NASHVILLE NOTES

Bank stocks are not yet buying the Fed's expectations game

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On Aug. 27, Fed Chair Jerome Powell announced a change to monetary policy. I am surprised it has not generated much pushback.

The pronouncement states — in so many words — that the Fed will allow inflation to run higher to achieve an average inflation rate of 2% rather than targeting a 2% rate that was adopted in 2012. So, if inflation averages 1% for a few years then inflation will be allowed to average 3% over a presumably equivalent time to produce a 2% average.

The objective, apparently, is to put greater emphasis on the Fed's dual mandate of "full employment" over "stable prices" as promulgated in the Humphrey Hawkins Act of 1978. Perhaps recent unrest in some U.S. cities has indirectly influenced priorities; or it is a mea culpa that the last rate hike or two of 2018 were ill-advised.

The third mandate, which is unwritten, is financial market stability — especially in the credit markets given their importance in financing the economy compared to decades ago when bank lending was dominant. As an aside, I include the leverage loan market as part of the corporate bond market even though loans are not securities in a legal sense because leverage loans are underwritten, distributed and traded like high-yield bonds.

The pushback I do not sense relates to purchasing power. Our central bank is working to clip the value of a dollar by a small amount each year. But a little bit adds up over time. The Rule of 72 implies that, if successful, the Fed will reduce the value of one dollar by approximately 50% in 36 years.

A couple of years ago I had the opportunity to ask James Bullard, then and now President of the Federal Reserve Bank of St. Louis, at a meeting in Memphis why the Fed had adopted the 2% policy compared to 0%. He said it might surprise me that an argument could be made (by him or the St. Louis Fed) that 0% should be the target.

And several years earlier (2010 I think), I attended a lunch in Nashville where then Atlanta Federal Reserve Bank President Dennis Lockhart said the Fed would never monetize U.S. Treasury debt in response to a question related to quantitative easing (or "bond buying").

Both answers then surprised me because reality seemed to be otherwise.

Today, the unanswered inflation questions include over what period is the "target" to be achieved and how is inflation measured. Inflation in this context is some measure of prices for goods and services rather than the growth rate in the supply of money, which is astronomical this year. If one believes the official inflation statistics (there are various indexes, the Personal Consumption Expenditures being the Fed's preferred measure), then the Fed has not been successful since it adopted the 2% target in 2012.

Why would the Fed be any more successful now? Maybe it will not (using official inflation measures) absent being able to directly transfer money to consumer bank accounts, which would require Congressional authorization.

The Fed seems to be focused on investor expectations. Inflation will be allowed to accelerate therefore nominal economic growth will improve (and lessen the risk of deflation). The logic seems like that of a stock split driving stock prices higher. It is nonsensical if one ignores Apple's and Tesla's recent stock splits.

Policy semantics aside, the Fed is boxed in a corner in my view. The Fed cannot raise short-term policy rates other than maybe a little tweaking unless inflation picks up a lot lest it risk tipping over a highly levered economy. I believe that was the markets message to the Fed in the fourth quarter of 2018 when the equity and high-yield bond markets went into a tailspin that culminated in the Christmas Eve washout.

The markets message I see today with the yield on the 10-year U.S. Treasury comfortably below 1% is that the Fed can make all the policy pronouncements it wants, but the risk is to the downside rather than significantly higher inflation. A very modest deflation as reflected in gradually easing prices beyond technology seems like a good outcome to me. The other is "bad" deflation in which widespread asset liquidations and job loss occur. The latter would equate to an extended version of March this year, something the Fed has sought to avoid since the 1929-1933 liquidation.

As it relates to banks, the group is due for a decent rally given the depressed valuations if the economy can gain steam. If so, investors will not be as concerned about the extent of credit losses to be realized; however, the NIM outlook remains tough. Earning power is decidedly depressed compared to before the COVID-19 economic lockdown no matter how "cheap" price/tangible book values appear.

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