FROM HERE IT GETS TRICKY

by Steve Brown

As expected, the FOMC left the Fed Funds target unchanged at 5.25% for the first time in 18 meetings. In addition, it left the door open for more rate hikes retaining its judgment that "some inflation risks remain" and said the future depends "on the evolution of the outlook for both inflation and economic growth." BIG's position is that inflation will remain the greater risk and the Fed will hike rates a couple more times. Ironically, we feel that the longer the Fed waits, the more the market will fear inflation and the higher rates will have to go in order to slow the demand side of the economic equation. Our reasoning is that we have had 4 consecutive months of elevated core inflation, 44-months of elevated headline inflation and an economy that is still showing ample momentum. If the Fed does continue to increase rates, then it will be business as usual, albeit at a slower pace. However, should the Fed indeed go on an extended hold, then the implications for profit margins may be stark. For starters, a majority of independent banks are asset sensitive and without the consistent upward resetting of Prime, most will now feel a greater margin squeeze. The lag in deposit resets will cause liability costs to continue to push upward for the next 6 to 18 months. Moreover, with the Fed being in a neutral position, the possibility of an extended flat or inverted yield curve has now increased dramatically. This is the worst of all worlds for a majority of banks, as the difference between Prime/Libor and long-term lending rates will be further reduced. Since this environment is a by-product of slower economic growth, loans, particularly construction loans, will be harder to come by (and in many markets already are). The slow- down in construction loan growth means that margins will come under greater pressure and fee income will be reduced. Smart banks have already been planning for this day and will do a couple things differently. On the loan side, bankers will increase the marketing of revolving lines and non-real estate commercial loans, as corporate earnings will come under pressure. Greater resources will be applied to credit management, as some commercial real estate projects will start to feel a cash flow squeeze with an increase in vacancies or slower absorption rates. On the liability side of the balance sheet, as much as we hate long-term CD promotions, they now become deadly. Extra duration in CDs will be costly in a flat or down interest rate trend environment. DDAs become more valuable and deserve some additional marketing resources to increase sales. However, MMDA accounts will decrease in value in a steady or down interest rate environment as mutual fund alternatives and non-bank investment products offer higher rates, leading to decreased bank balances. To counteract this trend, banks will again start marketing campaigns playing up the safety, soundness and flexibility that only a bank can afford. Finally, cash management, as a product set, becomes more valuable to corporate America, as they look for ways to enhance earnings. While we dubbed 2005 as the Golden Year in banking, 2006 is shaping up to be a transition year. Going forward, life in banking becomes more uncertain. Competitive banks will embrace change and look at the neutral position of the Fed as an opportunity to steal market share both from other banks and from non-bank competitors.

BANK NEWS

MBA Index

Mortgage applications increased 4.9%, from a four-year low the prior week. Refinancings rose 7.1% while purchases were up 3.4%.

Acquisition

Morgan Stanley will acquire residential mortgage lender Saxon Capital Inc (VA), in a transaction valued at nearly $706mm.

Preferred Lending

The Farm Service Agency has amended its Preferred Lender Program to allow qualified lenders to retain their status for up to two years after their loss ration exceeds FSA standards.

Competition

Recent acquisitions, an influx of out of state banks and new bank openings have increased competition for CRE lenders and boosted loan officer pay in the TX market by as much as 25%, according to HR consultants. First Horizon (the parent company for First Tennessee) said they recently hired 10 lenders from other banks in the state and Wachovia indicated they intend to hire many more as well in coming months.

Investigation of Unpaid Taxes

The commissioner of the IRS has ordered the audit committee to investigate as many as 40 different companies who may owe millions of dollars in unpaid taxes. The investigation has already led to 19 executives being laid off, mainly on fraud charges.

Market Niche

As the number of American millionaire households rises to 3mm, many banks are expanding services to attract this wealthy segment.