SNL Blogs

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Credit costs should be part of banking industry's post-Nov. 8 narrative, too

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The Nov. 8 election of Donald Trump as president has produced a rewrite of assorted narratives. One is that the banking industry is a winner. Investors agreed. The SNL U.S. Bank index rose 13.3% last week. Outside of the financial crisis era, it was the biggest weekly move in the index over the past 10 years. The largest was the trading week ended March 13, 2009, when it became clear the Obama administration was not going to nationalize the banks and, if my memory is correct, the week in which application of mark-to-market accounting was diluted.

Regardless of one's politics, I do not think it is controversial to state that a Republican administration, whether populist or not, will be beneficial for banks. Whether there is a broad rollback in Dodd-Frank (excluding higher capital requirements) or as I think more probable a trimming of the law’s excesses remains to be seen. Last week’s narrative included a widespread but unproven view that the new administration will be good for business with a rollback in the regulatory state, tax reform and more infrastructure spending.

What appeared to give additional legs to the bank rally were comments by Duquesne Capital founder Stan Druckenmiller that he is bullish on the economy and bearish on bonds. He described the Fed's rate policy as akin to holding a beach ball under water. Also, DoubleLine CEO Jeffery Gundlach has had a number of nonconsensus calls in recent years that proved to be correct, including when he strayed into the political arena in January when he predicted that Trump would be elected president. Gundlach's call last week was that the 10-year yield could rise to 6% in the next four or five years because Trump's policies are inherently bond unfriendly. Midyear, he proclaimed the secular low was in when the 10-year yield fell to near 1.3% in the aftermath of the Brexit vote. After the election, the yield pushed solidly above 2%. Prognostications aside, Gundlach and Druckenmiller are heavy hitters whose views are closely followed by global investors.

If one of them said it, I missed it, but rates also may be destined to rise if Trump engineers an intellectual change at the Fed in favor of a more honest monetary policy. This would occur at the same time deficit spending from higher infrastructure, entitlement and defense spending is poised to rise. Someone has to buy newly issued Treasurys to fund the government. Without buying in size from the Fed and other central banks, the market clearing price should be lower unless the economy rolls over.

Bank investors, rightly, cheered the prospect of higher rates. A slow-moving Fed means a steeper yield curve if Gundlach is right about inflation and where longer-dated yields are headed. Also, higher short-to-intermediate rates will "reflate" the value of core deposits — especially non-interest-bearing deposits — and thereby push NIMs higher. But there will be a debris field. One will be bond and fixed-rate mortgage portfolios, though core deposit funded banks have the capacity to wait on the assets to mature. Mortgage banking will finally see its comeuppance, too.

Another possible and more meaningful find in the debris field could be credit, or at least credit extended by poor underwriters and those who took outsized risk when ZIRP reduced asset yields to nominal amounts. The reduction in long-term rates that on a secular basis ran from the early 1980s through possibly July 2016 has been a powerful contributor to asset inflation. Lower rates equate to higher present values of future cash flows unless an offsetting increase in risk premium that investors require occurs. Those in the bubble camp may argue that not only have risk premiums not risen to offset lower rates, but the opposite has occurred with investors willing to accept lower risk premium in search of income and capital appreciation when safe assets yield virtually nothing. The result, if you buy the argument, has been alarming asset inflation in broad swaths of CRE, public and private equities, high-end housing, art, and other assets. Bubble or not, higher prices have reduced credit losses for banks even though commercial banks are theoretically cash flow lenders rather than asset-based lenders.

Rising rates will produce the opposite impact of lower asset prices if not offset by even lower risk premiums and/or higher cash flows produced by the assets. Proponents of the view that the Trump administration will prove to be good for the economy would argue this, I believe. That may prove to be true, but I think investor calculus should consider what higher rates could mean for today's ultra-low credit costs. In the event of default, losses may be higher than expected. We will not know for several years, however, assuming Gundlach, Druckenmiller and the new consensus are correct.

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