

NASHVILLE NOTES

What to do with the cash?

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Earnings season starts this week, with JPMorgan Chase & Co., Wells Fargo & Co., Bank of America Corp. and others reporting first-quarter results. One question I expect analysts and investors to ask all management teams: What do you do with the cash piling up in the banking system?

One response could be 'nothing,' for a couple of reasons.

If the current economic strength extends into 2023 as Jamie Dimon has suggested, then consumers and businesses should withdraw their excess deposits to fund increased spending. If the cycle is virtuous, then loan demand eventually will improve, too. That is possible, though Dimon sometimes misses the mark. Maybe it was an offhand response to a question, but he called for a 5% yield on the 10-year U.S. Treasury in August 2018.

Another reason to do nothing is concern that asset prices are extremely high. Torrid markets the past year have been fueled by liquidity, which in part has been provided by rising leverage. The collapse of Archegos Capital Management seems like a one-off, but it might not be. If liquidity starts to recede because prime brokers and other creditors tighten credit, then risk asset prices could fall as liquidity is withdrawn, assuming central banks do not intervene.

The cash question is tough because cash provides an option to invest when prices are down, weighed against the cost of doing nothing when the Fed pays 0.10% on cash that banks deposit with it and bonds yield little. Making matters worse is inflation that is around 2%, or higher according to some who do not believe government inflation measures.

In 2009, a colleague at FHN Financial published a piece for fixed-income investors in which he rhetorically asked what happens if rates do not rise. Short-term rates were near zero, as is the case now; credit spreads were wide; and the 10-year U.S. Treasury yielded more than 3% during much of that year.

The opportunity cost of waiting would prove enormous because the first hike in short-term policy rates by the Fed did not occur until December 2015, and the second occurred a year later. The caveat is that there were a few windows of opportunity, such as in the aftermath of Meredith Whitney's interview with 60 minutes in December 2010 when many investors dumped municipal bonds on the premise that many issuers' finances were poised to implode.

Management teams will deal with the issue in varying ways. A subset of smaller banks in growth markets have sufficient loan demand to work off the excess liquidity even if overall loan demand in the U.S. remains mediocre. Most banks are not in that position, however. Some will turn to cash acquisitions.

One acquisition that I think could be surprisingly good is the acquisition of AmeriHome Mortgage Co. LLC by Western Alliance Bancorp. Some reading this may dismiss my comment as absurd. Interest rates in developed economies are near all-time lows. The mantra today, as in 2009, is that rates have nowhere to go but up.

Mortgage banking is a tough business when rates rise as refinance volumes wane and funding costs increase. Profitability tends to evaporate. The highly cyclical nature of the business is why investors and acquirers usually assign lousy multiples to mortgage companies. Western Alliance paid adjusted tangible book value plus \$275 million for the origination platform, which at announcement equated to about 1.4x year-end 2020 tangible book value and 5.3x forecast 2022 earnings of \$189 million.

Nonetheless, I think the acquisition makes sense. If rates do not rise sufficiently to crush mortgage banking, Western Alliance may generate a sizable amount of capital over several years and quickly recoup its investment. Plus, Western Alliance will have an outlet to invest its excess liquidity by financing mortgage originations that will yield more than MBS yield, yet entail little credit risk. The servicing portfolio will provide a source of core deposits, too.

Should rates surprise some of us and rise, including Fed hikes in short-term policy rates, then Western Alliance has given up some of the upside of NIM expansion in its commercial bank that will be reduced by a drop (or elimination) in AmeriHome's earnings. That is a risk, but for the time being I think Western Alliance is paid to take it.

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