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NASHVILLE NOTES

The boom rolls on in Nashville and elsewhere

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By Jeff K. Davis

A couple of weeks ago I had the opportunity to visit with a CEO of a bank that is not located in Nashville, Tenn., but that does some business in the area. I asked him what he thought of Nashville. He said the growth and lending opportunities are incredible, but scary, too.

The response was similar to what I was thinking when leaving a reception at the entrepreneur center a couple of weeks earlier. I am in the area (about a mile south of the central business district) every four or five weeks. Since my last visit, I counted seven cranes I had not previously noted. That does not mean all of the cranes in the area were new, just that I had not noticed all of them. But then again, I had to pause when a commercial real estate broker friend offered that a lot of brokers are now rolling their commissions from completed projects into new ones. Better to buy high than not at all.

Does that backdrop count as a bubble? It is possible, but I think there are a lot of cities, such as Charlotte, N.C.; Denver; and Boise, Idaho, that could weave a similar narrative. Besides, booming growth has not made it to the front page of *USA Today* the way cryptocurrencies did in late 2017 as the "asset" peaked in value before plunging in 2018. Along the same lines, I saw a headline yesterday that said two-thirds of economists expect a recession by the end of 2020. Bob Farrell, the chief market technician at Merrill Lynch for decades, articulated 10 rules for investing. No. 9 is that whenever all the experts and forecasts agree, something else will happen.

There is no way a decade of really cheap money will not have some repercussions, though the severity from a creditor perspective is unknown. I think that is the message bank stocks are giving investors this year. Banks are modest underperformers even though earnings are booming. According to the Federal Deposit Insurance Corp., the industry's year-to-date pretax earnings of $148 billion rose 11% from the $133 billion posted in the same period last year. After-tax earnings rose 26% to $116 billion with the benefit of corporate tax reform. But the SNL Large Cap US Bank Index year-to-date through Oct. 2 was down 2% compared to a 9% rise in the S&P 500. The SNL Small Cap US Bank Index was up 3% compared to a rise of 8% for the Russell 2000.

Why the underperformance? The Street seems to be focused on sluggish loan growth and net interest margins that may not expand as much as anticipated over the next several quarters. That is because deposit competition has become wickedly intense and the Treasury yield curve has flattened.

The NIM concern is probably true for most commercial banks, excluding those with a large amount of noninterest-bearing deposits, but I think the market's primary message is that the Fed is running the risk of overdoing it. Inverted yield curves when the Fed pushes short-term rates too high typically precede recessions by 12-18 months, which in turn means credit costs for banks will rise. What is unknowable is how much credit costs will rise assuming that a recession occurs.

When the yield curve inverted in early 2000, banks were lagging the broader averages that were then being supported by dot-com and other technology stocks, the precursor to today's FANG stocks. Banks and other value stocks broke to the upside in March 2000 once the market concluded that the Federal Reserve would soon cut rates and that the 2001 recession would be sufficiently mild. In the one-year period ended March 8, 2000, the SNL Large Cap US Bank Index fell 29% — earnings were strong then, too — compared to a 7% gain in the S&P 500. Over the next year, the banks gained 39% versus a 7% loss in the S&P 500. Comparisons for the small-caps were more pronounced, with the small-cap bank index falling 18% compared to a 49% gain in the Russell. The ensuing year saw small-cap banks rise 32% versus a loss of 19% in the Russell 2000.

In addition to concluding that the recession would be mild and that bank valuations offered a good margin of safety — then around 13x trailing 12-month earnings — investors decided the dot-com stocks really were a mania. The NASDAQ rose 104% in the one-year period ended March 8, 2000, then lost 56% in the next 12 months with more pain to occur

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over the next couple of years as the tech stocks transitioned from a bubble to deep-value stocks.

Of course one never knows about inflection points. The yield curve inverted in late 2006, but unlike the mild recession of 2001, a national disaster was about to unfold. Most bank stocks were value traps during 2007 and 2008 until 2009 when the sector bottomed and earnings had been decimated.

My hunch is that if the Fed does not back away from an intention to hike multiple times in 2019 following a likely hike in December, then bank stocks may get cheaper by falling or trading sideways as earnings rise. Eventually an inflection point will be reached, but who knows what way it will go. In any event, Street estimates will not reflect rising credit costs until it is obvious and well after the market has discounted higher loan loss provisions.

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