NASHVILLE NOTES

Too Many Eggs in the Fed Pivot Basket

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By Jeff K. Davis

Jeff Davis is a veteran bank analyst. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of S&P Global Market Intelligence; Mercer Capital, where Davis is the managing director of the financial institutions group; or StillPoint Capital, where Davis is a registered representative.

Bob Farrell, the longtime and now retired Merrill Lynch market technician, developed 10 rules that remain widely quoted. Number nine states that when everyone agrees on an outcome, then something else will happen.

The big something else that could prove the consensus wrong this year would be rates remaining higher for longer. If so, that would be a seismic shift from the beginning of this year when investors were forecasting upward of six rate cuts by the Fed, which was double the Fed's forecast.

I am offering a glass-half-empty comment that the shifting rate environment is problematic for levered assets — especially commercial real estate (CRE). There is nothing new to the comment, nor is it intended to be part of the "CRE is doomed" narrative that is widely circulated. However, I expect that more cracks in the "asset quality is fine" narrative will develop the longer rates remain elevated.

So far, the problem CRE story largely has been confined to office, with trouble brewing in multifamily due to softening rents as supply rises in many markets. The last six months have brought an increasing number of office tower owners tossing keys back to the lenders who often are commercial mortgage-backed securities investors and insurance companies rather than banks.

> ***The value of New York Community Bancorp's multifamily loan portfolio is uncertain because it straddles an insane intersection of New York's socialistic rent-control laws and the Fed's decision to keep interest rates near zero for years.***

This year, KKR Real Estate Finance Trust cut its quarterly dividend to 25 cents per share from 43 cents per share after reporting a fourth-quarter 2023 loss. Short seller Carson Block has circled Blackstone Mortgage Trust Inc. as a candidate for a dividend cut in the second half of 2024. He cited issues he sees with its loan portfolio, in which many borrowers have been or will be pressured by declining operating income, maturing interest rate caps and the need for owners to provide equity if they intend to refinance.

Similar concerns about falling asset values and potential repossessions led to a wave of share redemption requests for Blackstone Real Estate Income Trust Inc. beginning in late 2022 that forced management to limit the number of shares the nontraded real estate investment trust would redeem each month at net asset value. Redemption requests have subsided this year, presumably because results through Sept. 30 reflect a company that so far has dodged outsized problems.

The most recent crack is New York Community Bancorp Inc., which posted a loss in the 2023 fourth quarter due to a large loan loss provision to cover elevated losses and to build the reserve. The company's primary issue is its $37 billion multifamily loan portfolio, which yields 3.85%, and secondarily the smallish office portfolio.

Although historical losses in the multifamily portfolio have been very low, the value of the portfolio and potential future losses are uncertain because it straddles an insane intersection of New York's socialistic rent-control laws and the Fed's decision to keep interest rates near zero for years. Plus, the FDIC sale of the Signature Bank loan portfolio did not inspire confidence in the value of the portfolio given financing support that was needed.

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These unique issues apparently have created regulatory pressure to boost capital sooner, rather than over time through earnings retention, as the board and existing shareholders would prefer. I think the low stock price reflects the market's view that the company may raise equity at a highly dilutive low price. (The shares closed at $3.55 per share on March 1, which equated to 35% of year-end tangible book value per share.)

The board has already taken the distasteful action of cutting the quarterly common dividend to 5 cents per share from 17 cents per share, which is the cheapest capital raising action any company can take. The dividend cut reduced new CEO Sandro DiNello's annual dividend income to $134,000 from $1.8 million, given his roughly 2.7 million share ownership, which came mostly via NYCB's December 2022 acquisition of Flagstar Bancorp.

As an aside, I covered the company as a sell-side analyst about 20 years ago. I thought the then-25 cent per share quarterly dividend was too high relative to the company's earnings power. Although the dividend was cut to 17 cents per share in 2016, it probably should have been cut further, which would have resulted in a better capital position today.

While NYCB's portfolio issues may be unique to New York-area lenders, I expect regulatory pressure to escalate this year regarding loan grading and, in some instances, capital. It may be that banks will respond by getting in front of regulators with more downgrades in challenged portfolios than occurred through year-end.

I am being flip, but of course multiple rate cuts on the order of what the consensus expected the beginning of the year would relieve pressure on many marginal credits, including some of NYCB's multifamily and office loans. However, a corollary to Farrell's ninth rule is that the market tends to go in the direction that causes the most pain for the most investors.

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