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Playing between the 40-yard lines

By Jeff K. Davis

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Last week was one of the most volatile weeks on record for U.S. Treasuries and other types of bonds, especially emerging market bonds. It is ironic that at the beginning of the week President Barack Obama seemingly fired Federal Reserve Chairman Ben Bernanke during a PBS interview with Charlie Rose in which he noted Bernanke had stayed in the job longer than he (Bernanke) had intended. It is hard for me to imagine the president appointing a hard-money type to discipline financial markets. President Harry Truman settled a tiff at the Fed about its support for the economy in spite of high inflation in 1947 and 1948 by sacking then-Fed Chairman Marriner Eccles. The capping of rates by the Fed continued for three more years until increased acrimony led to the "Treasury Accord" in 1951, over 20 years after the Great Depression began.

Last week's price action gave a glimpse into what life is like with rising rates, something that has occurred in a non-linear fashion beginning with the Treasury Accord and ending when Paul Volcker pushed the fed funds target toward 20% in 1981. Equities were the place to be during the 1950s and 1960s, but investors had to trade in and out of equities during the 1970s and early 1980s given several brutal bear markets as rates kept marching higher. It was during the carnage of the 1970s and early 1980s that the value proposition was re-established both for equities and bonds as earnings multiples fell and bond yields climbed. Bonds were then referred to "certificates of confiscation" due to the impact of inflation on fixed income; one might argue the same phrase applies today based upon the coupons.

We will not know for years whether the Chairman's comments represented a clear inflection point in the 32-year-old bond rally or rather the comments intended to lessen speculation by inflecting pain on levered investors. The cycle low, as measured by the 10-year U.S. Treasury, was set in July 2012 when the yield fell to 1.38%; it was not set December 2012 when QE4 began, and it was not set a week before Bernanke's testimony to Congress in late May when tapering was mentioned.

When the Fed might raise short rates vs. taper bond purchases is another matter. Think years, in my view. This economy can handle a modest increase in rates, but that is it. Housing is dependent upon long rates remaining low; the auto sector has been goosed with near zero-rate financing for borrowers who are extending loan terms toward 70 months; and commercial real estate cannot take much of an increase in cap rates given little growth in operating cash flow outside a few areas such as San Francisco, New York and Washington. And the federal government needs low short rates. A little more than 50% of the publicly held debt is financed with bills and bonds with maturities no more than three years.

A number of institutional investors were quick to hail the increase in rates as a reason to invest in U.S. banks as a steeper yield curve will portend higher net interest margins. The market seems to have taken that view.

The SNL U.S. Bank index declined 0.58% for the week and 2.87% month-to-date versus a weekly decline of 2.11% and a monthly decline of 2.58% for the S&P 500. Mortgage REITs seemingly would benefit from the same view, but the sector has been obliterated even though its key asset — agency MBS — is a staple in U.S. bank portfolios. The SNL U.S. Finance REIT index declined 6.37% last week and is off nearly 20% since March 31. One quarter's coupon does not soften that kind of blow. It seems investors are focused on the damage to book values given asset leverage and ongoing dividend cuts. Perhaps higher reinvestment yields will pre-empt dividend cuts by early next year.

A steeper yield curve is a plus for U.S. banks, but it is not an immediate path to NIM expansion or even halting erosion in the short term (Note: Many banks may show a one-time pick-up in the yield on their investment portfolio this quarter as they slow/halt MBS premium amortization). Bank balance sheets represent multiple assets (and liabilities) with different cash flow, re-pricing, duration and credit characteristics. Although reinvestment rates for new MBS and mortgage investments improved last week, I do not believe it is a game-changer yet. Absent taking losses and selling securities and mortgages to reinvest the proceeds (i.e., the opposite of taking charges to pre-pay FHLB fixed-rate advances in a declining environment), it takes a long time for portfolios to roll over.

Further, much of the recent and prospective pressure on NIMs is the result of rate competition at a time when 30-day LIBOR is only 0.22% and the three-year swap rate is 0.71%. To the extent CRE loans are priced-off the five-year swap rate, the move to 1.51% on June 21 from a recent low of 0.82% on May 1 will be helpful; however, the five-year swap rate has only been below 1% for about a year. In June 2011, the five-year swap rate averaged 1.85% and in June 2010 it averaged 2.29%. In effect, CRE portfolio yields for banks can go lower, especially if more banks return to the sector and increase price pressure absent better demand.

Are big changes in the earnings outlook afoot for U.S. banks? I do not believe so, though I recognize that the Street is highly sensitive to changes at the margin (i.e., flow) in the short run. Earnings are relatively good given the rate backdrop, and credit — the factor that overshadows all other factors by multiples — has improved dramatically. In time the NIM for a subset of banks may improve modestly if additional curve steepening occurs. Offsetting this will be lower earnings from mortgage and bond gains, and book values will decline from receding unrealized AFS bond portfolio gains. The net is that I think earnings remain on a sideways trajectory at best absent better economic growth regardless of what Street estimates say about 2014 and 2015. The mortgage and reserve release levers have run their course.

Should investors care? Maybe they should not with credit in reasonably good shape. For most banks, earnings tend to move between the 40-yard lines, but valuations vary between the 20-yard lines based upon perception and market conditions. This may be one of those times when expectations are modestly outside the 40-yard line given mid-teen earnings multiples (excluding Citigroup Inc., JPMorgan Chase & Co. and other mega caps) in a 0% earnings growth environment for most unless the steeper curve portends accelerating economic growth. PIMCO'S Bill Gross and Double-Line's Jeff Gundlach argue that the economy remains soft, which will cause bonds to rally. They are talking their book (bonds), but if they are right Annaly Capital Management Inc., Starwood Property Trust Inc. and other mortgage REITs may be the trade that offers more upside given the damage to the sector provided rates do not continue to move higher.

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