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John Thain, BDCs and market timing

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CIT Group Inc.'s shares crashed 7% on Feb. 2 following a noisy fourth quarter that modestly missed the consensus estimate; however, it was the Q&A with analysts that probably added to the downward momentum. It touched on the woeful valuation of aircraft lessors (under book value), what hurdles exist for CIT to spin-out or sell its aircraft leasing business, and marks applied to a modest energy portfolio. I thought CEO John Thain nailed the markets' zeitgeist when he said markets "seem to indicate a recession is imminent" given where CIT and other lenders' shares are priced. CIT is among the cheaper lenders, priced at 58% of tangible book value and less than 8x consensus 2016 estimates as of Feb. 2. Its shares are down 30% year-to-date, although asset quality has not rolled over. Nonaccruals and other real estate were less than 0.8% of loans and operating leases.

Thain's point is that markets are forward-looking. He disagreed with its view, noting that he does not see a recession and that lower energy prices do not cause recessions. I tend to agree, but that should be of no comfort to anyone reading this. Oil is the new global yardstick in addition to two time-tested metrics: the shape of the yield curve and the trend in credit spreads. All three are shouting today. In the lead-up to the last recession, the deteriorating market for subprime mortgages coupled with widening credit spreads and a flattening yield curve that began to signal danger in 2007.

As noted in this column and elsewhere for over a year, credit spreads have been steadily widening since mid-2014. Energy-related credits have been the primary culprit though the widening trend has spread to the broader credit universe the past few months. Is it just fleeing liquidity or is the ground shifting? I do not know. My experience is that credit markets get the memo about over-the-horizon problems well before equity investors because debt investors are focused on being paid back. Equity investors focus on earnings expectations, terminal values in the distant future and the "story." Story stocks usually are companies with not so great fundamentals today but lots of potential.

In a sense, the shares of many banks and other lenders were story stocks during 2014 and 2015. Fundamentals were fine, but the narrative was that it would get better. Rising short rates would lift net interest margins and validate the Street's 2016 and 2017 estimates. Since the Fed raised the funds target rate on Dec. 16, the yield on the 10-year U.S. Treasury has fallen 45 basis points from 2.30% to 1.85% as of Feb. 2. That, combined with the trend toward wider credit spreads, says the economy is slowing. The one-and-done scenario seems to be the most likely Fed path today.

Also, the move by the Bank of Japan from a zero interest rate policy (ZIRP) to a negative interest rate policy (NIRP) has not helped bank investor psychology; nor has inclusion of NIRP in the adverse scenario for this year's stress testing. Some of the downdraft in bank stocks this past week may have a tinge of what-if embedded in investors' psychology. The result is that bank stocks have been hammered this year, with Citigroup Inc. down 25% and Bank of America Corp. down 23%. Valuation has not provided much support with both banks trading below tangible book value and at single digit price-to-earnings ratios based upon 2016 consensus estimates. Is the risk-reward attractive? It looks so to me, although the evolution of credit quality this year rather than the lack of NIM expansion will be arbiter of whether the stocks have overshot to the downside.

Investors will get another look at credit from the perspective from business development companies (BDCs) over the next few weeks when most will release earnings. Among the larger BDCs to watch will be Ares Capital Corp., Fifth Street Finance Corp. and Prospect Capital Corp.

Like bank stocks of late, the performance of BDC shares has not been promising the past year with SNL's U.S. RIC Index, which includes BDCs, down 22% over the past year. Investor concerns have centered on declining NAVs for some BDCs in spite of a benign credit environment and dividend cuts due to inadequate dividend coverage from net investment income. Also, the Street has raised questions about whether the quarterly fair value marks for BDC investment portfolios have been sufficient given the amount by which many trade below book value. It's a fair question. I think a more important trend to watch this year will be whether the pressure on NAVs the past year predicted a material deterioration in credit beyond energy credits and structured credit investments like CLO equity. While BDC portfolios may not have that many "triple-hook" (CCC-rated) loans, there are plenty of B1/B credits that may be under pressure if the high-yield market is to be believed.

No one knows where debt and equity markets are headed from here, but open-market purchases by executives of banks, BDCs and other lenders to the extent they occur could be one signal the market has overreacted. Depending upon the amount of the purchase, insider buying can be a stronger signal than share buybacks.

Given his pending retirement as CEO on March 31, Thain may not be interested in acquiring CIT shares today even though the shares are statistically cheap. While it presumably was not a large sum for him, Thain made a statement (or at least an impression on me), when he bought $1.2 million of stock on Aug. 23, 2011, when he paid just under $30 per share. At the time, markets were in a tailspin because S&P had cut its triple-A rating of the U.S. government and, more importantly, the intra-European bank lending market had frozen. Prior to the August swoon CIT had been trading in a range of about $40 to $45 per share. Thain made a statement about his outlook for CIT at a time when the company was precluded from buying back its shares due to a written agreement with the New York Federal Reserve Bank that has since been lifted. As quiet periods end with the release of fourth-quarter earnings, executives may (or may not) send a signal to investors that the risk-reward of their institution's shares is enticing today, too.

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