THE FED MOVE

by Steve Brown

Yesterday, the 2-day FOMC meeting concluded and the announcement was a doozy. Since the FOMC could not lower short-term rates anymore and since they had run out of acronyms that start with the letter "T," the Fed turned to brute force. Most of the policy statement, including maintaining the bias for growth was completely expected. Even the announcement to increase securities purchases was widely expected. However, the ferocity and enormous amount of these purchases took the market by surprise and left many bankers thinking - now what?

In the statement, the Fed said it would increase its Agency purchases to $200B and its Agency MBS purchases by another $750B. The Fed also said it would purchase up to $300B of longer dated Treasuries over the next 6 months. The final score was an increase in the US balance sheet by another $1T. The announcement led to a massive rally in Treasury yields (down 50bp at one point) and pushed equities skyward.

The Fed's reasoning for this aggressive move is severalfold. First it did not want to lose recent gains in liquidity and credit it had made. By pushing long-term rates down, banks will be able to fund themselves cheaper, thereby helping margins. In addition, the Fed wouldn't mind some inflation sooner rather than later and dumping $1T of cash into the economy will so that over time.

Here, it should be noted that not all the $1T of new money will spur inflation. Some of the funds will come from debt issuance (yes, the Treasury issues short-term debt to buy long-term debt, however screwy that sounds). The issuance of more debt, doesn't create more inflation per se, as it is just a shift of cashflow from one period to another. Since no one really knows the net amount of new money that has and will be printed, the true vision of future inflation is hard to see. However, for a takeaway for planning purposes, you can bet that when rates rise (we expect that to happen towards the end of this year or early next year), the Fed will move swiftly to control runaway prices.

Finally, and most importantly, the Fed delivered help by boosting asset prices in the part of the curve that will have the greatest impact on the average household and business. Lower long-term rates mean less attractive fixed income investment alternatives and cheaper debt capital. Equities, real estate and prices for businesses all received a boost as a result of the FOMC action. Homeowners, in particular, will now not only have lower rates, but higher home values. That will help them qualify to refinance and jumbo loans should also drop to the low 5%'s (while confirming home loans should be available in the high 4%'s). As we have learned in the past, if you want to stoke the economic fires, reduce mortgage payments.

Action items for banks to consider at this point include cheaper long-term CDs; lower FHLB advance costs; reduced cost to issue under TLGP and lower coupons (or floors being hit) on Treasury/FHLB-indexed loans. More importantly, capitalization rates on real estate appraisals should slow their steady march upward and begin to stabilize. Demand for fixed rate loans will increase, so banks need to increase training in this area to make sure good credits are not flowing to national banks that can offer a longer-term fixed rate loan product. The 10Y Treasury rate will go back to the low 2% range, so any company that can borrow long will be aggressively looking to do so. This will also increase cashflow/refinancing on both floating rate loans and on MBS securities held in investment portfolios (so watch out for screaming prepays on premium coupon mortgages). The drop in rates will also give banks needed gains in their investment portfolios.

Overall, the move was good for community banks, but we question the long-run implications. What will really matter is how the move will affect the dollar and foreign buyers of our Treasury issuance. Over time, we expect them to continue to lose interest, slowly pushing rates back up as the US is forced to pay for all this stimulus.

BANK NEWS

TARP Return

Bank of America said it will repay the $45B in CPP is has borrowed from the government by late 2009 or early 2010, depending on the economy.

Trouble Report

According to a MSNBC report, 163 banks finished 2008 with more troubled loans than capital and reserves, compared to only 13 in 2007. However, the study also indicated that community banks have preformed relatively well, as many have avoided riskier lending.

Mortgage Boomlet

FNMA reported Feb. refinancing activity tripled to more than $41B, the best month in about a year.

Construction

Average delinquencies reached well above 10% in the 4Q for construction loans nationwide. Of note, condo construction delinquencies soared to 25% and single-family to over 17%.

Customer Acquisition

Analysis by Aite Group finds financial institutions that integrate marketing efforts throughout the company report seeing a 10% to 20% increase in results. Banks that want to capture more clients should try getting more organized across different units.