BANKS AND INFLATION

by Steve Brown

If you are looking for harbingers of bad things to come, yesterday handed the market an interesting one. For the first time in history, "TIPS" or the Treasury Inflation Protected securities auction resulted in a negative yield. The $10B, 5Y auction resulted in a market clearing -0.55% real yield that gets added to the inflation rate, in order to give investors a market return. This basically implies an approximate 1.6% rate of inflation, indicating that the Fed will be moderately successful in generating inflation with its much-expected quantitative easing program, part II (QE2).

Unfortunately, the picture isn't all that clear and its interpretation has some substantial implications for banks. A large portion of the recent rally in the stock and bond markets can be attributed directly to QE2. Junk bond issuance has set a record for the year, as demand contracts credit spreads. As proof, consider that Mexico just sold $100B of 100Y bonds at 6.1% and the issue was oversubscribed by more than 2x. Would your bank lend money to Mexico for 100Ys? Exactly our point - hyper-low interest rates are and will continue to cause a misallocation of capital. This may be bad for investment houses, but it could be potentially devastating for banks if they are not careful.

Consider the message from the currency and commodity markets. Here the signal is the complete opposite. The dollar has been sinking, while gold continues to the stratosphere. This is confusing to armchair economists like us that would think the world would want to hold more dollars if deflation were perceived as a real threat, as each dollar held would buy more goods and services if prices were to fall. Instead, the currency markets are forewarning that we have too many dollars in circulation.

Our conclusion is this - on this issue we tend to agree with Fed President Tom Hoenig, who believes the Fed is taking a "very dangerous gamble" by potentially creating "the next crisis 4 or 5 years from now." Usually, when the Fed wants inflation, it gets inflation -often in spades. Greater inflation may result in another credit shock, as the US economy is not on firm enough footing to handle higher rates across the board. While the capital markets may be signaling it can handle higher rates, Main Street is not. Lagging indicators are slowing; inventories are up; 15mm Americans are out of work and small businesses face uncertainty, higher health care costs and taxes. We may end up with a problem equal to the one we are trying to solve - namely the spurring of global inflation and high unemployment.

Banks could see a run up in long-term interest rates, without a corresponding increase in credit quality. Another way to look at this is that asset prices may start to increase, but at a faster rate than the discounted cash flow. This is why banks should consider originating fixed rate loans now and hedging them with either liabilities or our BLP program in order to mitigate a future run up in rates. This allows borrowers to lock in low rates and improves the stability and quality of debt service repayment, while limiting interest rate risk. Without this approach, given current market signals, banks could be either taking on future short-term rates that will impact credit (due to upward pressure in debt service coverage) or too much fixed rate asset exposure.

The US faces long-term structural problems that are being masked by cheap money. The monetary position for the country is tough, but community banks shouldnÃ¢Â€Â™t be lulled into the same trap as other investors looking for anywhere to park capital.

BANK NEWS

Consent Order

For the first time in history, a FHLB has been put under a consent order by its primary regulator. Yesterday the FHLB of Seattle agreed to enter into a consent order that requires it to make capital management, asset composition and other operational and risk management improvements.

Call Report Changes

Regulators have proposed changes to the Call Report effective March 31, 2011 in order to gain a better understanding of credit and liquidity risk exposures. Changes include: A breakdown by loan category of other loans and leases' that are TDRs; separating auto loans from other consumer loans; estimated amount of non-brokered deposits obtained through the use of deposit listing service companies; more detail about deposits of individuals, partnerships and corporations; a new schedule to capture variable interest entities such as securitization trusts and asset-backed commercial paper conduits; detail of loans and OREO covered by FDIC loss-sharing agreements by category; life insurance assets; assets of captive insurance and reinsurance subsidiaries; revisions addressing the reporting of construction loans; revising the treatment of assets and liabilities whose interest rates have reached contractual ceilings or floors for purposes of reporting maturity and repricing data.

Bankruptcy

Equifax reports small business bankruptcies in the 3Q fell by over 11% from the 2Q. This was the 5th consecutive quarterly drop and is down 19% from the high point reached in 2Q 2009.