NASHVILLE NOTES

3 Questions for Jamie Dimon

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Another earnings season begins at the end of this week. Few expect any surprises. Deposit cost of funds will jump and likely cause net interest margins to contract in 2023 after a big expansion in 2022, mortgage banking is abysmal, and loan loss provisioning will increase given the slowing economy. Wall Street businesses are mixed. Trading is OK, but investment banking for both capital raising and M&A is in a drought.

There may be a few banks that prove to be a mini version of Silvergate Capital Corp., in which bonds were sold at a loss to generate liquidity to fund deposit outflows. That said, I am not hearing vignettes from my fixed income friends of banks throwing in the towel and selling bonds to restructure their balance sheets, which in the past has signaled a peaking in the rate cycle. This time, the bond market seems to be signaling the peak occurred in October given the significant rally in the market since then that has trimmed unrealized losses.

A lot of eyes will be on SVB Financial Group. Its third-quarter 2022 earnings release caught investors off guard when sophisticated depositors withdrew deposits and otherwise demanded higher rates and thereby upended what was thought to be an asset-sensitive balance sheet.

But what I think the Street really wants to know with a high degree of certainty is how deep will the credit cycle be. Judging by credit spreads that have widened but not "blown out" maybe the answer is not that bad. JPMorgan Chase & Co. CEO Jamie Dimon always has an informed opinion that would shed light. If I could ask, my questions would be as follows.

First: Does it matter if the leveraged loan (and high yield) markets have not yet cleared?

Last quarter when asked if the leveraged loan market has cleared yet, he said it had not. I do not think he would answer differently today, though perhaps he would offer the nuance that the market is not completely shut, and high-yield credit spreads narrowed somewhat in the fourth quarter. Twitter Inc.'s debt financing, which is stranded on the balance sheets of Morgan Stanley, Bank of America Corp. and Barclays PLC and other banks who were unable to sell it, is emblematic of a troubled market.

Leverage finance is an important source of capital for American companies; however, I do not think it is broken like it was in 2008. Price and structure are the issue. Investors are sending a clear signal that there is a need to be less levered in a higher rate environment. Sponsors will have to contribute more equity for portfolio companies that want to tap the market if a company cannot generate enough excess cash flow to de-lever on its own.

The second question: Are systemic liquidity issues developing?

I ask this against the backdrop of the fourth-quarter gating of redemptions of large private real estate investment trusts managed by Blackstone Inc. and Starwood. Private assets and credit have been a go-to asset class for yield. Investors who cannot sell illiquid assets will sell what they can if they need liquidity in what can become a negative feedback loop. The gating issue is reminiscent of 2008 when many funds could not sell illiquid assets to meet redemptions.

In 2015, Carl Icahn called BlackRock Inc. an "extremely dangerous company" because of exchange-traded funds that it sponsored in which the underlying asset, such as high-yield bonds and levered loans, were illiquid. Yet, eight years later, illiquid assets in liquid ETF wrappers have not brought on any calamities.

The third question is similar to Icahn's: Has the structure of the market contributed to the overvaluation of assets and thereby allowed for more leverage?

The question does not speak to the credit cycle directly, but it does address the role of market structure in driving asset values and the risk that any sharp reduction in asset values creates widespread credit issues.

Passive investing has existed for decades but has come to dominate the public equity markets based upon the constitution of the largest shareholders in any given mid-cap, large-cap and often small-cap company. That is, capitalization rather than fundamentals has directed capital flows for funds tied to market capitalization. For instance, four of the top five institutional holders of Tesla Inc. are passive funds as of Sept. 30, 2022.

The bonus question would be whether Dimon sees an outsized opportunity for JPMorgan to benefit from any downturn in the credit cycle that may be centered around leverage finance. During the third quarter, he said the bank did not have much exposure to leveraged loans, which I took to mean stranded on its balance sheet because the bank is not at the bottom of the league tables.

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