SNL Blogs

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Fed may face a prisoner's dilemma if it attempts to exit ultra-loose monetary policy

By Jeff K. Davis

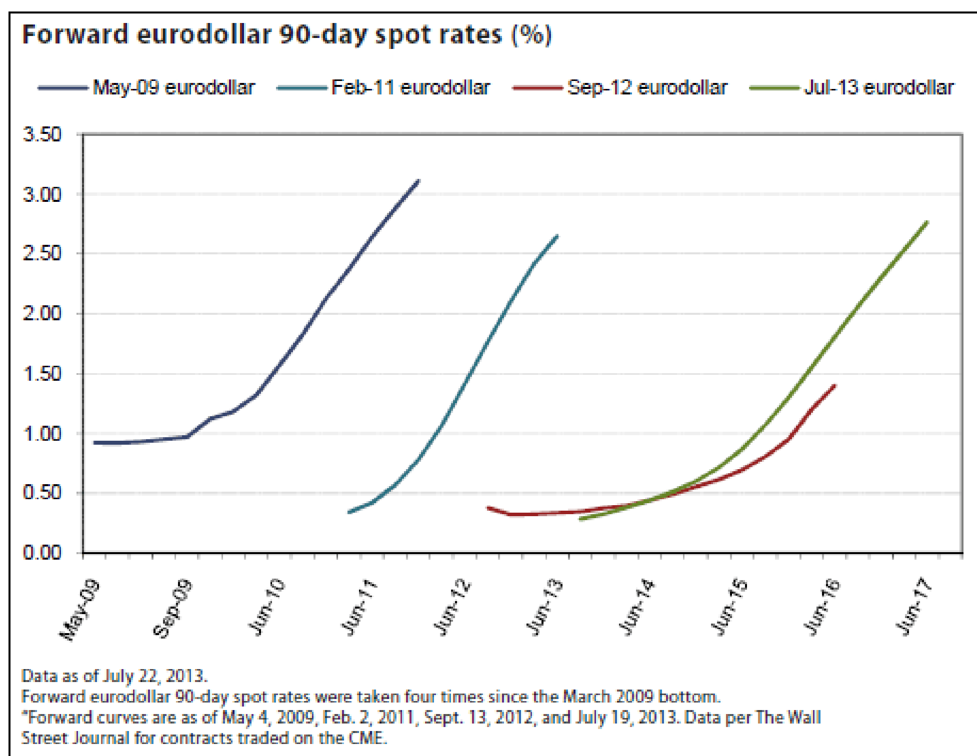
Jeff Davis, CFA, is a veteran bank analyst and SNL contributor. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of SNL or Mercer Capital, where he is the managing director of the financial institutions group.

Michael Temple, a credit analyst with Pioneer Investment Management Inc., noted that the Fed may face a "prisoner's dilemma" in an interview with Bloomberg last week. His reference was to the sell-off in the bond market during May and June following comments by Federal Reserve Chairman Ben Bernanke about conditions necessary to reduce the current round of quantitative easing in which $85 billion of additional bonds are being purchased each month. If the level of rates were higher, the Fed might not face a dilemma, but rates are very low and yet the pace of economic growth remains modest, even though rate-dependent housing has decisively strengthened in the past 18 months.

The second quarter earnings season also provided perspective of what higher long-term rates could mean for some financial stocks. Mortgage REIT CYS Investments Inc. reported that net asset value per share declined to $10.20 on June 30 from $12.87 at March 31 as the $17 billion asset entity incurred $445 million of unrealized losses in its mostly Agency MBS that was only partially offset by $216 million of appreciation in swap and cap contracts.

CYS was one of the worst performing mReits since May 1 in a sector that was decimated by the bond market sell-off and leverage used to finance its positions. Its shares declined 36% through July 19 versus -13% for the SNL U.S. Finance REIT index. CYS noted in its release that the (benchmark) 30-year 3.5% Fannie Mae Agency MBS declined from 105.4 on May 21, the day before the Federal Open Market Committee's minutes were released, to 102.0 on June 19 when the FOMC statement for the most recent committee meeting was issued. Management responded by shrinking the balance sheet by about $3 billion such that leverage declined to 7.5:1 compared to 7.8:1 at March 31. Almost all of the MBS reduction occurred in 15-year fixed rate MBS and hybrid ARMs as 30-year fixed rate MBS increased to 45% of the portfolio from 31%. I do not know if management was making a value call or did not want to sell longer duration MBS in a declining market, but hard sell-offs usually restore value propositions unless the go-forward operating environment has changed.

Investors seem to think it will. As shown in the accompanying chart, investors as of July 19 expect short-term rates to rise, beginning in the second half of 2014, as measured by 90-day LIBOR spot rates that are derived from Eurodollar prices. That is quite a jump from FOMC members (and nonvoting members) openly discussing the timing of QE tapering rather than rate hikes. One of the characteristics of investor rate expectations since mid-2011 has been for Fed-directed increases in short-term rates to occur further in the future. Prior to then, the expectation was that within a few quarters the Fed would begin to raise short rates, as seen from the May 2009 and February 2011 forward curves.



Data as of July 22, 2013.
Forward eurodollar 90-day spot rates were taken four times since the March 2009 bottom.
*Forward curves are as of May 4, 2009, Feb. 2, 2011, Sept. 13, 2012, and July 19, 2013. Data per The Wall Street Journal for contracts traded on the CME.

Higher short rates will boost commercial banks' net interest margins — all else equal — as commercial loan yields rise and core deposit values increase. SunTrust Banks Inc. and other management teams noted this during last week's earnings conference calls. Higher intermediate and long-term rates will gradually boost bond portfolio yields, but the cost will be steep in the form of a sharp reduction in mortgage banking gain-on-sale and a reduction in tangible book value per share. The market knows this but looked past it, maybe surmising better economic growth and higher short rates are on the horizon; hence, banks have seen share prices rise since May 1, while mReits have been crushed. One trader opined to me that is the difference between income/book value plays that are bond proxies versus bank stocks as equity plays.

It may also reflect a bet that equity investors are making that the Fed really does face a prisoner's dilemma and may not be able to reduce its ultra-easy monetary policies beyond gradual tapering. Past expectations for rising short rates by now were wrong. Because the Fed and other central banks have engineered a dramatic reduction in yields in all fixed income classes, flows finally began to favor equities this year. Low equity volatility probably has helped equity flows too. That environment could be seen in good trading results that were posted by Morgan Stanley, JPMorgan Chase & Co., Goldman Sachs Group Inc. and Citigroup Inc. Continuation of very low rates also implies that credit costs will be very modest, in my view. And that is much more important than being able to reinvest bond portfolio cash flows at a little bit higher yield.

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Jeff K. Davis, Managing Director of Mercer Capital's Financial Institutions Group, is a regular contributor to SNL Financial.
He can be reached at jeffdavis@mercercapital.com or 615.345.0350.