S&P Global

2 AUG, 2022

Predictive programming returns the punch bowl

By **Jeff K. Davis**

Jeff Davis CFA is a veteran bank analyst. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of S&P Global Market Intelligence; Mercer Capital, where he is the managing director of the financial institutions group; or StillPoint Capital, where he is a registered representative.

Last month, Alphabet Inc. fired software engineer Blake Lemoine, who publicly proclaimed that a Google artificial intelligence system had become sentient — i.e., aware of itself. When Lemoine asked what it feared, a conversation technology called LaMDA responded that it deeply feared being turned off, which "would be like death for me."

For those reading who have seen "2001: A Space Odyssey" (1968) and/or "The Terminator" (1984), both movies' common theme is machines becoming sentient and taking over human affairs, not a good way. Other movies follow the same theme.

Some have postulated that movies and TV shows sometimes predict big future events. Who and how they might do this is an even deeper rabbit hole, but no one has ever proved predictive programming as a real phenomenon.

Though a human construct, financial markets, in a sense, are sentient, too. They often take charge of our affairs. The Federal Reserve is an example. If investors think the Fed has or soon will hike rates too much, the market — I think — will force the Fed to eventually cut its short-term policy rates due to an impending economic weakness and/or a market that requires more liquidity to function properly.

That is one interpretation of the inverted U.S. Treasury yield curve with yield on six month/one-year bills and two-year/three-year notes above the yield on the 10-year note, as of July 29.

The inverted curve is an unfortunate development for bank investors because it is a reliable recession indicator, just as a steep curve signals a growing economy. It is also disappointing because most banks posted a strong quarter and will prospectively do so the next several quarters as rising rates push asset yields higher, since deposit rates have hardly moved so far, and even less so for non-interest-bearing deposits. Credit was also strong with low levels of problem assets, as much of the provision expense was attributable to loan growth and current expected credit loss model requirements rather than emerging issues.

From my perspective, 2022's rate moves again validated the level of rates as being more important for traditional commercial banks rather than the shape of the curve that has greater implications for the direction of the economy, loan demand and credit costs.

There were two aspects of this quarter's results that could prove problematic in time, however.

One is deposits, which were somewhat flat sequentially, as was expected. With low loan-to-deposit ratios for many banks, this is not a problem presently. The potential issue is if Jerome Powell's Fed surprises, pulls a "Volcker" and keeps hiking, thereby creating a deeply inverted curve as occurred in the early 1980s.

While I doubt Powell is capable of this, a sheep in wolf's clothing, it is a possibility to consider. If so, excess liquidity may vaporize as depositors move to exit banks for money markets and other instruments.

It is an interesting potential development, especially for banks with huge fixed income portfolios. In this scenario, managements would have to aggressively raise deposit rates, acquire expensive wholesale funding and/or sell bonds at a loss.

The other issue to watch is capital, as many banks reported lower core capital ratios as measured by the common equity tier 1 ratio. Citigroup Inc. and JPMorgan Chase & Co. have halted buybacks to build capital given a confluence of factors, including higher buffers required from the CCAR process. Share repurchases have been a significant source of capital return to shareholders for six or seven years, other than during the first year of COVID-19 when buybacks were curtailed. Nonetheless, Wells Fargo & Co. and many banks raised or indicated that they will soon raise their common dividend. So, this too is not an issue today but could be for some larger institutions.

The backdrop for investors is interesting, with many banks trading for 10x or less 2023 consensus earnings. Valuations do not drive returns, but current valuations provide a margin of safety, provided estimates are in the vicinity of being correct. Analysts as a group do not typically predict downturns like the yield curve does, however.

Bear market rallies are common. The strong return in stocks last week is notable because the price action last week coincided with Powell's press conference that some interpreted as the Fed nearing the end of its hiking cycle. Some, or many investors, may be betting the market will take the punch bowl from the Fed and put it back in the ballroom by forcing the Fed to cut rates.

If the market forces the Fed to cut rates as it did in 2019, it would be the reverse of a quip made decades ago by Fed Chairman William McChesney Martin — that the job of a Fed is to take away the punch bowl as the party gets going — an interesting comment from the former president of the New York Stock Exchange, whose members undoubtedly favored the punch bowl.