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Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

I am not sure it is because I have been doing this for as long as I have or because it really is the case, but the data is starting to look the same to me. I say this, because after reading this morning's Employment Situation report for November, I had to wonder: is that all you got? It was as if the Bureau of Labor Statistics (BLS) had somehow 'phoned it in.'

In fact, it reminded me of a scene in a somewhat obscure movie entitled "The Year of Living Dangerously." Granted, it isn't for all tastes, unless those tastes include giving a care about an aborted communist coup in 1960's Indonesia. However, if you have seen the movie, you might remember a scene when the Mel Gibson character phoned in his report about Indonesian strongman Sukarno to his bosses back in Australia. It goes something like this:

> "In short, Jakarta is a city where the questions outnumber the answers, but one thing is certain: that Sukarno's tightrope shuffle between the Communist P.K.I and the right-wing military is looking more precarious as the hours tick by. This is Guy Hamilton in Jakarta for A.B.S. News.
>
> Is that all?
>
> What do you mean?
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> You could have written that from here.
>
> What about the tightrope image? Everyone else thinks Sukarno is in control.
>
> Guy, that wasn't news. It was travelogue. Sydney out."

While this morning's report might not have been actual travelogue, I feel as though we have all been down the same road many times. In case you were wondering, I am not going to quote Robert Frost at this time. After all, he took the road not taken.

While I have not watched the television today, I am certain more than a few important sounding types have called it "good" or that it "all but guarantees the Fed will tighten in a couple of weeks." You know, that sort of thing, like déjà vu all over again or something. The truth is, unless the number had been truly horrific, and I mean at least two standard deviations to the left, the Fed had every intention of raising the overnight lending target at the upcoming meeting, and has had so for a very long time.

A long time in the central bank world meaning a solid 4 weeks, or thereabouts. As I type here on Friday afternoon, according to the Fed Funds futures market, there is a 100% probability the Fed will raise the overnight lending target 0.25% at its 2-day meeting ending 12/16….the exact same as yesterday. For its part, the stock market doesn't really seem to care.

If anything is different, that is. Not so long ago, the specter of a rate hike was enough to take a couple hundred points off the Dow Industrials. Now, it is a fait accompli. A what's next and a resounding so what? What's even more interesting is a potential rate hike has been great for financial stocks, at least up until now.

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I say this is interesting for the following drawn out reason. The conventional wisdom is a tighter monetary policy will bring down the long-end of the yield curve. Why? Well, tighter money should slow down money creation in the economy, which should keep a lid on inflation...or at least the potential for inflation. As a result, long rates come down while short rates go up, or at least don't go up as fast as short rates. Since banks borrow short and lend long, that compresses the spread they can make on each individual new loan. As a result, net interest margin decreases, which decreases revenue, which ordinarily has a negative impact on earnings or profit.

...or so the story goes.

This was the prevailing wisdom back when banks primarily made fixed rate loans. Any increase in short-term rates had an almost immediate negative impact to the bottom line. Therefore, a flattening yield curve (short UP + long DOWN) was bad news for the financial sector. Things have changed.

Banks now make a lot of variable rate loans off of things like LIBOR and Prime. When the Fed raises the overnight lending target, these things will go up. As a result, banks stand to earn more money off their variable rate loan portfolio when the Fed does a rate hike or two. What's more, banks typically won't move deposit rates in lockstep with increases in LIBOR or Prime. For instance, Prime will probably reset to 3.75% from 3.50% when the Fed raises rates on 12/16, but interest bearing checking or money market accounts probably won't go up the same amount. As a result, bank net interest margins stand to actually increase from a few 0.25% overnight lending target hikes.

Now, IF it appears the Fed is going to embark on a prolonged tightening policy, THAT could be bad for banks, as borrowers opt to refinance their variable rate loans on fixed terms. However, that doesn't appear to the case.

Going back to Fed Funds futures, right now, the bets are 33% the overnight lending target will be 1% at the end of 2017; 32% at 1.25%, 13% at 0.75, and 16% at 1.50%. As such, the markets are currently saying 94% chance the overnight rate will be 1.50% or less by the end of next year. If past performance is indicative of future results, and I am supposed to say it isn't, Prime will likely be no more than 4.50% over the next 12 months.

So, if you have a choice between keeping your Prime based loan or locking into a fixed rate at, say, 5.0%, what would you do? I suppose the easiest answer is you probably won't be a huge hurry to lock in over the next couple of quarters. Why would you when virtually no one thinks the Fed is going to be overly aggressive?

As a result, contrary to what my business school textbooks taught me a quarter century ago, a few rate hikes could actually be good for the banking industry. Voila! Financial stocks have rallied like the dickens over the last month. But how much higher can they go?

Um, no one's crystal ball is perfectly lucid in this industry, but the easy money is the easy money has largely been made in financials for the short while. Hey, love the rally and keep your fingers crossed; however, at some point, investors will wait to see IF this reasoning I just used pans out as envisioned.

Now, there would be some who would argue Trump's victory is the primary reason financial stocks have rallied, and I would counter with this: if Trump's election is the reason why the Federal Reserve is going to raise the overnight lend-

Disclosure

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ing target in a couple of weeks then, yes, that is the reason. Certainly, any potential roll back or easing of regulations should help the banking industry, but that type of stuff takes time. Loan rate resets are far more immediate, and banks are starting to enjoy a bump due to LIBOR already pricing in a Fed move in a couple of weeks. Finally, I would be remiss if I didn't mention the GOP retaining control of both Houses of Congress will probably keep the anti-banking folks in Congress, like Elizabeth Warren and Bernie Sanders, at bay for a while.

So, final tally: bank rally = 70% rate hike + 20% GOP control of Congress + 10% Trump. Whew. With that said, the rally in energy is virtually all due to Trump.

Absent financials and energy, guess what the rally in the S&P 500 would have been from 11/8 through 11/30? Well, the little table below is sort of 'back of the envelope' math, but it is a good guesstimate.

ETF	Principal Return	Weight SPX	Index Contribution
SPY (S&P 500 Proxy)	2.930%	100.00%	2.930%
XLE (Energy)	**7.370%**	7.52%	0.554%
XLF (Financials)	**12.610%**	16.04%	2.023%
Rest of S&P 500	**0.462%**	76.44%	0.353%

There you have it: a nice return, to be sure. But historic? Not on your life, unless you consider an 8.34% annualized principal rate of return historic. In fact, I would say outside of energy & financials stocks have performed sort of like stocks normally perform during November...that is they rally somewhat. Shoot, for all the noise on the TV, you would have thought stocks had gone through the roof after the election. Hey, 2.93% ain't nothing to sneeze at, but, wow, you would have thought it had been more than that, wouldn't have you?

In that regard, 24% of the market has been on fire, and the rest of it hasn't. It hasn't been bad, but, you know, it hasn't been memorable to any great degree.

…..sort of like this morning's Employment Situation report and even "The Year of Living Dangerously." There is something in them for fans, but the rest of us will feel as though we have lived through this previously.