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NASHVILLE NOTES

Change at the margin

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As I write this on Nov. 12, the equity markets are being pummeled following a rough October. The value restoration of overpriced assets continues, but I do not know if it is sufficient for Howard Marks, co-chairman and co-founder of Oaktree Capital Group LLC, to recant a mid-year opinion that "everything with a CUSIP is overpriced."

Market sentiment is sometimes mercurial for no apparent reason. Over extended periods of time, sentiment can become exceedingly bearish or bullish when the facts are not as bad or good as the market would lead one to believe.

U.S. equities have had a big run through mid-year 2018, whether one measures that from when the Federal Reserve backed away from a second rate hike in February 2016 or President Donald Trump's election in November 2016. In hindsight, the run is easy to explain. Corporate cash flows rose significantly with enactment of tax reform in late 2017. That was overlaid with a rollback in federal regulations and somewhat faster economic growth.

Now the glow of rising markets and the newness of the changes have worn off. Markets are being led lower by FANG and other technology and social media stocks. Has that much really changed since August other than the price of oil collapsing over the past month? It is not news that Apple Inc. and car manufacturers have priced their products too high and General Electric Co. is in bad shape, spending tens of billions of dollars in buybacks the past several years that are now sorely missed. It is also not news the Fed may push short-term rates higher than perhaps it should without a long pause for the economy to digest higher borrowing rates. A divided Congress will not vote to repeal corporate tax reform.

Given the damage financial stocks have endured since August, the market has focused on a change at the margin in the outlook for bank earnings that may or may not happen. Nonetheless, I think it is potentially significant given the drubbing bank stocks have taken.

A week ago I had lunch with the CEO of a publicly traded bank. He asked me what I thought was the problem with bank stocks. My short answer was that rising credit costs usually follow Fed rate hikes. The market was adjusting accordingly by lowering the price-to-earnings ratio until the Fed stops hiking and the market has a better sense of how much credit costs may rise. He noted credit costs have to go up in 2019 and 2020 given the level of reserves, the length of the current cycle and the like, but that Street estimates do not reflect higher credit costs. He also offered that the cost to fund a new loan at the margin has gotten very expensive, as opposed to the deposit beta the Street is focused on for the entire deposit base.

He was not in any way predicting a dystopian future for his institution or the industry. His observation was that the environment may not be as good over the next couple of years as it was in the recent past. The market seems to be digesting that theme, too, even though it will not be reflected in consensus estimates until it is obvious.

As an aside, a more downcast (or dystopian) answer has been offered by former Fed Chairman Alan Greenspan, who is making the rounds to promote a new book he has penned with Adrian Wooldridge, "Capitalism in America: A History." He sees the U.S. entering a period of stagflation in which inflation is high and growth is sluggish. Greenspan is not the maestro, but if he is halfway right equity prices will have to adjust lower as P/E multiples for all industries contract.

Greenspan's economic outlook is downbeat. But an alternate outcome in the current expansion — aside from no interruption — could be a slowdown that forces the Fed to cut rates next year. That would be consistent with history in which the Fed cuts after an extended hiking campaign. If so, there would be a lot of winners among this year's losers

provided credit is not a significant issue. Asphyxiating mortgage banks, specialty finance companies, mortgage REITs and other non-deposit funded lenders would benefit. Banks should too, especially those that heavily rely upon wholesale funding and/or have little noninterest deposit funding.

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