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# Howard Lutnick's predictions still look prescient

By Jeff K. Davis

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The talking heads are debating the meaning of the Fed's policy statement following the March 18 meeting of the Federal Open Market Committee. I once heard Alan Greenspan say they (the Fed) did not pay much attention to markets; they watched the economy. That no longer seems to be the case and probably has not been the case since Alan Greenspan organized the bank-led bailout of Long-Term Capital Management in 1998.

No doubt the Fed was paying attention to the market reaction to the statement and Chair Janet Yellen's press conference. Traders in seemingly all asset classes viewed it as dovish given the rally in equities, government bonds, corporates and gold, while the dollar fell. I have thought for years that the Fed and most central banks in developed countries are trapped in their easy money policies. If so, maybe risk asset prices are destined to continue to grind higher with an occasional pullback until the system gives.

Aside from how high can risk asset values go, I have a different take on the Fed's "it depends" stance: income matters more than ever for a broad swath of investors, and the outlook for credit is more nuanced after years of improvement.

The obvious is that bank net interest margins will remain under pressure to the extent the Fed does not raise short rates and thereby "revalue" core deposits — especially non-interest bearing deposits — while intense competition pushes loan yields lower. Stronger loan growth may not be an antidote depending upon pricing and terms. While loan growth can be funded with excess liquidity that resides on bank balance sheets, loan growth requires capital. The analogy for an operating company is EBITDA — how much capex is required to maintain or grow EBITDA? Loan yields with a three-handle, or less, may not be worth it. Absent lower valuations, I think bank common equities will disappoint by underperforming the broader market. On the other hand, moving up the capital structure into bank preferred equity and sub-debt continues to look interesting given higher capital and parent company liquidity than existed pre-crisis. The yields for small- and mid-cap banks are about 6% to 9%, which an investor can enhance with leverage.

Also in the "income play" category is commercial real estate. For some investors it is a bond proxy given rental income with an embedded inflation hedge to the extent rents rise with inflation. If the Fed is not going to move, it seems CRE should be a beneficiary as a levered, income-producing asset. A wrinkle in the bond proxy thought process is the terminal value. A corporation that pays off a maturing bond at par is not the same proposition as monetizing an illiquid asset.

In March 2013, I saw Cantor Fitzgerald LP and BGC Partners Inc. CEO Howard Lutnick speak in Nashville. I do not know what his thoughts are today, but he thought then that short rates would stay anchored to zero for at least five more years. As a result, he thought CRE would do well as investors accepted lower cap rates (i.e., pay higher multiples of cash flow). It was a good call. Green Street Advisors reported that its commercial property index rose 1% in February 2015. Investors were described as having a "healthy appetite" for commercial property by pushing prices to "new highs."

Lutnick also offered that structured products would perform well to the extent a reasonable return was offered for a reasonable risk taken. I do not know how he feels about structured finance today.

Lutnick did not address business development companies, but one might describe a BDC as a form of a structured finance vehicle that uses limited leverage to make senior and subordinated loans and in some cases make investments in CLOs and private equity. Although the sector is tiny relative to commercial banks, it has seen strong growth since the financial crisis. Growth has been driven by a rebound in leverage lending and regulatory limits on banks' ability to lend to levered companies. It also has been supported by investors' willingness to fund the growth because the credit backdrop has been favorable and because BDCs pay high common dividends as regulated investment companies that must distribute at least 90% of taxable income.

For a year or so following Lutnick's comments, BDCs performed well; however, the sector has struggled since mid-year 2014 due to dividend cuts by some and widening credit spreads. Earlier this year I had a post about the sector that raised questions about credit marks, asset yields and dividend capacity.

Like with banks, I see the obvious impact of the Fed's inaction as being reflected in pressure on yields for new asset originations. Credit, though, is where investors in financials should focus. I say this not because I think BDCs are bad at underwriting credit or credit is poised to turn; rather, BDCs may be at the forefront of the next down cycle because BDCs lend to riskier companies and their investments are subject to fair value marks each quarter.

While the past five years have seen improving credit quality among most lenders, I think the marginal impact of Fed largesse on credit may be running its course. Prospect Capital Corp., Fifth Street Finance Corp. and Triangle Capital Corp., among others, booked realized losses and/or negative fair value marks during the fourth quarter of 2014. A common theme may have been the impact of widening credit spreads on fair value marks and a year-end clean-up of underperforming assets. Still, I think BDCs will be an important sector to watch — especially if the Fed surprises me and others by tightening more than once.

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