NASHVILLE NOTES

Recency bias

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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.

A Nashville friend told me the other day that he passed a McDonald’s that was advertising daily pay on his way to meet me. Let that sink in for a moment.

McDonalds and other businesses are suffering from a shortage of workers in part because the government is competing with the private sector for labor via sizable pandemic payments. Large businesses that can afford to do so have upped minimum wages, with Bank of America Corp. announcing it would boost its minimum wage from $20 per hour presently to $25 per hour by 2025 — about 10x the minimum wage I earned in the late 1970s and early 1980s in central Kentucky as a teenager.

In the age of digital currencies and non-fungible tokens, it seems reasonable to debate what money really is; not so with debt, however. Doug Noland, a portfolio manager who writes a blog with the tagline "chronicling history’s greatest financial bubble," notes U.S. dollar-denominated debt rose $9.199 trillion, or 12%, over the past five quarters.

It is all very surreal, but will it continue? Recency bias — the cognitive phenomenon in which we project current conditions into perpetuity — says yes. Logic says it cannot, however.

As it relates to markets, recency bias is a procyclical phenomenon. It tells us today’s good times will continue until further notice, while economic downturns often are expected to be drawn-out affairs.

That said, the current economic backdrop of unconstrained federal government spending and debt monetization by the Federal Reserve is breathtaking. If the bond market will not take the car keys from the politicians and the Fed, then why can't unconstrained spending by Washington and "support" of the economy by the Fed remain open-ended?

Theoretically, rising inflation should be one reason.

The primary market debate today is whether inflation is "transitory," and if not, whether the Fed will, or be able to, raise short-term rates. The bond market appears to question the Fed’s ability to raise short-term rates given the muted reaction to the 5% increase in consumer prices from May 2020 as measured by the CPI. The yield on the 10-year U.S. Treasury bond closed at 1.45% on June 11, about 30 basis points below the March 31 close even though the highest inflation reads in years were recorded in April and May.

Markets are forward looking and reflect a probability distribution of outcomes. If one outcome is sustained higher inflation, another is an economy that may not remain nearly as strong as it is today, or a possible deflationary bust if the Fed ever hikes short-term rates too much.

So, the bond market — assuming it is a true market — is not pressuring the Fed to do anything for now. Recency bias implies the firehose of liquidity being pumped into the banking system and markets will continue this year and maybe part of next year. Hikes in short-term rates remain over the horizon.

For bank investors recency bias implies more of the same should be expected, notwithstanding incredulity that current high inflation and microscopic interest rates are incompatible.

Ralph Babb, the prior CEO of Comerica Inc., used to say management was focused on spread revenues, not the net interest margin calculation, when he was quizzed about the company's NIM. I think that perspective is especially correct in the current environment where liquidity is overwhelming balance sheets.

The Fed is not going to raise short-term rates until further notice, in my view, while competitive pressures will gradually grind on asset yields. Rarely does a day go by that I do not see a story about a company that has refinanced its loans or issued lower-coupon bonds and preferred shares to call higher-rate issues. Citigroup Inc. and Wells Fargo & Co.'s new cashback programs for their card users are another form of price competition that may be classified as marketing expenditures.

The phenomenon of competitive pressures pushing yield lower happened last decade, too, prior to our experiment with rising rates during 2017 and 2018 that began to unravel in 2019. What is new today is an extreme liquidity torrent.

So far, stories of banks pushing large depositors off balance sheet into money market funds is limited to the large banks, but the phenomenon could spread. Loan demand is tepid; low-risk fixed income investments offer little income; and leverage ratios (though not risk-based capital ratios) are under pressure as balance sheets expand. Recency bias says loan demand will be weak for a long time, but that should change in time assuming no economic shocks.

If in Europe all roads lead to Rome, then for U.S. banks all roads lead to M&A. It is the only logical outcome for an operating environment that seems poised to continue indefinitely.

Recency bias also implies the ascent in risk assets may continue, although a correction is overdue. If so, the Fed may find itself in a place it does not wish to be. Would the Fed be willing to pop the asset bubble in an economy that many believe is dependent upon elevated asset prices to drive "wealth effect" spending? I doubt it, but if so, NIMs would be higher — though some might question go-forward credit costs.

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