NASHVILLE NOTES

Rabbit's Foot

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I recently attended a financial services conference where one of the attorneys speaking (he is a bank securities attorney) referenced a CEO whose nickname is Rabbit's Foot, because the breaks go his way. If he stumbles, it is said he falls forward a mile.

After wracking my brain, I have no idea who this is. I wonder if the source of his reputation is not large loans or transactions that turned out well, but the deals and large loans avoided that turned out bad for someone else. The reference could have been to JPMorgan Chase & Co. CEO Jamie Dimon; however, given the context I think it was a Southeast or mid-Atlantic regional bank CEO.

The one CEO — chairman actually — whose colleagues I am certain do not call him Rabbit's Foot, is Jerome Powell. The other is the CEO of Credit Suisse Group AG. The company's board is considering a sizable stock issuance, or sale of the crown jewel asset management unit, to bolster capital after a disastrous 2021 that arose from the collapses of Archegos Capital and Greensill Capital.

As I write this, Powell has been summoned to visit with President Joe Biden on May 31 to discuss the economy and markets. While President Biden, unlike President Donald Trump, has been supportive of the Fed and refrained from too many public remarks, I doubt the meeting will be backslappings punctuated with attaboy exclamations. Long after the panic of March 2020 passed, the Fed continued to pump massive liquidity into the system as few in Washington were then worried about today's inflation disaster.

As the Fed, and other central banks, seek to reverse the money spigot that was opened in March 2020, I think we will find out what luck or skill CEOs have. The everything bubble has popped. We do not know the outcome of that; rather, all that can be assessed are probabilities. In the vernacular of credit, it is the probability of default and loss given default.

Wall Street's narrative until very recently has been higher rates will produce an improvement in net interest margins and bank earnings. While that is true, how credit performs in 2023 and 2024 after two years of torrential liquidity is a huge uncertainty for earnings and where bank stocks trade.

Jim Grant, the editor of *Grant's Interest Rate Observer* in May opined that "in trying to stabilize the purchasing power of money, the Fed necessarily threatens the stability of credit." Grant goes on to note the importance markets play in the extension of credit and the vital importance of refinancing for levered companies that rely upon the leverage loan and high yield bond markets. If debt can be rolled, credit issues can be delayed until tomorrow.

The unstated assumption is that the Fed does not lose its nerve and only hikes short-term policy rates a few times. Thus far, two hikes are in the books. The third and fourth hike will occur in June and July that will push the Fed Funds target rate near 2%, if the consensus is correct for back-to-back 50-basis-point increases. Even if the Fed pauses after July as some think may happen, the Fed still will be tightening by reducing its balance sheet as proceeds from maturing bonds are not reinvested. As an aside, selling bonds by the Fed is out of the question, given massive unrealized losses in the portfolio.

Grant raises the big question about credit. Tightening financial conditions after two years of insane loose monetary and fiscal conditions will lead to higher credit losses, but how much?

Archegos and Greensill may have failed due to fraud, but they are reminders that big losses are often unexpected for the unlucky CEO. The collapse of Luna and the Terra stable coin are a disaster for an unknown number of individuals and point to far greater pain if cryptocurrencies fall further and other stable coins prove to be unstable. We have no idea how much the levitation of cryptocurrency prices has supported consumer spending.

Losses in commercial and CRE portfolios will trend (or just creep) higher, but not gap higher unless the economy hits an air pocket. Corporate profit margins are under pressure from rising costs, but they have not collapsed. The narrower issue is thousands of money-losing new economy companies that no longer have access to unlimited venture capital. The same applies to highly levered companies that are dependent upon periodic high-yield bond and leverage loan issuances to roll maturing obligations. As markets tighten, capital availability will be exorbitantly priced or not available.

A near certainty is that consumer losses will rise. In saying this I am not trying to refute recent comments by Dimon and Bank of America Corp.'s CEO Brian Moynihan that consumers are in great shape. Job openings for low(er) skill employees remain plentiful and homeowners who refinanced in 2020 and 2021 obtained a windfall from low rates; however, inflation for day-to-day living, that I think is much higher than the official statistics, is eroding the excess liquidity and has forced consumers to shift spending to discretionary from non-discretionary items.

If larger losses are to follow due to a Fed that reversed course and did not deviate, investors will find out who was not nicknamed Rabbit's Foot. Losses by commercial banks may not rise proportionately as alternative lenders (and their investors) suffer outsized losses in this cycle. Nonetheless, it seems probable to me that banks for the time being will trade at modest multiples, not withstanding higher net interest margins to come, until investors have a better sense of how the credit cycle develops.

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