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Reading the tea leaves at Ruth's Chris Steak House in Lafayette

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Maybe I am reading too much into it, but I was struck by how the Ruth's Chris Steak House in Lafayette, La. was packed on a mid-March Tuesday night. A banker I met with the next day had eaten there the day before and offered the same observation. A year ago when I ate there I was one of maybe a half-dozen people in the restaurant. Perhaps it is just a coincidence, but the price of oil nearly doubled over that period. The regional economy may not be that responsive to moves in the price of crude, but people's reaction of being tight-fisted vs. loosening-up can change quickly based upon perceptions.

The consensus can change quickly, too. At the beginning of the year, the probabilities assigned to a March rate hike were low. By March 13, the consensus reflected a high probability the Fed would raise the Fed Funds target rate 25bps to 0.75% to 1.00%, which it did on March 15. Did much change in 75 days? I do not think so other than an exuberant market gave the Fed cover to act. The debate now is focused on when next and how many more times this year? It is a snoozer debate relative to the big picture.

The good news for commercial banks is that the value of core deposits — especially non-interest bearing deposits — will increase with rising short rates and produce wider NIMs all else equal for the likes of Comerica Inc., SVB Financial Group and other banks with lots of non-interest bearing deposits and loans that are priced off LIBOR. Nothing is new with that line of thinking. Others will benefit, too. Hercules Capital Inc, a BDC that is focused on making senior secured loans to venture capital-backed tech companies, put out a press release on March 16 that outlined the expected impact on its net interest income (i.e., higher).

Could there be any surprises, or aberrant behaviors? Whether some banks decide to "spend" the increase by lending at narrower margins over 30-day LIBOR or some other benchmark rate remains to be seen. That may seem illogical, especially for banks that have relatively high loan-to-core deposit ratios. Yet, a form of that may be playing out among online brokers that have undergone another round of price reductions for equity trading commissions that have been described as a race to zero. The increase in spread income from idle customer balances, whether held at the broker-dealer or swept into an affiliated depository such as Charles Schwab Bank, may be the catalyst to cut commission rates in an effort to retain and attract more client funds.

More likely investors will discover past rather than new aberrant behavior that will not be fully understood until the rate environment "normalizes" or at least rises enough to cause disruptions, as has been the case in the past. Hercules may see its interest income rise with LIBOR, but what about borrowers' ability to service the debt?

The spike in rates in the early 1980s after a 30-year trend of higher rates contributed to the LDC (less-developed-country) debt and savings & loan crises that festered during much of the 1980s. During 1994 the bond market was slaughtered when the Fed hiked the Fed Funds rate 300bps between January 1994 and January 1995, which included a 75bps hike in November. A lot of levered investors playing the carry trade were caught by surprise after a period of low rates (then a 3.0% Fed Funds target rate) and had to sell bonds to meet margin calls. One of the casualties was Orange County, which was forced into bankruptcy. And while there were other factors besides rising US rates, capital flight from Mexico resulted in a currency crisis that culminated with a Treasury-led bail-out in 1995 by the Clinton administration. It is hard to image the Trump administration orchestrating that today if a similar scenario occurred.

The gradual increase in the Fed Funds target rate from 1.0% to 5.25% during 2004 to 2006 did not create the bust that began to unfold in 2007, but several years of easy money and perhaps the absence of a brutal 1994-like series of hikes allowed the subprime mortgage bubble and more speculative CRE lending to gain steam. The last rate increase of that cycle occurred in early 2006. By late that year the subprime mortgage market was gasping for air as liquidity flowed out of that market and would then be withdrawn from a wider range of markets that culminated with the likes of General Electric Capital Corp. struggling to roll-over its maturing commercial paper during the fall of 2008.

Are those scenarios far-fetched for 2017 and 2018 if the Fed is on a path to raise rates only a couple times more this year, and maybe two or three times next year? Seemingly the answer is yes because less financial leverage is employed by banks and other market participants than was the case in 2007; however, we will not know for sure until the process has been underway for a while — assuming the Fed continues to raise short rates.

The risk for investors and lenders is not so much the Fed's actions rather than elevated asset prices—or valuations if you prefer. Liquidity is fickle. It is widely available when not needed, and exorbitantly expensive if available at all when it absolutely has to be obtained. If liquidity tightens too much with Fed rate hikes, asset prices at these levels seemingly could fall a lot. Liquidity determines solvency, not capital; although ample capital gives creditors more comfort.

That said I am very much in the consensus that gradually rising short-rates will be a boon to commercial banks, though perhaps not as much as the market seems to think. I get the same sense in talking to bankers around the country that many think the same thing, too.

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