NASHVILLE NOTES

Waiting on the match

By Jeff K. Davis

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This year is weird in a not so good way, as the events of 2020 have set in motion a reorganization of our world that in street vernacular could be described as a dumpster fire. The prevailing theme for the economy is shortages of everything, including labor, and inflation everywhere. For most people reading this, the shortages and inflation are annoying, but probably not inflicting hardship. In less developed poor countries, these issues create misery.

In the inconvenient category is the travails of Southwest Airlines Co. over the weekend of Oct. 9. Southwest canceled around 2,000 flights, which the airline blames on weather and air traffic control; there were also reports that some (or many) Southwest employees may be calling in sick to protest the company's vaccine mandate, though the company denied this. The mandate issue where enforced could roil other sectors of the economy if the alleged quiet protest spreads.

Other issues are more serious. There seems to be a sizable shortage of coal around the globe needed to generate electricity. It is odd that China and India, the two largest countries, are facing rolling blackouts because not enough coal has been procured. How does that happen? Europe is short on natural gas and may be in a jam if it is a really cold winter. Natural gas and gasoline are expensive in the U.S., but neither are in short supply as far as I know.

It is as if someone threw a match on the global economy and pockets of fires have popped up in unexpected places.

As it relates to U.S. banks, the match has not found the ample kindling yet in the form of massive amounts of liquidity that, if converted into loans, will power revenues and earnings. The second match is in the Fed's hand: an increase in short-term policy rates that would push LIBOR, SOFR and other lending rates higher.I have my doubts the Fed will raise rates given the amount of debt that is accumulating, but that is just an opinion.

My sense is that investors seem reasonably confident the Fed will oblige and begin to raise short-term rates within the next 12 to 18 months in an acknowledgement inflation is not transitory. If so, perhaps 2023 will be the return to normality that was expected to occur in 2021 when the response to COVID-19 triggered a deep but short recession in the spring of 2020. Earlier this year, 2022 was the target.

The 10% or so rally in bank stocks the past few weeks coincided with a roughly 40 basis point increase in the 10-year U.S. Treasury yield to 1.6% as investors concluded that the Fed likely will begin to reduce its bond purchases later this year to be followed later by rate hikes. The market has been right the past year. Much of the 75% increase in the KBW Nasdaq Bank Index for the one-year period ended Oct. 11 was predicated on the absence of significant net charge-offs that were assumed in the spring of 2020.

Few investors, I think, are expecting any sign of the match with the release of third-quarter earnings. If anything, pre-provision net revenues likely will fall into the "meh" category, especially for regional and community banks once PPP-fees are excluded. Even at market-leader JPMorgan Chase & Co. the trend in PPNR has been sideways the past three quarters at just over $13 billion.

Based upon the Fed's weekly H.8 data (assets and liabilities of commercial banks), we should not expect much loan growth though pipelines are reportedly building. Refinancing in the capital markets remains a dominant theme, and businesses and consumers are liquid. Eventually loan demand will pick up absent a recession. Loan demand and its corollary bank liquidity have been counter-cyclical forever.

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I think the metric to watch this quarter is loan yields. NIMs are hard to parse because there is so much liquidity parked at the Fed that earns virtually nothing. Loan yields — stripped of PPP fees — reflect risk and price competition. Once (or if) the Fed begins to raise policy rates, loan yields will rise. Until then, competition is going to slowly grind yields lower. There is too much liquidity and not enough loan demand generally for this not to occur in a near zero rate environment.

It is just a vignette, but I think it is telling. During the April 2021 conference call for Origin Bancorp Inc., management was asked by an analyst about loan pricing. Management relayed a story where a "big national bank" that I take does not operate in Origin's Louisiana market offered one of Origin's "really good" C&I borrowers 1.8% fixed for two years if they moved their business.

Origin did not indicate how much price concession was required to keep the business. Judging by the two-year offer of a fixed 1.8% rate — equal to about 30-day LIBOR + 170 basis points — it appears the "big" bank expects core lending rates to rise by the first half of 2023, too.

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