

NASHVILLE NOTES

Credit markets, not equity markets

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Perhaps it was a signal of shifting fortunes on Wall Street that Wells Fargo & Co. saw its shares rise 3.7% on Jan. 14 when it announced fourth-quarter 2021 earnings while JPMorgan Chase & Co. fell 6.1%. Wells Fargo has been a great stock measured from year-end 2020; its shares rose 59% in 2021 and 17% year-to-date through Jan. 14 compared to a gain of about 25% in 2021 and flat year-to-date for JPMorgan. The S&P 500 Bank Index rose 32% in 2021 and nearly 9% through Jan. 14.

First Republic Bank and Citigroup Inc. released earnings Jan. 14, too. First Republic underwhelmed and has seen its shares fall 7% this year after a 41% gain in 2021. Citigroup has a lot of ground to cover as CEO Jane Fraser implements her strategic repositioning plan. There is a reason it is a perennial value stock.

I do not think there was anything especially surprising in the results. The transition from outsized deposit growth and weak loan demand appears poised to reverse as liquidity and loan demand are countercyclical. Overlaid is the potential to juice returns for traditional commercial banking if the Fed raises short-term rates. Wells Fargo noted net interest income would increase by upwards of 8% in 2022 if the Fed hikes three times this year.

There are always countervailing forces, however. Mortgage banking looks like it is going to be tough to no one's surprise. Also, Wall Street businesses as reflected in JPMorgan's trading, underwriting and advisory results were good-to-great, but it feels like 2022 is not going to be as lucrative.

And a common denominator for banks and all companies is the impact of inflation on expenses. Investors seemed unsettled about JPMorgan management's comment on expenses and the limiting impact that and other factors would have on its inability to achieve its targeted return on tangible common equity of 17%. Inflation may not be good for corporate margins after all.

The earnings trajectory for traditional commercial banks could still be good even with inflated costs if loan growth picks up and the Fed raises short-term rates. Investors seem to be betting on this path for some banks. Comerica Inc., an asset sensitive commercial lender, saw its shares rise 56% last year and 16% year-to-date through Jan. 14. The shares trade for about 17x consensus 2022 estimates and 15x 2023 consensus.

While investors and the Fed indicate a rate hiking cycle is a given, it is reasonable to ask if the Fed can taper bond purchases and then hike more than a couple of times without blowing up asset markets given the vast amount of liquidity that has been pumped into markets the past two years.

If the answer is no, then the Fed will have to choose between addressing broad-based inflation and its credibility as an institution that is tasked with maintaining price stability, or protecting asset values by halting rate hikes or even cutting as occurred in 2019.

Market participants know this; they likely will test the Fed after a couple of hikes if not sooner. If the Fed is forced to choose, I think credit markets rather than the equity markets will be more important.

Bank loan committees may be steady(ish) in terms of providing credit to the economy as conditions change, but capital markets spigots that are wide open today can and do periodically close. Leverage loans, high yield bonds and direct loans from private credit funds are an important source of capital in the economy today that was not the case a decade or more ago.

If institutional investors go on strike or demand rates that issuers cannot pay, then I think the Fed will quickly back-off and thereby choose asset values over inflation in the name of supporting the economy via credit markets.

Such an outcome would preempt the widely anticipated increase in net interest margins, but it probably would be good for prospective credit losses because loans and high yield bonds that can be rolled tend not to gather losses according to a long-time saw.

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