

NASHVILLE NOTES

Zeitgeist capital

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By Jeff K. Davis

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It is funny in an odd way how the zeitgeist of the moment can be so intense and then change radically with a new era.

In early 2016, spreads on high yield bonds and leverage loans were gaping wider as a sustained fall in oil prices was overlaid with a Federal Reserve that was talking about four rate hikes in 2016 following its initial hike in December 2015. The yield on the 10-year U.S. Treasury fell below 1.7% from about 2.3% at year-end 2015. Equities, which initially ignored the credit markets, began to wobble, too. Then, if my interpretation is correct, Fed Chair Janet Yellen in testimony to Congress on Feb. 10, 2016, said in so many words the Fed would back-off. Markets stabilized and began to recover only to be briefly interrupted for a few days by the media frenzy known as Brexit. Like 2015, the Fed only hiked rates once in 2016 during December following the national elections that launched — or reinvigorated if one picks an earlier start date — the current rally in risk assets.

Today, the zeitgeist of the market is borderline euphoric — "laissez les bon temps rouler"! What superlatives are left to describe an equity market that cannot string together a few down days much less a normal 5-10% pullback in share prices that usually occurs a couple times each year? *The Wall Street Journal* ran a story on Jan. 27 about the return of retail investors to the equity markets, citing stepped-up trading at E*TRADE Financial Corp., TD Ameritrade Holding Corp. and Charles Schwab Corp. Investment "opportunities" in bitcoin and weed stocks were cited as part of the draw for a crowd that was last seen in 2000 before moving on to speculating in housing when the zeitgeist of the dot com era imploded.

The positive economic backdrop is real, I think, even when viewed without partisan glasses. Washington's massive regulatory apparatus that slowly grows year after year is being pared back (at the margin). After-tax earnings that accrue to common equity shareholders of C-corporations will increase by up to 20%, assuming all income that was taxed at 35% is now taxed at 21%. A very tight labor market seems to be producing a pickup in wage gains that if sustained may boost the participation rate, which would be a great outcome for U.S. society.

For bankers and bank investors, the past 14 months have been akin to waking from a long sleep to find Tinker Bell sprinkling pixie dust on the industry. Much of the industry's pie-in-the-sky wish list from two years ago has been realized. Corporate taxes are lower, loan demand may pick up, interest rates are higher (though the curve is flatter), all of the Obama-era leadership of the federal banking regulators have been or soon will be replaced, and there is bipartisan support in Congress that will grant regulatory relief to community and regional banks.

Nonetheless, trees (asset prices) do not grow to the sky and the economy always has been and always will be cyclical. My point in stating this is not to offer a buzzkill to anyone who, like me, is immensely enjoying the ride. Rather, now is the time to reduce risk by unloading edgier portions of a loan portfolio — as we have seen a few banks do with healthcare — add capital, or even sell if the intent is to unload all risk.

My comment on capital may not resonate with many bank boards because industry capital is high. But for banks that are growing rapidly or have a very high level of commercial real estate exposure, adding capital when it is readily available is not a bad risk-mitigating strategy. At worst, the excess capital is not immediately deployed and is valued dollar-for-dollar. Plus, whenever the cycle turns, new capital that was cheap when times were good becomes really expensive or — as many leveraged oil companies discovered in early 2016 — is unequivocally not available.

Also, unless the parent company has no or just a nominal amount of debt, I would favor common equity over issuing sub

debt for three reasons. One: Shareholder dilution is much less an issue today than it was prior to the rally with bank stocks trading at valuations that are attractive to the issuers (and less so to the investor). Two: The tax deduction for interest expense is worth less now that corporate tax rates have been reduced. And three: It is getting latish in the cycle for commercial real estate, which has forever bedeviled banks when the economy rolls over.

One final observation: When will the good times end? I have no idea. The set up seems to be that this cycle will run much longer than historical comparisons suggest because the 2007-2009 downturn was so severe and many are looking for the next shoe to drop. But the traditional signs are there: The yield curve is flattening; once liquid bank balance sheets are "loaned-up" today with a need for more core deposits; corporate America has levered up to repurchase stock with cheap debt; and real estate prices are very high.

What may be "the" sign that the zeitgeist is shifting? I am looking for *USA Today* to run one or more front page stories similar to *The Wall Street Journal* article about retail investors piling into the stock market after the big run we have witnessed. The media usually is a great contrarian indicator when stories move to the front page from the back page.

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