AT LEAST THE VALUE OF VAULTS IS UP

by Steve Brown

Yesterday, fear was monetized and it will have a profound impact on banking going forward. To be clear, this is not 2008 all over again and what we are experiencing is a correction in the reinflation of equity asset bubbles. We are not having another banking crisis, real estate prices should improve and this is largely a European problem. Part of the problem is one of too much liquidity (at least in the US) chasing too few assets. Equity prices are stabilizing to a less optimistic outlook, but the stark takeaway is that the price of liquidity has increased which makes sense if you consider the amount of stimulus in a market that lacks a long term positive outlook.

More proof that you are not charging your customers enough for the safety, soundness and convenience of banking comes from the Bank of New York Mellon (BONY) who yesterday announced that it will charge a 13bp fee plus an additional fee if the 1-month Treasury yield dips below zero on depositors that have accounts with an average monthly balance of $50mm per relationship. In short, next week, BONY will move will move to a negative deposit rate in order to offset the 10bp FDIC assessment. Now a custodian bank charging a fee to large accounts isn't exactly the same as a community bank charging negative rates on their customers, but the situation merits a review to understand what is happening, as we are in rarified territory.

Yesterday, as the equity markets sold off, money moved into Treasuries, particularly short-term bills. Three month Bills went to a 0% return and went negative for part of the day. A negative return is crazy by all economic fundamentals, but it is rationalized as certain accounts can only be exposed to certain asset classes and have to be in Treasuries as they are not allowed to take the risk in other instruments such as bank deposits, commercial paper or assets with longer duration. Elsewhere, investors with more flexibility were not about to suffer a negative return and moved out of Treasuries and into other instruments either farther out the curve, asset classes with more credit risk or to bank deposits. The custodian banks that handle asset managers (such as BONY, State Street, JP Morgan and BofA) got hit with a huge amount of incoming liquidity. While most banks have places to put money to work, BONY doesn't have a large credit origination ability and has virtually no place to go with the excess liquidity.

To make matters worse, investors that had their money in money market mutual funds, worried about getting a negative return on their holdings and had huge redemptions with funds flowing into bank deposits. Luckily, bond and bill prices were up, so breaking the buck (taking losses) was not a huge concern (although the redemptions did cause some pain for some funds). To place competitive rates in perspective of the 50+ money funds that we utilize (mostly larger funds) we have about 20% of the funds at 0%, a third at 1bp and a third at 6bp (the rest are specialized funds and are slightly higher in the 11bp range).

While we will be covering the longer term impact and strategy implications of current market happenings in our Monthly Asset-Liability Package due out today, the short-term direct impact is banks will see more deposits. Many investor types will just be happy to have their cash in a vault and not be charged a negative rate. While we don't advise going negative on deposit rates, we do continue to underscore trying to get your total cost of funds below 75bp and increasing fees on unprofitable accounts. In addition, money market fund customers should be targeted. Yesterday's market movement highlights the fact that we have too much liquidity which will make policy makers question a 3rd round of quantitative easing and the Fed's 25bp on excess reserves. We mean can the Fed really afford to pay an overnight rate at the same level the market values the 2Y Treasury Note? At a minimum, banks should consider the impact of earnings of what would happen if the Fed stopped paying 25bp and should relook at tightening lending margins in accordance with risk in order to try to put some of this liquidity to work.

BANK NEWS

Volatility

One of the many risk indicators that we watch for is the VIX which is an option index based on the negative volatility of the S&P 500. The higher the number, the higher probability the market places on stock prices heading down. As of yesterday, the VIX jumped 35%, the largest increase since Feb of 2007.

Mortgage Rates

The 15Y mortgage and the 5Y adjustable ARM hit their lowest rates ever recorded at 3.54% and 3.18%, respectively.

S&P

Not that you would know it from yesterday, but we have had 409 of the 500 S&P companies report earnings with income exceeding expectations in 74% of the cases.