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You Mostly Never Know

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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.

Last week I was chatting with a buy-side friend who reminded me of his first trip as a young analyst in 2002 to visit then-Detroit-based Comerica Inc. Shortly after the visit, the company issued a press release that third-quarter results would include a $328 million charge, the majority of which was to cover charge-offs and to build the reserve.

Management of course could not say anything during the visit, and my friend says the body language did not betray anything. The charge was a surprise to the market because the company's shares dropped about 20%on the news.

One never knows for sure about credit and lender earnings. Losses above an expected level may take years to manifest, if at all. Downturns in the economy, sharp increases in borrowing costs and falling collateral values usually will push losses above some baseline, and a reversal of those factors in time will push loss rates down once the unsalvageable credits are purged.

Ally Financial Inc. saw its shares fall 17% on Sept. 10 when management noted at a conference that retail auto delinquencies were higher than expected for July and August. The adjective I would use to describe the increase (20 basis points for delinquencies; 10 basis points for charge-offs) is negligible, but the market is on edge about the state of the non-prime borrower, with recent blow-ups in consumer-focused Dollar General Corp., Dollar Tree Inc. and Foot Locker Inc., among others.

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When Comerica made its preannouncement in 2002, the economy had transitioned to a sluggish recovery from the shallow 2001 recession even though the Fed had cut the fed funds target rate to 1.75% by December 2001 from 6.50% in December 2000. At the behest of then-Vice Chair Ben Bernanke, the Fed would later lower the target rate to 1.0% by mid-2003.

The ultra-low rate would prove to be a disaster for housing, especially subprime borrowers, after a few years of a boom. However, capital flowed freely elsewhere. Comerica's chief credit officer remarked to me a year or so before the bottom fell out how the company reduced its auto industry exposure by selling loans to credit funds that had seen an influx of income-seeking capital. Lucky or highly insightful, it was a great call as GeneralMotors Co., Chrysler Corp. and other companies in the auto manufacturing ecosphere would later file for bankruptcy.

So, the 2024 Fed has initiated a rate-cutting cycle that has begun with a 50-basis-point reduction in the fed funds target rate to 4.75% to 5.0%. No one, including the Fed, knows how much the Fed will cut or if it might be forced to pivot to hikes if inflation reaccelerates. Unlike the fall of 2007, when the Fed cut 75 basis points, capital markets are open today.

Credit is widely if not freely available to corporate borrowers. Ever since late last year, when markets sensed the Fed would shift gears, activity in the high-yield, leveraged loan and competing private credit markets has soared both for refinancings and new issues. Credit spreads in the high-yield and leveraged loan markets have tightened this year, which is not what one would expect if a recession was imminent. It is the opposite of what was occurring in the fall of 2007.

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Some of the market action can be explained by the rise of private credit and to a lesser extent tight markets in 2022 and 2023, when Fed rate hikes caused leveraged buyout activity to fall. Pitchbook reports that the share of B-minus-rated credits has declined to 25% of the leveraged loan market from 30% in early 2023 because private credit has taken share. Leveraged loan investors (technically lenders) have fought back by cutting lending spreads.

There are issues, of course. Ally's troubles point to what I would have assumed was a widely known issue, that low-income Americans are stressed by inflation, a less robust job market and the evaporation of pandemic-era savings. Likewise, it is not new news that large office CRE is stressed, though I think this is mostly an issue for investors in CMBS below the AAA tranches.

There are certainties, too. One is that the negative gap between the rate the Fed pays on bank reserves (i.e., a Fed liability) will narrow versus the yield on its multitrillion-dollar bond portfolio. Also, lower rates will benefit the massively indebted US government.

As for bank net interest margins, there is less certitude. The cost of funds will drop, but margin expansion may be limited by deposit competition and repricing asset yields.

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