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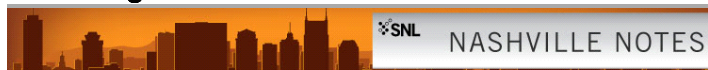

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KeyCorp's Weeden and Huntington's Kimble have 1 thing in common other than Ohio

By Jeff Davis

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In early March of 2011, I visited Jeff Weeden, the retiring CFO of KeyCorp in Cleveland. I asked him if he would consider adding corporate bonds to the investment portfolio to pick up yield given surging liquidity, weak loan demand and what was then viewed as unappealing Treasury, agency and agency MBS yields. The 10-year Treasury yielded about 3.5%, while Moody's long-dated (20-plus years) Aaa- and Baa-rated corporate indices yielded 5.1% and 6.1%, respectively, according to the Fed's H.15. Weeden said it was funny that I asked because his staff had just reluctantly started to study that option.

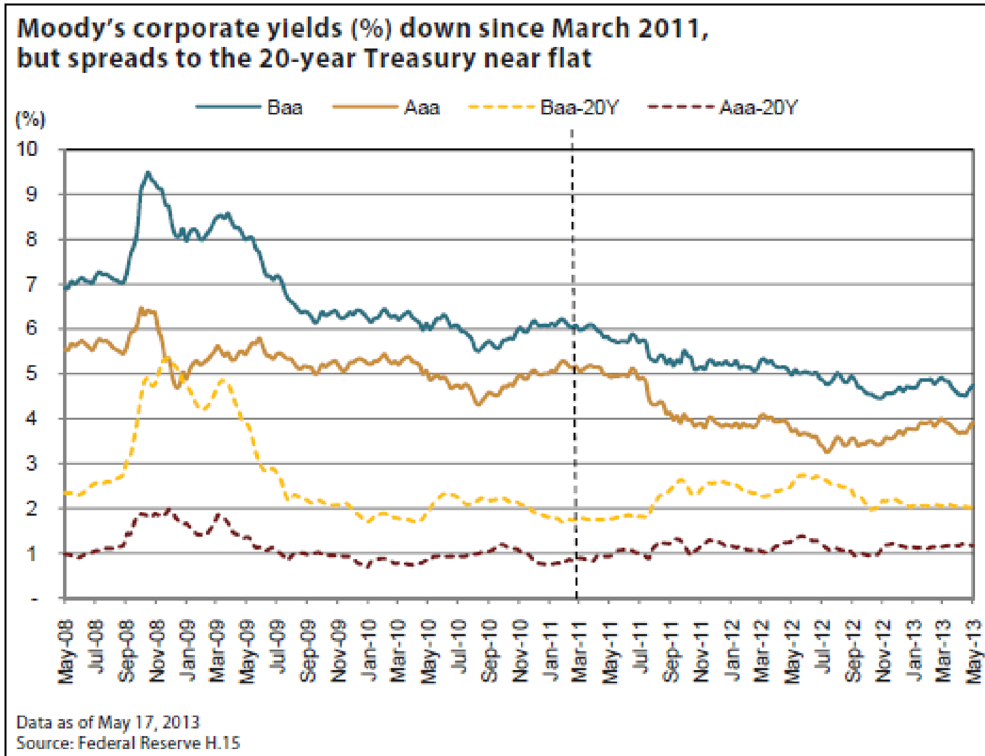
The next day I visited Huntington Bancshares Inc. management in Columbus, Ohio. I asked Don Kimble, then CFO and now the successor to Jeff Weeden, the same question. His response was the same. His staff was studying the possibility, but he did not want to do so. He added that the problem in doing so was that he would have to take duration risk in addition to credit risk to obtain any yield since the front end of the corporate curve was so low. The response was understandable given the events of 2008 and 2009, in which Huntington dealt with small, but troublesome portfolios of private label mortgages and trust preferred CDOs. Plus, Huntington began to produce net loan growth before most of its peers. In the summer of 2009, CEO Stephen Steinour made a mark on me when he assured me that Huntington would not be the last bank to restart lending even though the company still had capital questions to resolve.

Intermediate- and long-term rates are now lower, while investment-grade credit spreads are nominally wider because in early 2011 the consensus was that the economy was on the cusp of strengthening at a faster pace. On the same trip, I visited with an economist with the Cleveland Fed who offered a constructive view on a gradually improving economy — though the one stat he indicated puzzled the staff was the employment/participation rate for young men who were not in the military or education system. They were unaccounted for.

As of May 17, the 10-year Treasury yielded 1.93%, compared to 3.91% and 4.74%, respectively, for Moody's Aaa- and Baa-rated corporate indices. More interesting, I think, is the reduction in junk bond yields and spreads over this period following a spike in both in the third quarter of 2011. The yield on the BAML high yield index, which has a shorter average maturity than the cited Moody's yields, fell to 5.2% in early May; Barclay's high yield index fell a few basis points below 5%. In March 2011, the BAML index yielded about 7%. The old rule of thumb for high yield was that regardless of the spread to similar duration Treasuries (4.4% at present versus the long-term average of about 6% and about 9% in early October 2011), high yield should yield more than 7%. Junk bonds now yield less than money markets did in mid-2007 at the onset of the financial crisis.

Last week I visited with several bank management teams. The discussions invariably turned to rates and the Federal Reserve. One CEO talked about when (short) rates begin to increase, the industry's NIM and profitability will rise. The other offered that short rates may remain low for a long time. When I asked another person if M&A modeling entails a protracted easing in a target's loan yields and NIM, the answer was "some, but maybe not enough." All noted what price competition was doing to loan yields.

These comments occurred against a backdrop of Chairman Bernanke testifying before Congress last week that the Fed may taper its monthly purchase of $85 billion of agency MBS and U.S. Treasuries if the economy improves sufficiently. Taper does not mean stopping purchases, selling bonds or raising short rates, though it probably is a prerequisite for those things to occur. I think investors and managers do not want to contemplate what many more years of the Fed's zero interest rates imply for profitability for banks that are predominantly dependent upon spread revenues. Short of unexpected rate hikes, the hoped-for outcome, which is plausible, is to maintain current earnings via loan growth combined and expense cuts. KeyCorp and Huntington seem to be on that path.



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