NASHVILLE NOTES

Bond market administers rough justice

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The bond market has a reputation for administering rough justice to issuers that push the envelope of what is acceptable to investors. The reputation has frayed in the years since the financial crisis given the amount of debt governments in the developed world are issuing with seeming impunity. The same could be said about many corporate issuers that have increased leverage without too many repercussions other than in the challenged energy and retail sectors.

The term associated with this power is "bond vigilante." My theory is that bonds as mundane (at best) investments offer an investor the prospect of being paid interest with the return of principal if everything goes right. Bond investors have to punish issuers that take actions that are detrimental because the downside in a default can be draconian relative to the reward of interest and principal repayment.

I do not know how long the bond vigilante moniker has been around, but I believe it was popularized by James Carville when as an adviser to President Bill Clinton in early 1993 he used colorful language to say that when/if he comes back to life he would come back as the bond market so that he could intimidate everyone.

The timing of Carville's musing about the form of his afterlife was fortuitous. Within a few months Wall Street was reeling from a spike in interest rates. The yield on the 10-year U.S. Treasury rose from 5.2% in October 1993 to 8.0% in November 1994 in anticipation, I think, of inflation and Federal Reserve rate hikes that would take the fed funds target from the then-unheard-of level of 3.0% in early 1994 to 6.0% by early 1995.

It was a big move in rates that was much bigger than expected at the time. As is usually the case when rates move dramatically higher something tends to break as the vigilantes extract retribution. The big blow-up from the era was Orange County, Calif., which filed for bankruptcy protection because the spike in rates caused an investment strategy employed by the county to implode.

In the years since the financial crisis the bond vigilantes allegedly have been missing or even neutered by the policies of the central banks in the developed economies. Exceedingly low rates and continuing bond buying in the case of Europe and Japan have forced investors to look the other way to actions that are not in the interest of creditors.

It is with great irony that the vigilantes have reappeared in the U.S. after the Fed continued to raise short-term rates last year when, in my opinion, the market was yelling at the central bank not to do so by the third quarter. With the yield on the 10-year U.S. Treasury around 2.1% today compared to the current fed funds target range of 2.25% to 2.50%, Jay Powell's Fed is the one having its chain jerked by the vigilantes. A generation ago it was Alan Greenspan's Fed that was jerking Wall Street's chain with aggressive rate hikes in 1994.

Chairman Powell and the other members of the Federal Open Market Committee have been caught flat-footed this year even though they have not yet admitted it. Like 2000 and 2007 when the curve flattened and then inverted, the bond market has been sending a signal that something is amiss. What that may be with certainty is unknowable; however, given the sharp reduction in Treasury rates and forward LIBOR rates the market is signaling that the Fed miscalculated how high it could raise rates without something breaking.

And the thing that is badly broken may not be in the U.S. Perhaps emerging markets or China borrowed too much money, especially in dollars that are now harder to come by given the increase in U.S. rates.

Falling rates and by implication a slowing economy presage potential — though not preordained — trouble for bank stocks, beyond what has occurred thus far. The SNL U.S. Bank Index is down 12.0% for the one-year period ended June 7 compared to a gain of 3.7% for the S&P 500. The gap could get much wider if the Fed is forced to really cut rates due to a recession.

Bank stocks are now in a "show me" mode in which investors bestow modest multiples on what may be peak earnings. The largest banks are trading around 9x 2019 consensus estimates — or worse for the perennial value stock Citigroup Inc. — and ~10x for larger regional banks. Net interest margins have peaked for sure, while the much larger earnings risk is from deterioration in credit. Thus far modest widening in credit spreads for the high yield and leveraged loan markets is not signaling imminent issues, in my view.

Nonetheless, the earnings and valuation dynamic for banks at this point in the economic and rate cycle is standard fare — we have seen this before.

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