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NASHVILLE NOTES

Second derivative liquidity and credit

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Legendary value investor Marty Whitman passed away last week at the age of 93.

He was a proponent of investing in deep value (i.e., really cheap for a reason) and usually focused on the integrity of the balance sheet rather than the income statement to measure the margin of safety he had as a debt or equity investor in a company whose fortunes were depressed. As an equity investor he had a great run. His Third Avenue Value Fund reportedly produced an average annual return of 12% from 1990 through early 2012, when he managed it. By comparison, the average annual return was 9% for the S&P 500 during the same period.

A protégé credited to Whitman a view that only three or four variables would drive an investment; the rest was noise. With Whitman in mind, here are my own variables for bank investing: asset quality, capital, profitability and growth. An underlying premise is the presence of strong management.

The market is focused on growth today; not asset quality and capital as was the case a decade ago. At this point in the cycle the focus on growth is logical because falling credit costs no longer drive earnings and valuations provide less margin of safety than five years ago. Plus, earnings (or cash flow) drive stocks over time absent big changes in the level of interest rates that cause market multiples to meaningfully expand and contract.

Thus far among banks that have reported first-quarter earnings there have not been any surprises in the key variables. Besides, how often does the operating environment change meaningfully in a 90-day period? Asset quality, capital and profitability (supported by corporate tax cuts) are in good shape. Growth as measured by loan and deposit expansion was lacking, but that is not a surprise because information contained in the Fed's H.8 release throughout the quarter made clear that loan growth was soft. If lending does not pick up, capital returns to shareholders should increase given high levels of existing capital.

It's a good scenario, especially considering that Fed rate hikes have pushed LIBOR- and prime-based loan yields up and widened the spread over the minuscule rates paid on deposits. Of course, I am stating the obvious based upon current operating conditions. Markets make opinions according to the Street saw; it is easy to rationalize prices based upon recent performance.

Is there anything to be concerned about? There always is. The concern du jour is the flattening yield curve as measured by the spread between the yield on two-year and 10-year U.S. Treasury bonds. The flattening curve signals two issues — the lesser being incremental pressure on net interest margins, at least for those banks that do not have a healthy amount of non-interest-bearing deposits. Perhaps this is a larger problem than in past cycles if the industry is on the cusp of having to aggressively reprice deposits.

The bigger issue, however, is the economy.

When the curve inverts it is the market's signal that the Fed has raised short rates too much. Often a recession occurs a year or so after inversion even if the Fed responds by cutting short-term rates. Recessions mean rising credit costs for banks, though one never knows how much until the recession is in the rear-view mirror. When the 2/10 spread turned negative in 2000 and 2007 the bond market correctly predicted recession, though not how deep.

Bank stocks for this reason are sensitive to the information conveyed in the shape of the curve and are categorized as early cyclicals, meaning they tend to lead the market down (and up) relative to other sectors before the economy turns. The current curve narrowing merits attention.

Back to Marty Whitman. He had a spectacular career, but he died after his firm had seen its best days. Fund assets peaked in 2006 at $26 billion and then fell to around $10 billion in May 2015, when *Barron*'s interviewed him about his style of value investing and how the firm was performing post-crisis. It only emerged after that interview that more trouble was soon to come due to falling oil prices and debt prices for highly levered energy companies.

One variable that may have mattered to him but was not named was liquidity. The Third Avenue Focused Credit Fund, which was established in 2009 when high yield bonds and loans were virtually bid-less, was waylaid by the rout in high yield bonds and loans that occurred during late 2015. At the time investors were pulling money from high yield credit funds as the rout among energy credits began to spread to other sectors. The fund drew SEC scrutiny and became the focal point of a still ongoing debate about what can happen when investors can sell shares in a fund (or ETF) when the underlying assets are illiquid.

I did not include liquidity for a bank as a key variable for equity investors (Whitman's limit is four), although it is an important fundamental that bank regulators and bank credit investors watch. Liquidity for a bank is based upon the ability to meet loan demand or to tap alternative funding sources if large depositors and other creditors want their money back. But it is the second derivative of liquidity that I think matters more. If the yield curve is forecasting a slowing economy in the next year or two, marginal credits that have been easily financed in our ultra-low rate world may go bid-less at which point earnings estimates will prove to be too high as credit costs increase seemingly out of nowhere.

It is just my opinion, but it is a scenario in which asset quality could replace growth as the key variable bank investors care about.

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