BATTERED ABOUT

by Steve Brown

A week ago, soft employment data pushed Treasury yields down 10bp. This week, tough talk from FRB speakers and a spike in inflationary data drove yields right back to where they were. Like a sailboat trapped in the midst of rough seas, bankers are riding every data wave to its crest, only to slip into a deep trough. As our banking boat tops this most recent wave, we scan the horizon from our lookout and report what we see. [1] Amid worries about heightened inflationary trends, it is all but certain that the FOMC will raise interest rates another 25bp to 5.25% on June 29. Some major economists are even calling for a 50bp rate increase at this meeting. [2] Despite increasing signs the economy is weakening, it generally remains on decent footing. As a result, the FOMC will err on the side of overshooting inflation, since history has taught us once an inflationary storm gets rolling, it quickly grows into something that can be too big to handle. [3] Chairman Bernanke is known to be an inflation hawk, which somewhat reiterates our 2nd point. Just how much of a hawk he is, however, is worth highlighting. Over many years, he is on record that he would prefer the FOMC to have a stated inflationary target. As a result, the more inflation seems to be popping up, the more likely Bernanke will be the first one to begin battening down the hatches. This guy is not a jellyfish and he can ill afford to drift on this issue. [4] It will be decades before Asia is potentially displaced as the world's manufacturer. In order to keep U.S. consumers buying, Asia needs to hold our long-term rates down and will continue to buy long term Treasuries (keeping our 10Y yield at or near the Fed Funds level for years to come). Note that futures markets predict the 10Y yield will only increase 5bp from current levels over the next 5Y. [5] As if the Asia juggernaut weren't enough to keep long-term yields low, high global savings levels and better match-funding of pension assets and liabilities have also dropped anchor. Wrapping up, banks should be prepared for the FOMC to continue to push the Fed Funds rate up to 5.75% or 6.00%, until inflationary pressures assuage. As the economy strains and masts eventually break (and the FOMC cuts rates), the course from the data (and FRB speakers) is clear. If a 9% Prime rate seems hard to believe (because it would strain credit), keep in mind the long-end is not moving. That means floating rate loan refinancing will continue to accelerate. Surveys currently indicate that at this point in the cycle, floating rate customers prefer a fixed rate loan at a margin of 3 to 1, so one can only imagine what another 100bp might do. How "customer service" oriented can a bank be if it does not offer customers their preferred loan structure, particularly when it is 200bp cheaper and offers more certain cashflows. This is another time to conduct stress testing, review the strategic plan and zero in on liability optimization. It seems to be destiny that quality loan growth will be harder to come by over the next few years, so preparation and testing is imperative. Captains may want to stand on the bow of their boat and scan the water ahead - since sharp coral and rocks lie just below the surface.

BANK NEWS

Merger of Equals

National Mercantile ($488mm, CA) and First California Bank ($480mm, CA) have announced a merger of the two entities in a transaction valued at nearly $88mm.

Soaring

Health insurance premiums for small employers jumped 9.2% last year, up from 11.2% in '04 and 13.9% in '03.

Small Business

A new study found that 84% of businesses with 10 or fewer employees do not offer a retirement plan, despite the fact that 67% of all millionaires in the country own their own business.

Investments

Money-market funds are offering the highest yields since 2001 and have increased assets to a 3Y high (as investors moved out of the stock market). Investors deposited nearly $60B into taxable money-market funds as of June, compared to withdrawals of $57B in the same period last year.

Housing Sector

According to a Harvard University study, 82 major cities across the country saw home prices increase more than twice as fast as incomes last year.

Booming

Research shows prepaid or stored-value cards mushroomed to $126B last year and are expected to grow to $470B by 2010.

Copyright 2021 PCBB. Information contained herein is based on sources we believe to be reliable, but its accuracy is not guaranteed. Customers should rely on their own outside counsel or accounting firm to address specific circumstances. This document cannot be reproduced or redistributed outside of your institution without the written consent of PCBB.