THE PERILS OF FORECASTING

by Steve Brown

If you blow up your screen view to at least 355%, you will see the picture on the left shows FOMC participants believe the economy supports rate hikes (working left from right) this year (1 person), next year (4), in 2015 (13) and 2016 (1). You may also recall that we ran a story at the beginning of Feb about Ground Hog Day. It's one of our favorite holidays given the societal implications of relying upon a large rodent for the forecasting of weather trends. This year, Phil didn't see his shadow and therefore predicted an early spring. Like those whose job it is to predict the beginning and end of economic trends, it's not always that easy to get it right. We see now that colder temperatures have continued across much of the US later into the spring than usual and people are looking for someone to blame, so Phil gets the bad rap. Things got so bad in OH that a prosecutor recently issued an indictment against Phil on the charge of felony misrepresentation against the peace and dignity of the State of Ohio. The prosecutor is asking the Governor of OH for Phil's extradition from PA in order for him to stand trial on his furry little legs.

What would happen if our wizened economic predictors had such penalties at stake we wonder? The most widely watched forecasting body is of course the Federal Reserve. Can you imagine if the states asserted their rights in some fashion related to FOMC actions? After all, this group's actions are watched much more than Phil we would argue and even the smallest signals (or lack thereof) are interpreted and analyzed by financial pundits into minutiae.

In an effort to blow some of the smoke out of the room, in early 2012 the Fed made real efforts to de-mystify its thought processes. Chairman Bernanke added press conferences immediately following meetings and the Fed has ramped up way more information on its website. It even publishes the "inside scoop" projections for GDP growth, unemployment, inflation and core inflation. Also of interest is the bar graph above of FOMC participants' appropriate timing of policy firming. For instance, we know that after the March 20 meeting, 13 members sit squarely on 2015 for likely policy tightening, but what are the components that go into these time projections? The Fed has also given us specific targets (see our box on the bottom right of this publication) - an unemployment rate of 6.5% and a 2% inflation rate as key triggers for rate hikes.

While we are all glad for the additional information, it is still based on highly educated predictions so it is subject to revision or outright change. This is because part of the Fed's job is to adjust if necessary, keep market surprises to a minimum to avoid unintended consequences and keep growth on track if at all possible. The economy has been gradually improving, but that growth is expected to remain "moderate" this year and next. Large cuts in federal spending are just beginning to take effect and this complicates forecasting because consumer reaction is unknown. It is believed that these cuts will likely further reduce government jobs and slow private sector hiring. This has the Fed trimming its GDP forecast in 2013 by 0.4% and increasing the expected unemployment rate by 0.2%. For bankers, that means softer loan demand, higher projected unemployment and a longer timeline for the FOMC to reach its 6.5% unemployment threshold. Will we get there in 2015? At this point it is anyone's guess, but perhaps the next time this survey is taken, you may very well see some of those in the 2015 camp shifting to 2016.

BANK NEWS

M&A

BBCN Bancorp ($5.6B, CA) will buy Foster Bankshares ($412mm, IL) for about $4.6mm.

Q1 Earnings

Bank of America reported higher quarterly profit and revenue, driven by a $1B cut in expenses, higher investment banking fees and strong brokerage income. Loan growth was soft and NIM declined to 2.43% (vs. 2.51% same period last year). US Bancorp reported profit increased 7%, as net income climbed vs. the same quarter last year. Mortgage banking revenue fell 11%, non interest income declined 3.3% and US cut expenses by 3.5%. Comerica reported higher quarterly profit, driven by lower expenses, a 3% cut in staff vs. Q1 2012 and 1% loan growth vs. Q4.

Small Business

Research by JPMorgan finds 94% of companies pay individual and not corporate taxes.

Fed Purchases

If you were wondering when you might have an opportunity to buy securities once again at levels that would support your bank operating costs (2% yield needed), know that the Fed is expected to buy $1T of assets this year, or nearly all of the net supply. Looks like it will be mid 2014 before it makes any sense for banks to start buying investment securities again.

GDP

Looking at the data that has been reported, with a few more revisions on tap, it appears 1Q GDP will come in at about the 3.0% level. Meanwhile, the IMF has trimmed its 2013 US outlook from 2.0% to 1.7%.

Mortgages

Since the start of quantitative easing #3 in Sep. 2012, the Fed has been purchasing about 60% of total mortgage backed securities available in the market.

QE Ending

The latest FOMC minutes seem to indicate the Fed will begin reducing its bond purchases at the end of this year, so bankers should be prepared. Comments ranged from cutting back "around midyear, with purchases ending later this year;" to "slow(ing) purchases later in the year and to stop(ping) them by year-end;" to continuing at the current pace "at least through the end of the year." Taken together, year-end is a likely scenario.

Even Better

JPMorgan now projects home prices nationwide will improve 7.0% this year vs. 3.4% prior.