federal bank regulators are recalling retired examiners to "help unravel the bond mess."

What is to unravel? Either capital is expended today to sell bonds at a loss to reduce expensive funding and/or build liquidity that for now yields 5%, or the bonds are held to maturity to preserve capital today, though the negative carry slowly erodes capital.

So far, the default position for most banks has been the latter. That is not illogical because negative yield curves usually are resolved through the Fed cutting short-term rates, and bond prices will rally too if intermediate- and long-term rates ease. The cynic could respond with another saw that "markets will take a direction that tends to inflict the most pain on the most investors," which could be translated into higher for longer from a monetary policy perspective.

My middle-of-the-road solution for banks would be to restructure in blocks over a year or more rather than all at once in order to limit the near-term reduction in capital in case the economy rolls over. Plus, optionality would be retained if rates fall.

I think the "carry" issue is going to be the big issue in second-quarter earnings releases for most banks other than those with very large non-interest-bearing funding bases. According to the Federal Deposit Insurance Corp., the cost of average earning assets for banks with $1 billion to $10 billion and $10 billion to
$250 billion in assets was 1.35% and 1.70% in the first quarter. The cost of funds will rise significantly in the second and third quarters.

Once investors see the magnitude of the negative carry, I suspect many will start to push banks to restructure the portfolios except where there is a concern about material near-term loan losses that require excess capital. My middle-of-the-road solution for banks would be to restructure in blocks over a year or more rather than all at once in order to limit the near-term reduction in capital in case the economy rolls over. Plus, optionality would be retained if rates fall.

Price is set at the margin, not on average. And changes, good and bad, will begin at the margin. Banks are going to have to work on this issue at least at the margin, where it is the easiest for now. Selling liquid bonds is easier than selling quasi-liquid residential mortgages, and it is unequivocally easier than selling commercial real estate loans, as I am sure the management at PacWest Bancorp can attest.

Bond portfolios are supposed to be a source of liquidity and incremental earnings. They also serve as a macro hedge for the traditional commercial banks that are inherently asset sensitive in most rate environments assuming a reasonable amount of secured overnight financing rate/ London interbank offered rate-based commercial loans and non-interest-bearing deposits. When rates rise, spreads on the "core" bank widen and narrow on the bond portfolio. The opposite occurs when rates fall, and the increase in bond values can serve as a source of capital gains to offset credit losses in some downtowns.

Markets seemingly are now at an extreme with wide spreads on core banking and negative carry on most bonds. Extremes tend to be resolved, but when is always uncertain. Absent the Fed reducing borrowing costs to a rate that approximates the coupon of bonds pledged to borrow, I think a lot of managements will acknowledge that they have to address the negative carry issue by starting to whittle away at it.

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