Bauerle's Bank Notes

Herbstnebel

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This week's announcement of a one-quarter percent increase in the Federal Funds Target Rate is the most widely anticipated move by the Federal Reserve Board of Governors in the last decade. The Fed's just-ending zero interest rate policy, or ZIRP, has reflected anemic demand conditions in the U.S. economy, as well as unavailability of fiscal stimulus as a policy tool due to Congressional political gridlock and federal debts piled on since the turn of the century. To find anything resembling the last nine years' ZIRP, one must look back to the 1940s. Then, the Fed used expansive monetary policy to help transition the economy from war production to peacetime.

Fed's chairs Bernanke and Yellin's commitment to policy "transparency" has made this week's rate bump a self-fulfilling prophecy. The market expects it and the Fed must deliver it or risk damaging business and consumer confidence. Moot is whether now is truly the optimal moment for higher real interest rates.

Having months-ago factored the Fed's rate move into their market conduct, bankers, corporate treasurers and traders have recently been cutting their exposure to industrial commodities, especially oil, mining and primary metals. High yield bonds too have faltered. Mutual fund complex Third Avenue took the rare action Friday of liquidating its junk bond fund, Third Avenue Focused Credit (NASDAQ: TFCVX), after investors stormed the exits.

Nobody expects the downdraft in these economic sectors to end any time soon. "Lower for longer" has settled in like autumn fog, *Herbstnebel* in German. Energy industry optimists look for recovery in 2017. Meanwhile, bad omens abound: China's unfolding recession, OPEC's disarray, unusually warm weather as winter begins in the U.S. (bad for natural gas demand and prices), climate change meetings in Paris, and Congressional hostility to continuing tax subsidies for renewable energy investments like wind and solar technology. So who in his or her right mind would embrace the energy sector as a sound

investment opportunity?

Robert Johnson, for one. President of the American College of Financial Services, in Bryn Mawr, Pennsylvania, Johnson authored of a piece in *Barron's* this week, titled "Rising Rates Spell Stock Trouble." Johnson summarizes his twenty-five years' work alongside two academic economists.

> What we have found is that there are very strong patterns of returns related to monetary policy present in the capital markets.
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> Domestic equities perform quite well when the Fed is pursuing an expansive monetary policy, and provide more pedestrian returns in a restrictive monetary environment. This may not be a big surprise, but the magnitude of the return differences is remarkable.
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> From 1966 through 2013, the Standard & Poor's 500 returned 15.2% annually during expansive periods (when rates were falling) and only 5.9% during restrictive periods (when rates were rising). After adjusting for inflation, the average real return to equities during the restrictive periods was less than 1%.

Generalizations that broad are subject to qualification and exceptions. Adds Johnson,

> During expansive periods, consumer-discretionary industries such as apparel, retail, automobiles, and durable goods are top performers. . . .
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> During restrictive periods, defensive industries such as food, energy, and utilities have performed better than most. When money is dear, people still have to eat, drive their cars, and heat their homes.

Sounds like a recipe for sector rotation in the stock market as well as for avoidance of junk bonds, whose best performance occurs during periods of expansive monetary policy, according to Johnson's and his colleagues' analysis. Ditto real estate as an investment class. Not so commodities, Johnson says.

> From 1970 through 2013, the Goldman Sachs Commodity Index, which represents a broad index of 24 different commodities, had a -0.2% return in expansive periods and a 17.7% return during restrictive periods. Our findings suggest that investors facing rising interest rates should consider this beaten-down asset class and "be greedy when others are fearful," as Warren Buffet says and often demonstrates in his investing.

Johnson does not address whether shares or bonds of banks and other financial services companies are likely to fare well or poorly as the Fed shifts its stance. Our own industry experience suggests there will be winners and losers, depending on how well managers and executives run their shops.

Banks that follow Buffet's advice will gain by disciplined underwriting and funding of energy industry companies led by seasoned operators. Those that chase the next fad will suffer. Bank regulators' current aversion to commodity industry lending cannot be ignored. Neither should one be cowed by it and so miss out on sound, profitable banking opportunities.

Banks that have liability-sensitive balance sheets are more likely to be at risk. As interest rates rise, these banks will have to pay more for deposits but will not be able to reprice loans to higher rates as quickly. It's a phenomenon not seen in American banking since the 1980s. It destroyed the thrift industry after Congress deregulated deposit rates in the 1982 Garn-St. Germain Act without recognizing that long-duration mortgages thrift institutions held in their loan portfolios could not be repriced as deposit rates rose. Today, once again, there are banks on the horizon that have imprudently high levels of interest rate risk embedded in their balance sheets. As the fog of ZIRP burns off, we will learn who has been running naked.

Banks in this business cycle have heavied-up on asset-based loans, ones that tightly bind the amount of credit available to borrowers to the value of the borrowers' accounts receivable and inventory. Partly that's normal business cycle practice. But the post-2008 regulatory push for tighter controls has also played a part in the growth of asset-based lending. Most every bank is aggressively selling asset-based credit. The competitive pressure will eventually lead to loans that fall out of bed, just as surely as sunshine burns off morning fog.

What do these trends portend for middle market companies and the financial institutions that fund them as we arrive on the doorstep of 2016? That will be the focus of our next installment. In the meantime, we wish you a blessed holiday, not overfilled with eggnog.

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