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Fed policy, pushing on a string?

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Confirmation hearings for Janet Yellen to chair the Federal Reserve Board were uneventful on Nov. 14. There were no savers in the gallery with pitchforks and torches. Senators were not especially aggressive in their questioning, which is not surprising because human nature is to back off when the subject matter is not a familiar one. Yellen commented that unemployment is too high and inflation is running below the Fed's 2% goal. One might interpret that to mean not much change should be expected in monetary policy until the economy gains more traction.

Commentary from Wall Street banks in recent weeks is pointing to a Fed that will deemphasize asset purchases and emphasize forward guidance that short rates will remain anchored near zero for much longer than the 2015-2016 consensus assumes. If the Fed is getting uncomfortable with the size of its balance sheet, Yellen did not say so, beyond acknowledging that there are pros and cons of continuing the current policy of asset purchases.

I do not see how the Fed keeping short-term rates tethered to zero for many years should be a surprise: Government finances, asset values, housing, autos and tepid economic momentum are dependent upon very low rates.

As for the presumed wind-down of asset purchases, I do not think the impact for the bond market, bank stocks, mortgage REITs and other lenders is straightforward. The conventional wisdom is that long rates will rise and the yield curve will steepen further once the Fed reduces and then ends bond buying; however, there seems to be a "buy the rumor, sell the news" aspect to the bond market and quantitative easing. The 10-year U.S. Treasury yielded between 1.43% and 1.65% during July 2012 — a month before Chairman Ben Bernanke discussed the potential for QE3 at the central bankers' annual Jackson Hole confab in August 2012. The 10-year yielded between 1.70% and 1.88% during April 2013, the month before comments by Bernanke brought "taper" into the nation's lexicon. It may be that market sentiment toward a quickening or slowing pace of economic growth and inflation is what will matter the most, as has been the case in the past.

In my view, extended guidance that the Fed will keep its target funds rate tethered to zero is like a new form of Regulation Q. Banking legislation adopted during the early years of the Depression included "Reg Q," which prohibited the payment of interest on demand deposits and limited the rate that could be paid on savings accounts and time deposits. Like any price-fixing arrangement, it was intended to help someone. In the case of Reg Q, the intent was to support banks' net interest margins by limiting deposit pricing. It also may have been a bone thrown to a banking industry reeling from the Depression and an onslaught of regulatory oversight. Reg Q had an unexpected permutation. It helped facilitate the development of the shadow banking system and Merrill Lynch's cash management account in the 1970s, as inflation eventually pushed market rates above the cap. All but the prohibition on payment of interest on business demand deposits was phased out during the 1980s; the prohibition on paying interest on demand deposit accounts ended in 2011.

For investors in banks and other financial service firms, I see a number of implications of a Fed funds rate that remains near zero for years.

The "asset-sensitive" trade will remain a dream as it relates to accelerating EPS growth that will occur when rising short rates will benefit banks such as Comerica Inc., with lots of LIBOR-priced loans that are funded with noninterest bearing deposits. The same applies to institutions with a lot of client cash that is invested at a negligible yield, such as Charles Schwab Corp. and Federated Investors Inc.

The yield curve will remain steeply sloped unless the economy slows and/or low inflation turns into deflation. Since 1976, the spread between the Fed funds target rate and the yield on the 10-year U.S. Treasury has averaged about 1.29%. The spread was 2.66% on Nov. 13. If the Fed set its funds target near the current inflation rate of 1.5%, then an average spread would produce a 10-year U.S. Treasury yield around 2.8%, which is near the current yield.

While a steep yield curve is positive for all lenders, it is much more positive for mortgage REITs, aircraft lessors and others that lend long and borrow somewhat shorter compared to commercial banks, which mostly lend and borrow at the front-end of the curve. Nonetheless, investors may remain skittish toward mortgage REITs after witnessing the reduction in dividends from the low rate environment and the destruction of book value when rates spiked in midyear.

Fixed-income carry trades for banks will remain profitable to the extent they are funded with shorter duration borrowings and/or excess deposits; however, most bankers are loath to aggressively add fixed-income leverage to their balance sheets, fearing that an increase in rates will create big unrealized losses. I suspect most executives warned their boards earlier this year that those huge unrealized gains in the bond portfolios could prove to be transitory, which was the case. Few will want to report to the board a sizable unrealized loss, even if the bonds will be held to maturity.

That said, I doubt Wall Street will show the same restraint as bankers in adding leverage to exploit the carry trade. Retail investors may increasingly invest in structured products that are designed to create yield and use margins to fund income producing assets. Interactive Brokers Group Inc. advertises margin rates as low as 1.5% and over 500 stocks that yield 5% or more.

While the consensus seems to be that credit spreads are tight enough given the absolute low level of yields, I think spreads could surprise by tightening modestly because the Fed's easy money policies imply that the next credit downturn will not occur for a long time. Historically, Fed rate hikes have preceded and perhaps precipitated a credit downturn a couple of years after the first hike occurs. As of Nov. 13, the Bank of America/Merrill Lynch High Yield Index yielded 5.84% compared to an average yield of 9.63% since 1997. The option-adjusted spread on the index was 4.37%, which was less than the average spread since 1997 of 5.94%. While these may be ridiculously low yields for "high yield" it is a yield starved world.

And the corollary to a distant turn in the credit cycle is that yields on new loans will remain under pressure and lenders may not have to provide much for loan losses for years, especially given the lack of loan growth. But let's not kid ourselves. The absence of loan loss provisions masks bank profitability because incurring loan losses is part of the business model.

So my hunch is that many more years of zero rates can be boiled down to this: continuation of gradual pressure on yields, an increasing willingness by many to accept interest rate and capital risk to generate income, and years before the next credit cycle emerges, absent an exogenous event. But there is one more aspect of Fed policy that investors should watch: During her testimony Yellen mentioned the potential for the Fed to reduce the 0.25% rate it pays on reserves as a means to force the reserves that have been created by its bond buying into the economy. Last year I noted the potential for the Fed to use negative rates to try to force the reserves into the economy. If it comes to that, it may be the ultimate Fed admission of pushing on a string that is associated with liquidity traps.

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