NASHVILLE NOTES

# Scouring Papers For the Next Story

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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.*

Earnings season is underway as I pen this with the releases of JPMorgan Chase & Co., Citigroup Inc., Wells Fargo & Co., and PNC Financial Services Group Inc., who all beat, or blowout in the case of JPMorgan, the consensus earnings per share estimate. West coast thrift Washington Federal Inc. missed consensus as its net interest margin declined from the prior quarter. PNC's NIM also declined, but it managed to beat the EPS estimates.

> ***There is an old saw in investing: Look for stories inside the newspaper that may move markets in the future, rather than stories that already moved the market and are now on the front page.***

The story this quarter is deposits and the cost of funds. It has been a developing story over the past year as the Federal Reserve raised its short-term policy rates 475 basis points, while most banks until recently were able to seriously lag deposit rates. The duration- or liquidity-induced failures of Silicon Valley Bank and Signature Bank brought the issue to the front page of many newspapers beyond the financial press.

Yet there is an old saw in investing: Look for stories inside the newspaper that may move markets in the future, rather than stories that already moved the market and are now on the front page. I think that is what has happened to the "deposit run" story. The deposit run ended weeks ago; the slow walk of deposits to higher yielding money markets and Treasuries continues to the extent that banks do not sufficiently raise money market and certificate of deposits rates to stem the outflow.

Around 50 years ago, deposit outflows were a potential problem when the first money market fund was introduced as a way around Regulation Q, a depression-era regulation that prohibited banks then from paying interest on demand deposits and capped non-demand rates at 5.25%. When the Reserve Fund was introduced in 1971, rising inflation was then putting pressure on the competitiveness of bank deposit pricing that would only get worse as inflation intensified.

Merrill Lynch was an innovator, too. The company introduced the Cash Management Account in 1977. The CMA allowed customers to sweep excess funds, credit brokerage balances, into a virtual bank account that had check-writing privileges and a credit card.

While there was zero danger of the CMA disintermediating deposits from commercial banks when it was introduced, the introduction of the money market funds, CMA and phaseout of Regulation Q laid the groundwork for a much more competitive environment for bank deposits. Technology — especially the introduction of smart phones and apps — would make the process near instantaneous and seamless, too.

And in an ironic twist, the credit balances at Merrill Lynch can now be swept into FDIC-insured deposits at Bank of America Corp. The same applies to credit balances in brokerage accounts where there is a bank affiliate through a common bank holding company parent such as Charles Schwab Corp. and Raymond James Financial, Inc.

Both the Reserve Fund and Merrill Lynch moved to the front pages in the fall of 2008. Merrill Lynch was within hours of failing when Bank of America agreed to acquire it; and the Reserve Fund broke the "buck" — that is the $1.00 per share stable net asset value — because of a position it held in Lehman Brothers commercial paper.

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No one knows the future, so scouring newspapers for possible troublesome stories (or Twitter for memes) that will become front page (or trending) news will not yield anything decisive. CRE credit is a possibility, but the surprise at this point would be if it did not become a major issue for banks, because CRE is becoming a front-page story for CMBS investors.

Another possibility is the potential return of stagflation, which was last experienced in the 1970s when growth was sluggish, and inflation and interest rates were high. This possibility may be one reason why bank stock valuations are so low in the absence of developing credit issues in which deposit rates have much further to rise.

According to the FDIC, the cost of funds measured as a percentage of average earning assets was 1.28% for banks with $10 billion to $250 billion of assets in the fourth quarter of 2022, compared to about 3.50% during the second half of 2006 and 2007 when the Fed Funds target rate of 5.25% was near where it stands today.

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*Jeff K. Davis, Managing Director of Mercer Capital's Financial Institutions Group, is a regular contributor to S&P Global Market Intelligence, formerly SNL Financial. He can be reached at jeffdavis@mercercapital.com or 615.345.0350.*