NASHVILLE NOTES

Banks Ripped in 1995 Too

Friday, December 22, 2023 8:53 AM ET

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 David is the managing director of the financial institutions group; or StillPoint Capital, where Davis is a registered representative.

In the summer of 1994, I was working on a fairness opinion for a bank that had agreed to be acquired by Union Planters Corp., which today is part of Regions Financial Corp. I remember being mildly surprised that the market and Union Planters' shares were holding up given rapid rate hikes by the Fed that would double the fed funds rate to 6.0% by February 1995.

The Nasdaq Bank Index managed to rise 4% between the first rate hike in February 1994 and the last hike a year later with only limited sell-offs in the interim. The big failures of the era — the bankruptcy of Orange County, Calif., and the collapse of Barings Bank — were both undone by individuals. In contrast, the Nasdaq Bank Index fell by about 50% between January 2022 and May 2023 as First Republic Bank became the third S&P 500 bank constituent to fail this year. Had the Fed not concocted the Bank Term Funding Program, the damage could have been far worse.

When the Fed reduced its benchmark target rate to 3.0% in September 1992, it seemed an unimaginably low level to me. While the early 1980s saw short-term rates briefly around 20%, the fed funds target rate was near 10% in early 1989. I do not remember the term "pivot," but the Fed was forced to cut rates over the next several years due to distress in the commercial real estate (CRE) market and widespread failures of savings and loans, and to a lesser extent banks that were heavy CRE lenders. The early 1990s saw a mild recession too.

The reduction in rates and a steep yield curve that developed in the early 1990s became a backdoor recapitalization of the banking industry. It was also a great setup for bank stocks that were very cheap at the beginning of the decade as the economy and earnings would soar in time.

> ***Time will tell if the Fed achieves a soft landing in 2024. Perhaps it already has, because the economic performance in 2023 has been better than most expected.***

Whether by luck or engineering, the Fed managed a soft landing, helped by three 25-basis-point rate cuts implemented in the second half of 1995 and early 1996. The Nasdaq Bank Index would peak near 2,300 in the spring of 1998, up almost 6x from the beginning of 1990. The peak of the index coincided with a wave of bank deals, including several megadeals that formed today's Bank of America Corp. and Wells Fargo & Co., among others.

Time will tell if the Fed achieves a soft landing in 2024. Perhaps it already has, because the economic performance in 2023 has been better than most people expected at the beginning of the year, including me.

So why did Fed Chair Jerome Powell pivot at his presser Dec. 13 when he broached the subject of rate cuts (three are reflected for 2024 in the Fed's dot plot) after declaring it "premature" to discuss rate cuts on Dec. 1? Is an issue brewing that the Fed thinks may create trouble? Did the Fed get a tap from Washington that tight money in an election year is unwelcome? Or is it that the issue in plain sight — growth in government debt and interest expense — appears to be going parabolic?

I do not know, but it appears to me that Powell follows the market when Wall Street turns up the heat. In December 2018, the Fed hiked for the ninth and final time and the upper end of the Fed Funds target range rose to 2.5% — a rate markets could not handle after a decade of near-zero rates.

Although the December 2018 sell-off in equities got a lot of press, I think it was tight conditions in the high-yield and leverage loan markets and slow issuance in the fall that may have forced Powell to relent in January 2019 when the Fed took further rate hikes off the table. The Fed would later cut three times in the summer, and then had to provide repo financing in September when banks would not or could not provide sufficient liquidity to an important market.

> ***If the Fed follows through and trims short-term rates, I expect M&A and IPO activity to increase, maybe explosively, given pent-up demand.***

Five years after Powell got a Bronx cheer for a 25-basis-point rate hike to — let's admit it — a measly 2.5% short-term policy rate, Wall Street was cheering from the rafters following Powell's Dec. 13 pivot. The Nasdaq Bank index rose 7% for the week, while other interest-sensitive and small-cap stocks posted strong gains too. It was confirmation of a rally in these stocks that had been gaining strength in November as the 10-year US Treasury yield fell decisively below its October peak near 5%.

We will see if the rally has staying power, but equity rallies that are broad-based are more durable than narrow advances. If the Fed follows through and trims short-term rates, I expect M&A and IPO activity to increase, maybe explosively, given pent-up demand. Real estate may see some relief, too, but only to the extent that borrowers can engineer affordable refinancings. Another positive sign is tighter spreads in the leverage loan and high yield bond markets.

As Dow theory author Richard Russell said decades ago, markets make opinions. Likely rate cuts create good vibes on Wall Street, and might lessen whatever increase in credit costs may occur. There was no material credit downturn after the Fed hikes of 1994 to 1995 were followed by three rate cuts. Maybe this hiking cycle will entail the same, as unlikely as that seems to me.

This S&P Global Market Intelligence news article may contain information about credit ratings issued by S&P Global Ratings. Descriptions in this news article were not prepared by S&P Global Ratings.

This article was published by S&P Global Market Intelligence and not by S&P Global Ratings, which is a separately managed division of S&P Global. Published with permission.

Jeff K. Davis, Managing Director of Mercer Capital's Financial Institutions Group, is a regular contributor to S&P Global Market Intelligence, formerly SNL Financial. He can be reached at jeffdavis@mercercapital.com or 615.345.0350.