MOUNTAIN OF WISDOM

by Steve Brown

Over the past few days we have heard from a plethora of FRB speakers. Once you get through all the humming, it is clear the mantra from all of them is the same Â– the economy is moderately strong, the housing slowdown will not hurt the economy much, oil prices (and therefore inflation) are lower and the FRB is armed to the teeth ready to defend against any whiff of inflation. This brings us to the forward curve and what the market thinks of all this banter. To begin, it is interesting to note that Federal Funds (adjusting and using Eurodollars as a proxy) are poised to drop from their 5.25% current level to 5.00% in March 2007 and then to 4.75% in September 2007. Once rates hit 4.75%, FF will sit and languish for the next 3Y (to March of 2010). While we all know these projections are probably wrong, the forward curve tends to be better than the top economists over time. Further, forward rates indicate a bias in the market. Despite comments from FRB speakers that everything is fine, investors have a jaded view and believe history will repeat itself. Based on these patterns, somewhere between 6 and 18 months after the last rate hike, the FOMC is forced to cut rates (because they usually overshoot the mark). As such, investors are voting with their pocketbooks, building in 2 rate cuts in 2007. Shifting gears, as evidenced by Treasury futures, banks may also be interested to know that investors expect long-term rates will only move 5bp from current levels over the next 5Y. Again, while the forward curve may not be correct, it indicates a willingness on the part of investors to put their money to work longer, amid expectations of slow and steady economic growth for the foreseeable future. Interestingly, by adjusting yields to account for currency differences, we find the U.S. 10Y Treasury yield (even at its current level) is nearly 100bp above most other countries. Putting ourselves into the shoes of an international investor, the U.S. market remains the place to invest funds, so that isn't likely to change anytime soon. What does all this mean for independent banks? To begin, Prime will stay at current levels for about 4 more months, while the lagging effect of FOMC rate increases squeezes margins somewhere between 25bp to 45bp over that same time period. Unfortunately, the market is predicting NIM for independent banks will get squeezed down to about 3.50%, so we will all have to do an exemplary job of managing costs and increasing efficiency. As evidence of their enormous excess cash balances, the latest data on the S&P 500 shows companies continue to buy back stock at a record pace (more than twice the level of the past 2Y). Since these customers don't want loans, national banks are looking elsewhere to originate. As such, look for competitive pressures to mount on the CRE and small business front as these banks continue to come "down-market." Because of the economic environment, borrower demand for long-term fixed rate loans will continue. Specifically, national banks will continue to make long-term fixed rate loans to independent bank customers and then swap them back to floating rate to better match funding alternatives. Independent banks need to be wary of any drop in loan volume or acceleration in prepayments on larger loans, for signs of national bank presence ramping up within the market. Once a client is wrapped up for that long, it is easier to cross sell them products and deepen the relationship, marking it even harder for an independent bank to get these customers back. The market isn't going to change, so independent banks will need to architect themselves to live off tighter margins. For some, this means operating more efficiently, while for others it means extracting more value from loan production, restructuring liabilities, or learning how to originate and convert long-term loans. While it is more difficult to achieve nirvana, banks that practice now are more likely to find the path to bliss later.

BANK NEWS

M&A

TCF Financial ($9.6B, MN) has agreed to sell 10 MI branches, totaling $235mm in deposits, to Independent Bank Corp ($1.4B, MI) for an undisclosed sum.

More BofA Antics

After the din of its discounted equity trade program has died down, BofA is at it again by hinting that it will come out with a new program that will dramatically reduce the cost of SFR mortgages to borrowers. While the details have not been released, it is anticipated that BofA will waive more fees, drop closing costs and reduce rates in exchange for checking balances.

Customer Risk

A new study finds an amazing 63% of business owners say they rarely worry about securing customer data.

Accounts

A recent study predicts nearly 15% of all checking accounts will be opened online within the next 4Y, compared to only 3% today.

Bank Statements

A study by Forester Research finds nearly 40% of people with online access to their bank now receive their statement electronically.