SNL Blogs

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Not stressed — credit should be the focus if the Fed hikes rates

By Jeff K. Davis

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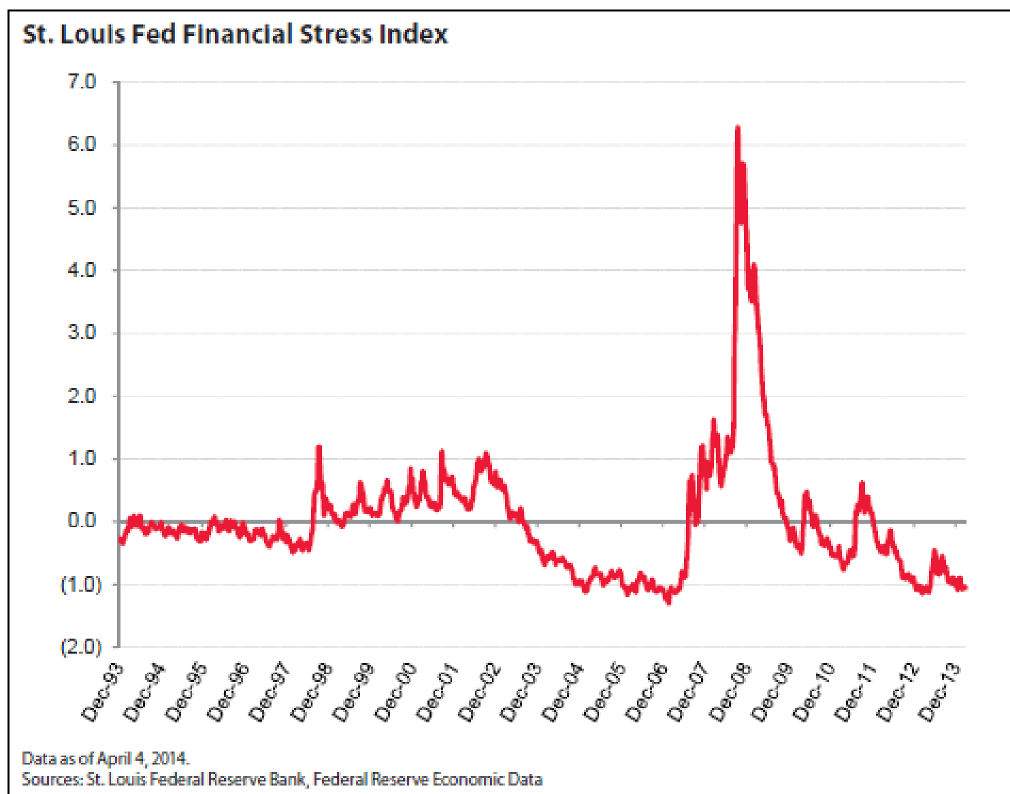
JPMorgan Chase & Co. and Wells Fargo & Co. will release first quarter earnings on Friday. The bar may be low because expectations — at least from a qualitative perspective — are not high given a challenging environment for fixed income capital markets and mortgage banking. Aside from the potential for loan growth to modestly surprise to the upside, the Street is focused on how NIMs will react if the Fed begins to raise short rates in the second half of 2015. I have my doubts the Fed will follow through next year. Nevertheless, maybe investors should be more focused on how credit metrics could evolve in a rising short-rate environment rather than exclusively the NIM. And the directional outlook for credit conditions usually impacts bank valuations given the leverage inherent in the balance sheets.

It remains very early, I think, in the current credit cycle, in spite of loosening of credit standards in a number of areas. The rise of covenant-lite leveraged loans, interest-only CRE loan structures, more non-recourse lending and subprime auto lending have received much press. These practices may become an issue one day, although that day could be many years in the future. Credit after all is very cyclical. The credit cycle in the U.S. the past 25 years or so has been one with long stretches of very low credit losses and then big spikes in 1990 to 1991 and 2008 to 2010.

A build-up of weak credits that typically are originated late in the credit cycle and an unexpected event can create a tipping point for credit. Often times the tipping point is Fed rate hikes in conjunction with something else, such as a spike in oil prices as occurred in 1990 and 2008.

I doubt there are any tipping points in the immediate horizon, especially following what amounted to a 100-year flood in terms of losses in the banking sector. Plus, banks have more capital than ever. Still, I think credit spreads and other debt indicators are worth watching more so than trying to discern how much NIMs will rise (or not) if the Fed begins to raise short rates next year.

The St. Louis Fed has created an index that measures financial market stress. It is debatable how forward looking the index is, but it adds perspective at a time when few seemed concerned about credit. The St. Louis Fed Financial Stress Index measures financial stress based upon observations derived from 18 weekly data series, 13 of which are rate-related or corporate spread-related. A reading above neutral zero reflects above average stress; below zero reflects less than average stress.



A cursory look at the index shows a slightly positive environment during 1993 when the index was created until a pivot occurred in August 1998, which corresponds to the implosion of the massively levered Long Term Capital Management hedge fund. Fed Chairman Alan Greenspan then avoided a Lehman-type event by arranging a Wall Street consortium of banks to bail-out LTCM by taking over its positions and slowly unwinding them. A massive injection of liquidity by the Fed after 9-11 appears to have limited the potential credit damage in 2001 when C&I losses had modestly increased.

The index pivoted again when the over-levered Bear Stearns hedge funds were overwhelmed with margin calls in mid-2007 as the value of their mortgage-related assets went into a freefall. The Bear Stearns hedge funds and Lehman implosion a little over a year later were not necessarily predictable, but credit markets had begun to fray in early 2007 as subprime originators began to fold.

Today the index reflects abundant liquidity and the absence of stress given a reading near -1.0. This may point to why the Fed feels confident enough to taper bond purchases. Next year will be a different decision for the Fed once additional bond purchases end beyond reinvesting interest and maturing principal from the portfolio. If credit spreads are widening before or as the Fed raises short rates, they may back-off.

All of this is just speculation, but my point is that investors should not be myopic in their focus on what higher short rates will mean for net interest margins. Even if credit losses do not change much, periods of widening spreads are usually associated with multiple compression. This happened in both 1999 and 2007 before credit losses materialized as P/Es contracted.

As for the Street's expectations for JPMorgan and Wells Fargo, it looks like the Street is not expecting much change with consensus net charge-offs for JPMorgan for 2014-2016 to be 0.66%, 0.64% and 0.71% and for Wells Fargo's to be 0.42%, 0.42% and 0.54%. Interestingly, consensus estimates do not reflect much change in either company's net interest margin.

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