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NASHVILLE NOTES

What if the inflation narrative is not fake news?

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Last week, I was chatting with a CFO of a bank in which our conversation about the bank's performance migrated to the bond portfolio. The CFO is relatively young. He lamented that the portfolio had an unrealized loss for the first time since he has been CFO. My response was that he better get used to it given his age and a narrative that is gaining credence in markets that inflation and therefore rates are on the upswing. If so, he (and investors) may be looking at losses in fixed-rate bonds owned and purchased as far as the eye can see given the tendency of rates to exhibit long-term trends to move in one direction.

The narrative until recently has been that inflation was dormant, dead, minimal or something along those lines. Central bankers have been actively trying to engineer higher inflation since the financial crisis. The media seems to be cheering them on based upon my anecdotal observations of talking heads on TV, whether expressing an opinion or reading the teleprompter that "low" inflation is a problem.

Yet, many reading this probably find the premise of negligible inflation other than maybe electronics and apparel to be a joke. Only government statisticians seem to have trouble finding inflation. Maybe their calculation has a bias not to do so after the 1996 report by the Boskin Commission that was appointed by the U.S. Senate to study inflation. The commission concluded the consumer price index overstated inflation by over 1%. Funny that no one coined the term "fake news" then.

Let's assume the system is going to increasingly find more inflation. In a world in which central banks do not pin interest rates to the floor, then rates will trend higher (and bond prices will fall). Or, stated differently, markets that are defined as willing buyers and willing sellers will become less distorted if central bankers that have been buying government bonds and other assets regardless of price/value really do stop buying and allow the market to function freely.

What happens then? Rates have to rise, I think, with or without a mushroom cloud until the system is on the precipice again and the central bankers step in to start buying again. What is the appeal of a 10-year U.S. Treasury with a yield of, say, 3% other than it is up from less than 2% prior to the November 2016 election? It still is an unappealing proposition for most investors; or, in Street terms, a return-free risky asset. Corporate bonds, whether investment-grade or high-yield, are not much better with a bit more coupon income but limited margin of safety to the investor otherwise.

For banks, there are a number of implications. One is that the higher rates trend the more valuable core deposits become, especially non-interest-bearing deposits. Bank of America Corp. has been a huge beneficiary of the reflation trade the past 18 months or so, given its national deposit franchise. The corollary to this is that commercial banks that rely upon a disproportionate amount of wholesale funding probably will be penalized through a lower net interest margin and a lower multiple assigned to the earnings. I am sympathetic to Banc of California Inc.'s recently announced three-year plan to boost core deposits among other initiatives to boost earnings, but core deposits are not a switch that can be flicked beyond rate, and to the extent deposits are sensitive to rate they are not really core.

An obvious unit that will be impacted by higher rates is mortgage banking. If rates continue to trend higher, refinance volumes increasingly will be viewed from the prism of the rear-view mirror. Also, mortgage prices, all else equal, will be lower and financing costs for mortgages and MBS held in a portfolio will be higher. Mortgage REIT Annaly Capital Management Inc.'s shares have struggled this year, declining by about 14% year-to-date through Feb. 9.

The most impactful aspect of higher rates for banks and other lenders is the impact on credit costs. Rising asset prices mitigate loss rates, all else equal, as collateral values rise. To the extent rising inflation is associated with rising wages as opposed to asset prices, then consumer lending may portend suppressed loss rates to the benefit of Discover Financial Services and Capital One Financial Corp.

As for commercial real estate lending, it seems like higher inflation and higher rates at best will be a wash for a couple of reasons. One is that asset prices for real estate are in the stratosphere, in my opinion. How much more appreciation can occur over an intermediate time frame? Going forward, higher inflation portends a higher growth rate in operating income from rising rental rates, but the offset should be a higher discount rate used to value the cash flows. It seems like CRE is an asset class that should not be overthought; it has soared to the moon in recent years.

For long-suffering fixed income desks, rising rates theoretically should benefit because cash flows from existing portfolios can be reinvested at higher rates; so maybe the bonds will be an easier sell. Also, more banks will be in a position to restructure bond portfolios by taking "non-recurring" charges to sell bonds at a loss to buy new bonds that have a higher yield or to payoff wholesale borrowings. That said, it may be a tough sell to get treasurers to buy new bonds when the price direction for existing bonds has been lower due to rates that are trending higher. I am not an expert in treasury management, but I bet the easiest way for a treasurer to be fired is to report to the board that he or she proposes to take a loss in the bond portfolio that rivals what was realized in the CRE portfolio during 2009-2010. That is not as far-fetched as it sounds if rates move much higher than the market anticipates.

So the outlook for bank earnings and bank stocks from here with rising rates is, I think, constructive as long as the pace of increase is modest. If the narrative that inflation was dead and/or is gradually increasing is just fake news and it is set to rip higher, price-to-earnings multiples will contract a lot. And the contrarian call is the other side of the fake news narrative: Few are prepared for a drop in rates. The business unit that would surprise to the upside is the one that is struggling the most today: mortgage banking.

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