NEW STRATEGY GIVEN THE FED

by Steve Brown

The Fed left the overnight target rate unchanged at 5.25% yesterday for the 6th time. Despite their unanimous vote, the policy statement was moved from an asymmetric bias to tighten (due to inflation) to a neutral position. However, the Fed appeared more optimistic in the growth paragraph of the statement as they acknowledge "tentative signs" that housing may have stabilized and inflationary growth will continue. Inflation, the Fed said, should "moderate over time," but remains a concern due to the cumulative nature of past accommodative monetary policy. Because of this policy change, the statement was characterized as more dovish, but the wording remained more on the hawkish side. In retrospect, the Fed hit the right tone, as yields dropped only slightly and the equity markets had one of the more active days of the year in terms of both volume and the 159pt rise in the Dow. The question now arises what, if anything, can banks do to take advantage of this change. The market interpreted the change in bias as a precursor for lower rates and the futures markets now price in 100% chance of a 25bp move down by the August meeting and another 25bp for year end. Despite the forward market, we remain unconvinced. The weaker dollar, strong consumer, relatively low rates and growing business earnings all point to some continued growth in the economy. By our estimation, inflation will remain a concern for the next year. While it remains to be seen how much the subprime shakeout will ripple through the economy, the most likely scenario that the problems in the mortgage market will offset some of the economic growth. This yin and yang should keep rates largely unchanged and flat for the foreseeable future. This means a continued drag on earnings for banks, both in terms of loan pricing and deposit pricing. CRE loan demand will remain elevated, but less than it has in the past and the cost of deposits will rise, as banks offer greater and greater promotions in an attempt to raise funds. The continued squeeze on margins will reward banks that lower their cost structure and become more efficient. Different from the end of 2006, the risk of a slowing economy and lower rates is now greater than higher rates. As such, banks should take extra care to position their asset duration slightly longer (within asset-liability constraints) which means longer duration investment and loan portfolios. The higher probability of lower rates also points to the fact that the downside risk of deteriorating credit is now greater. Banks should more closely at monitoring loan portfolios, be prepared to devote a greater number of resources to workouts and look for avenues of liquidity for troubled loans (we remain buyers of both performing and problem loans). Given a neutral stance, volatility will increase which will create more media attention in the market akin to what we have been experiencing the past several weeks. This will create continued opportunity for banks that choose to market deposit products on the precepts of safety and liquidity. The state of the economy will continue to present challenges for banks and will benefit management that is architected for both endurance and flexibility.

BANK NEWS

M&A

Southwest Bank ($298mm, TX) has been acquired by First Texas ($745mm, TX) for an undisclosed sum.

Too Big to Fail

FDIC Chair, Sheila Bair, commented that she doubts the government will intervene to prop up a bank with liquidity or guarantees in order to keep them solvent. Bair added that the FDIC has a committee devoted to planning for such a large scale event.

Competition

Business Bank of Nevada is offering a new loan for small businesses which allows business owners to use their homes as collateral for business loans up to $250,000. While most banks require personal guarantees, the difference here is that the bank will just look to the equity remaining in the home as collateral.

Subprime

In hopes of staying afloat, Fremont General (CA) is selling off $4B of subprime loans at a $140mm loss. Rumor has it that pricing is between $0.60 and $0.77 on the dollar. In related news, several of the larger subprime lenders have secured short-term loans from hedge funds at 13% rates.

Competition

Key Bank is rolling out a revised program going after the unbanked. They will offer enhanced check cashing for a small fee and money orders for free. This program is targeted at low income unbanked Americans that make up 10% of the population.

Crazy Competition

Huntington Bancshares (OH) is offering an "Anywhere Savings Account" through their internet bank "DirectHuntington." The account allows customers to create and manage savings accounts entirely online. The cheaper account start up and maintenance costs are allowing the company to offer a 5.2% interest rate on accounts less than $1mm and 3.94% on accounts over $1mm.