NASHVILLE NOTES

Only bad bond prices

Tuesday, May 10, 2022 8:08 AM CT

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I do not remember the year, but it was in the early 1990s when I was having a conversation with Jack Parker, then CFO of Memphis, Tenn.-based Union Planters Corp., about the change in accounting for securities. Prior to then, securities were either carried at cost unless there was impairment or designated as "trading" and marked-to-market through the income statement.

Parker asked me what I thought about the addition of the "available for sale" classification in which AFS designated bonds would be marked-to-market directly to book value without impacting regulatory capital. The accounting profession and the SEC were, I think, attempting to force more market value accounting for balance sheets while bypassing the political firestorm of forcing banks to do so through the income statement.

I shrugged my shoulders and said I did not think it mattered. The value of securities portfolios was (and is) available in Call Reports for anyone to see. Plus, my securities training was (and is) predicated upon the primacy earning power absent a material balance sheet issue.

He disagreed. He may have had other objections, but he said it would impact return on equity for banks by introducing market volatility.

Within a year or two of the conversation, the Fed waylaid the bond market in what I think was the worst drubbing since this year. At the beginning of 1994, the Fed Funds target rate was then today's aspirational rate of 3.0%. By February 1995, the rate had doubled to 6.0%. The yield on the 10-year U.S. Treasury bond began the year just under 6%, rose to around 8% by November and then began to decline as investors apparently began to anticipate the final rate hike.

The damage to fixed income investors who used leverage to juice returns was widespread. The largest casualty was Orange County, Calif., which declared bankruptcy in December 1994 after strategies employed by the county treasurer resulted in nearly $2 billion of losses.

As it relates to banks, I do not remember anyone complaining about the reduction in book values that occurred from the sizable markdowns in bond portfolios then. Maybe it was because the economy was strong and loan-to-deposit ratios were higher than today.

This year stands in sharp contrast to 1994. Immediately before and during earnings season last month, many were up in arms over the size of unrealized loss in available-for-sale bond portfolios. The impact varies by institution, but the average reduction in tangible book value for publicly traded banks was about 6% from year-end 2021. There were outliers, however. Cullen/Frost Bankers Inc., KeyCorp, Popular Inc., The PNC Financial Services Group Inc. and Zions Bancorp. NA saw reductions of at least 15%.

While the consternation about the drop in bond prices and tangible book value per share seems to have died down for now, expect the issue to resurface by late June given the shellacking the bond market has endured this quarter. The yield on the 10-year U.S. Treasury has risen to 3.12% as of May 6 from 2.32% on March 31 and 1.52% as of year-end 2021. Unlike 1994 when rates were far higher, there is little coupon income associated with bonds now to cushion the impact of rising rates.

So far, the drop in bond prices mostly is related to duration rather than credit spreads. IEF, an ETF that tracks U.S. Treasurys with maturities of 7-10 years, dropped 12% this year through May 6 while long-term U.S. Treasurys tracked by TLT (20+ years) dropped 23.3%. High yield bonds and commercial mortgage-backed securities as reflected in the JNK and CMBS ETFs have fallen 11.2% and 8.8% year-to-date, respectively.

The Nasdaq Bank index has declined 13.6% year-to-date with much of the decline occurring since quarter-end. The S&P 500 is down 13.5%.

Whether credit holds will depend upon the strength of the economy. If the Fed really does raise short-term policy rates to 3%, then credit quality may become an issue as the economy slows and/or investors go on strike and demand unaffordable rates from levered companies that need to roll over maturing debt. As an aside, such a scenario will be another opportunity for private credit lenders to step into any break in the market and gain market share.

Also, the big jump in mortgage rates has slowed housing. For those of you who, like me, think house prices are insane, then the increase will puncture a bubble.

Nonetheless, bank investors should be thankful rates are rising and look past the impact higher rates have on bond portfolios. Rising rates mean the value of core deposits — especially noninterest deposits — are increasing in value. Net interest income will rise meaningfully if the Fed can hike as much as the market thinks it will without having to pivot and cut rates as occurred in 2019 and 2020.

Yes, bond portfolios are underwater. A long-time Wall Street saw is there are no bad bonds, only bad bond prices, which is a corollary to another saw, "bought right is half right."

Buyers' remorse is pervasive; however, in time the bonds will mature at par while in the interim cash flows will (or should) be reinvested at much higher rates. The real risk for most commercial banks is not rising rates to the extent higher rates do not create credit issues; rather, the risk is rates fall and crush the amount of net interest income that can be generated without taking on more credit and duration risk.

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