NASHVILLE NOTES

Some Cuts Matter More Than Others

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What was expected to be an uneventful bank reporting earnings season lived up to expectations: Margins contracted, funding costs rose substantially, and credit issues were episodic. The balance of the year looks to be similar with funding pressure slowing and probably rising provision expense. Although analysts have been reducing estimates since last fall, the predisposition for many was to cut 2024 EPS estimates, though not as dramatically as earlier in the year.

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The more interesting cut to me was Fitch's downgrade of the US government to AA+ from AAA on Aug. 1. Fitch subsequently downgraded Fannie Mae and Freddie Mac to AA+ from AAA later in the week. The accumulation of debt by the US government at nearly 119% of GDP has reached a level that is so absurd that it is an abstract concept, and the debt is piling up faster. Fitch estimates that deficit spending in 2023 will be 6% of GDP, which may explain the resilience of the economy this year even though rates have risen sharply.

A more succinct way to say this is that there is plenty of money, but it buys less and the outlook for the purchasing power of a dollar is not good.

Aside from JPMorgan Chase & Co. CEO Jamie Dimon, Treasury Secretary Janet Yellen and others from the government, few seem to care what a rating agency has to say about the creditworthiness of the US. That was not the case when S&P downgraded the US to AA+ on Friday, Aug. 5, 2011. I remember far more howling from Wall Street and the officialdom than what occurred last week, egged on by a 6.7% drop in the S&P 500 on Monday, Aug. 8, 2011.

Several years after the S&P downgrade, I had a chance to visit with an ex-official of the Bank of England where the topic of the downgrade came up. He said markets were on edge when the downgrade occurred because a French bank was on the ropes and the widely known Southern Europe sovereign debt crisis was intensifying.

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A classic risk-off environment produced a drop in the yield on the 10-year Treasurys from 2.6% before S&P's downgrade to about 2% by early September.

Had Fitch downgraded the US a couple of days before Silicon Valley Bank failed March 10, maybe a greater commotion would have ensued. Fitch did so in a calm market that optimistically confirmed the US as a split-rated credit with Moody's and DBRS retaining Aaa and AAA ratings (DBRS has the US on negative watch; Moody's does not), respectively.

I think it is just coincidental that the Treasury yields rose sharply Aug. 2 and Aug. 3 following Fitch's downgrade, before easing Aug. 4 with the release of the August employment reports. The bond market continues to be a paradox with a deeply inverted yield curve that historically signals the Federal Reserve will be forced to cut short-term policy rates, whereas massive federal deficits imply upward rate pressure.

My inclination is that curve inversion will be resolved through Fed rate cuts, but that is just a guess based upon past precedent, and the popping of a massive global bubble will have negative consequences.

FHN Financial Chief Economist Chris Low had forecast last fall that the Fed would raise the upper bound of the fed funds target to 6.0% when the median Fed dot plot indicated a peak rate of 4.5%. Last week he affirmed that forecast, with the Fed hiking to 6.0% by the end of this year and rate cuts not beginning until the fourth quarter of 2024. Low acknowledges that an exogenous event like (another) war or supply shock could force the Fed's hand.

Low's forecast is an opinion, like mine about the yield curve and Fitch's about the US government's creditworthiness. Nonetheless, I am struck by the implications if the Fed maintains short-term policy rates that high for that long.

Second-quarter bank earnings were OK, especially in the context of intense funding pressure. But another year like the past four quarters is going to be a grind, especially if credit costs trend higher. Many banks are carrying boatloads of low-yielding fixed-rate securities and loans in which very high marginal funding costs would go higher. It would make a tough refinancing environment for commercial real estate much tougher, too.

It is a quiet desperation, but many commercial banks and much of Wall Street are desperate for rate cuts, though the banks' depositors and Wall Street's investors are not.

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