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Buckle Up

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When we contemplate the economic and capital markets landscape each morning, we scarcely know where to start with that day's litany of woes. What should we worry about today? The inversion of the yield curve, or the ongoing meltdown in Hong Kong and its possible implications for a trade deal, or the possible political impacts of our recent spate of mass shootings? Should we worry about a president who seems to do trade policy off the cuff? Should we worry about the massive and burgeoning national debt—enabled by both political parties—that will eventually come home to roost? How about the sorry saga of Brexit and how that may jolt the world this October? And on and on...

We're at least heartened that we are not the only ones suffering an economic anxiety attack at this bad news overload. We heard a brilliant discussion recently—on August 12, to be precise—on *Bloomberg Surveillance TV* (it was continued immediately after on radio) between the erudite host, Tom Keene, and his guest Carl Weinberg, who is the Chief Economist of High Frequency Economics, one of the Street's best economic research shops. Mr. Weinberg is an old hand not only on the subject of the yield curve but also on the subject of China, which makes him doubly valuable in times such as these. (This conversation is available as a podcast online, and we strongly urge that readers give it a listen.)

Mr. Weinberg addressed the "peculiar place" in which we all find ourselves right now—facing the growing use of "negative interest rates" as a central bank monetary policy tool globally in an effort to try to stave off the damage from trade wars, aging demographics, imperfect (or non-existent) banking unions (the Euro Zone, specifically) and on and on. And while we think that such an interest rate environment could not happen here—the American public would likely revolt and demand the firing of the FOMC—even the *Wall Street Journal* felt that the possibility of negative rates merited coverage in an article on August 12, titled "Investors Ponder Negative Bond Yields in the U.S."

Carl Weinberg expressed great discomfort with the idea of any prolonged regimen of negative rates, saying that such an environment would inevitably lead to systemic failure as "money dies" (i.e., is seen to have no value) and the holders of money turn to consumption instead. Indeed, he said that the present environment is one that he had not experienced before, and that "you don't know what you don't know when you're off the grid with interest rates." He also made a comparison with which we immediately identified—that the environment of falling house prices nationally in 2008 was similar, in that no one knew what that meant until the meaning became suddenly and painfully clear.

Bank stocks are clearly signaling anxiety with this idea of "we don't know what we don't know" and the *Wall Street Journal* titled a piece "Bank Stocks Are Having a Rough August" (August 12) which catalogued the litany of headwinds facing the banks. That headwind has grown into a gale force wind with the inversion of the yield curve—with the first-ever dip of 30-year yields to 2.06% and the 10-year rate below the 2-year--and it is becoming more apparent daily that the collective memory of the events of 2008 is leading to an exodus from financial services stocks.

While the reality is that the banking industry is immensely better prepared to weather any recession—and indeed the major banks will likely use the downdraft in their stocks to put capital to work in share repurchases—we think that today's air of panic will likely persist for a few months. While Mr. Weinberg said that he saw the risk of recession at about 20% (and that sounds about right to us), we also think that the Fed will be unwilling to cut rates as fast or as much as the markets may want. We listened with amusement (and irritation) as Jon Golub, chief equity strategist at Credit Suisse, said on *Bloomberg* that the Fed must act immediately on the inverted yield curve and that it "can't fight the markets."

With respect to Mr. Golub and every other panicked strategist out there, we would say one thing: Get a grip. The Fed cannot prevent recessions—particularly those that may be triggered by non-monetary reasons, like trade wars, rebellion in Hong Kong or repeated episodes of Presidential folly. Secondly, recessions do not normally result from yield curve inversions that occur at the long end of the curve. Instead, they occur when the Fed hikes short-term rates and chokes off the economy. And finally, we would remind that the equity markets have moved in pretty much one direction—that would be UP—since the election of Donald Trump and are long overdue for a sizeable correction, and it is August after all and half the Street is away.

What should the banks do in response to the events of the past few days? That answer is simple—they should keep doing what they have been doing for the last many years. The major banks should be able to capitalize on volatility in their capital markets operations, and the imminent relaxation of the "Volcker rule" should help with those revenues. It is also likely that the largest banks will go back for one more round of cost-cutting, with headcount likely to be reduced substantially and branch expenses to get yet more layers of trimming. We would also note that the recent CCAR findings will allow banks like **Citigroup (C)** to buy back huge portions of its outstanding shares (12% for Citi, by one calculation) and we would pay attention to price-to-tangible book value ratios to gauge when the bottoms may be approaching.

The community banks are often judged to be at a disadvantage to the larger banks in these times as they have fewer revenue sources and are more exposed to moves in the yield curve. We want to push back on that conventional wisdom just a bit, as we think that they have a unique and important advantage—they know their customers, they can have conversations with them to clarify their situations, they can convey the need for a collegial and mutually advantageous relationship in times of turmoil, and they can be early to do relationship triage as necessary. They also have the advantage of being able to do accretive deals, and this ability will, we believe, be increasingly in play.

We have seen this movie before—and we lived to see the ending. And frankly, it did not end too badly. The economy came back, the markets flourished, American industries like technology thrived, and millions of people got jobs and bought homes. The actors and the circumstances may be different this time, and we will readily admit that there are a few things here that are quite out of the range of what anyone could call "normal." But for those of us who love to collect dividends—and that is one place where banks excel—this could not be a better environment. Fasten your seat belts—it's going to be a bumpy and exhilarating ride, and one that we hope will help the banks exorcise the ghosts of 2008.

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