SNL Blogs

NASHVILLE NOTES

Monday, October 27, 2014 6:08 AM CT

A witty saying proves nothing

By Jeff K. Davis

Jeff Davis is a veteran bank analyst and SNL contributor. The following does not constitute investment advice, and the views and opinions expressed in this piece are those of the author and do not necessarily represent the views of SNL or Mercer Capital, where he is the managing director of the financial institutions group.

French philosopher Voltaire is credited with saying, "a witty saying proves nothing." He may not be right as it relates to markets.

I know an elderly New York-based gentleman who invests in banks and real estate, among other assets. During early 2009 he remarked about the darkness of it all to me, but thought it might all work out; he even initiated a position in Chicago-based Taylor Capital Group Inc., which in my mind contradicted the adage that one becomes more conservative as you age. He recounted the impact of the downturn in real estate in the late 1980s and early 1990s (it almost took Citibank down then, too), while holding out for an OK outcome. His motto, "stay alive until 95." Real estate markets soared until 2007. The CEO of a Southeast-based bank told me at the Gulf South Bank Conference in May 2008 the "sun will shine in late '09." He called the turn two or three years early, but when grading on a curve he gets a pass. One that remains unfulfilled is an analyst report I saw in the late 1990s entitled, "Three Reasons BB&T will Buy Atlanta's Fidelity Southern Corporation: Location, Location, Location."

Few of us have an original thought or catchy saying; we hear them from others. One that I remember from the early 1990s is "cash is trash" when the Fed had lowered the Federal Funds target rate to the then unheard of rate of 3.0% (in 1981 the Fed briefly pushed the target rate over 20%). The saying reappeared in 2003 or thereabouts when the Funds target was lowered to 1.0%.

I did not hear trash uttered during any third-quarter conference call, but bankers clearly want to convert liquidity to loans. The opportunity cost of holding cash and excess bonds versus making loans absent an impending credit debacle is sizable. Earning assets that yield nearly zero are mislabeled. Commentary that I heard during third-quarter calls touched on several themes that are unchanged from the past couple of years: strong and building capital, moderate loan growth, low credit costs and loan yields that continue to grind lower quarter-after quarter.

More bankers also are talking about easing credit standards employed by competitors to drive loan growth. Pinnacle Financial Partners Inc. CFO Harold Carpenter noted that yield-seeking REITs and insurance companies were encroaching on banks' traditional lending markets by making smaller loans, leading to unexpected payoffs. I have heard similar comments from others.

Competition-related comments like Carpenter's have gotten a lot of press; however, loan yields have not gotten as much play, but they should. I see declining yields as a source of slow asphyxiation of bank profitability; it is akin to oxygen gradually being sucked out of a room. No one notices for a long time because it is a gradual thing. The same thought applies to insurance companies and their investment portfolios.

Loan yields have been declining since late 2007 when the Fed began to cut the Fed Funds target rate, but there have been offsets via declining cost of funds, lower credit costs since 2010 and mortgage originations that periodically boomed. The offsets have run their course, however. Besides, I think most sell-siders and maybe buy-siders focus too much on the shape of the Treasury yield curve and the evolving earning asset mix to notice the risk that the yield issue represents if it continues for a couple more years.

Loan spreads — i.e., the margin over a base rate such as 30-day LIBOR — widened somewhat in 2008 and 2009 when banks were able to extract a premium from borrowers for credit. I heard a BB&T executive remark during 2008 that banks would get paid for lending for the first time since he was a young man. I do not believe his pricing power call lasted too long. A backdrop of an improving economy and more recently intense competition among lenders who need to put excess liquidity to work has produced an environment where loan yields seemingly decline every quarter.

Kansas City-based Commerce Bancshares Inc. seems to be representative. The yield on its "business" loans in the third quarter was 2.81%, compared to 2.85% last quarter and 2.96% in the year ago quarter. The yield on the overall portfolio was 4.01% in the third quarter, down four basis points from the second quarter and 25 basis points from the year ago quarter. I have not heard any executive remark during a conference call that the slow walk lower is nearly over.

I do not believe Street estimates for 2015 and now 2016 reflect this; rather, most estimates appear to assume the Fed will raise short rates next year, thereby driving commercial bank NIMs higher. Maybe, but during last week's panicky selling of equities and corporate bonds, St. Louis Federal Reserve Bank President Jim Bullard noted the Fed could extend its bond buying if need be. If so, the logic implies the Fed would delay its much discussed but as yet to occur rate hikes that always are one-year away in the view of many Street participants. Or stated differently, Bullard may have put a "nail-in-the-coffin" narrative of rising rates will boost NIMs and render analysts' out-year projections credible. But as Voltaire noted, a witty saying proves nothing.

Published with permission.

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