Vol. 9, Issue 18
June 12, 2015

Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

Last night, I had my parents over for dinner. As usual, my father veered off into current events almost as soon as he sat down. Let's just say the pace of societal change has him a little perplexed, which I can certainly appreciate. A lot has changed over the last, well, umpteen years, and it seems to be accelerating, thanks to our instantaneous access to information. That, and the need for all these news services to fill up 24/7/365 with "newsy" items that get clicks, likes, and shares.

When I told him I had enough other things to worry about than some of the things on which he has been focused, he shifted to the following: "How much longer can the stock market keep doing this? We have to have a day of reckoning like we had in 2008 sometime soon."

No, he didn't ask for my opinion, as he considered his observation a mere statement of the obvious. This even though he has never worked in the investment industry, and I have. Oh well, I am still a kid in his eyes, regardless of the fact my hair is basically white as snow.

The thing is, my dad isn't alone in his contention.

First things first: US stocks haven't done much of anything thus far in 2015, apart from bouncing around like a cat on a hot tin roof. As I type this, at 1:55 pm on June 12, the principal return of the S&P 500 year to date is a less than impressive 1.61%, and the total return is around 2.58%. The latter works out to be an annualized 5.87% rate of return, which is well less than the accepted historical return for large cap stocks of roughly 10.00%.

So, how much longer can stocks continue to do this? It depends on what you mean by "do this." If grow modestly and underperform history, the answer is simple: forever. In truth, there is very little fuel left for stocks to surge, say, 20-30%. Economic growth is okay, but not awesome, and the Fed doesn't have a lot of ammo left to do anything too stimulative, even if it was of the mind to do so. It has to play defense now.

However, from where I sit, I don't know exactly what the impetus will be to cause another 2008. Greece? Maybe. Opaque accounting standards in China masking a financial crisis of Biblical proportions? That is a possibility. Feckless monetary policies creating money out of thin air? Could be. Global political unrest and nuclear armed terrorists? Perish the thought.

You know, the more I write…..

There is an old expression: "those that don't learn from history are doomed to repeat it." The bear market of 2000-2002 was mainly about working off excessive valuations due to unrealistic growth assumptions caused by Y2K. The collapse in 2008 was due to a complete freeze in global liquidity. But for the much maligned TARP and bailout of AIG, the US economy would have collapsed, as banks failed left and right. The FDIC wouldn't have been able to do anything about it, really, as there just wasn't enough money in the coffers to truly backstop every deposit account of a certain size. The end result would have been a sharp decrease in the money supply, and an extremely painful, almost overnight restructuring of the US economy.

So, why can't it happen again? Well, I don't believe it will because there is a huge difference in mispricing risk and mistakenly believing you have eliminated it. Before the collapse, we were taking

Inside this issue:

Somebody's boring me. I think it's me.

Dylan Thomas

Something to Think About Cont.

chicken effluent, proclaiming it chicken salad, and charging a premium for it. Today, we are taking the same chicken effluent and folks are buying it, for whatever reason. That might seem like so much semantics, but it really isn't.

Then, there is the simple, or not so simple, issue of bank capital. Consider the chart below, which I cut & pasted from an article printed in Forbes magazine on March 6, 2015, and which outlines common equity Tier 1 capital ratios for the country's money center banks:

	Q4'12	Q1'13	Q2'13	Q3'13	Q4'13	Q1'14	Q2'14	Q3'14	Q4'14	TARGET (Basel)	TARGET (Fed)
Morgan Stanley	9.50%	9.70%	9.90%	10.80%	10.50%	10.20%	10.70%	11.77%	10.67%	8.50%	9.50%
Citigroup	8.74%	9.34%	10.03%	10.50%	10.59%	10.46%	10.58%	10.66%	10.58%	9.00%	10.50%
Wells Fargo	8.18%	8.39%	8.55%	9.54%	9.78%	10.04%	10.09%	10.45%	10.45%	8.00%	9.00%
Goldman Sachs	8.80%	9.00%	9.30%	9.10%	9.17%	9.30%	9.40%	10.00%	10.24%	8.50%	9.50%
JPMorgan	8.74%	8.86%	9.33%	9.33%	9.50%	9.58%	9.79%	10.11%	10.18%	9.50%	11.50%
Bank of America	9.25%	9.52%	9.60%	9.00%	9.06%	8.99%	9.55%	9.53%	9.64%	8.50%	9.50%

Now, this is important, because bad things happen when the money supply contracts, and these guys dominate the US banking sector. For anyone who says no bank should be "too big to fail," I say: "Baloney."

According to the Bloomberg, at the end of 2014, these 6 banks had total deposits of, get this, $5.154 trillion dollars. According to the Federal Reserve's H.8 report, total deposits in commercial banks across the US were approximately $10.448 trillion. So, these big 6 banks represent about 50% of total deposits in our financial system.

Now, those capital ratios are all significantly higher than they were at the end of 2007. For instance, Wells Fargo currently has a Tier 1 capital ratio of 10.58% which is pretty doggone good for such a massive firm. Back in the day (end of 2007) the ratio was slightly less than 7%. For Bank of America, the numbers are 9.64% today, and about 4.50% back then. I will save you the boredom, and tell you the news is pretty much the same for the others.

So, the firms that have the deposits are in much healthier shape today, as defined by their Tier 1 capital ratio (which is pretty darn important). This makes a sharp decrease in the money supply unlikely.

Further, according to the Fed's H.3 release, total reserves in the banking system were $42.580 billion at the end of 2007, before all hell broke loose. This was a paltry $1.744 billion more than "required." In May 2015, get ready for this, there were $2.584 TRILLION in excess reserves in the banking system, fully $2.483 TRILLION more than required.

In essence, bank capital is significantly stronger today than it was before the financial panic, and reserves (particularly excess reserves) are through the roof….suggesting there is ample liquidity to keep the wheels greased for all but the absolute worst case scenarios.

If there is another financial panic, the big banks will not be the culprit. It will be smaller regional banks to blame, as they have stretched for yield in their loan and securities portfolios. Any significant increase in interest rates, and I

Disclosure

Something to Think About Cont.

mean a near instantaneous increase across the yield curve, will absolutely wreck the market value of these banks' assets on their balance sheets. This will cause equity capital to decline which will turn of the spigot for regional, speculative commercial real estate activity more than anything else.

The brainiacs at the Federal Reserve should know this, and they would be wise to "talk down" the long-end of the yield curve if and when they decide to raise the overnight lending target IF the long-end doesn't fall with inflation expectations (which it often does). This would mitigate any downward pricing pressure on fixed rate, longer-term loans on regional bank balance sheets. The rest of the portfolio SHOULD be in floating rate 3-7 year stuff which wouldn't get clipped too hard regardless, as loan rates would reset higher as the underlying indices react to Fed policy.

Nerdy stuff this.

However, I don't get into the weeds like this in casual conversation. The duration gap of bank portfolios and bank capital ratios vis a vis Fed monetary policy is/are extremely dry stuff, and most people don't really appreciate it. Let's just say I think the banking sector is a little more on top of the situation in 2015 than it was in 2007…..at least by all outward appearances.

That isn't to say we won't get some kind of correction, of some type. That is just part of the territory when it comes to investing. Shoot, 2011 wasn't a barrel of monkeys, nor was 1994. 1990 was uncomfortable, and 2005 and 2007 were kind of disappointing too, more meh than anything else. Shoot, even during Paul Volcker's manufactured recession at the start of the 1980s, the worst year for the S&P 500 was –4.92% (total return) in 1981, which isn't fun, but isn't a death knell for retirement balances either. Particularly when the index returned a stellar 21.55% in 1982.

Basically, and perhaps this is the most important thing, the biggest risk to the financial system is a sharp, sudden increase in intermediate to long-term interest rates. Period. However, given the fact the Federal Reserve, alone, owns $2.5 trillion in US Treasury Notes and Bonds, our central bank has enough ammunition in its OWN portfolio to keep the long-end of the yield curve from exploding bank balance sheets. It can essentially readjust its maturity structure a la Operation Twist and the like. *Further, I can't really imagine what would cause such a sharp, sudden increase in domestic rates absent a coup or something along those lines.*

It and we have never had that type of luxury previously. The Fed prints money out of thin air with its quantitative easing schemes, which allows us to low long-term interest rates….forever. Beautiful. Hey, I might be whistling past the graveyard, and I might have had enough of the Kool-Aid, but I don't think I am being overly sanguine on this. Continued rally? Probably not so much. Collapse? Probably not that either.

In the end, I told my dad to not expect things to fall apart, but also not to expect the same type of returns we have been providing him over the last 6 years. He was more than okay with this, and we all ate the Nicoise salad I made knowing, and hoping, we weren't about to fall off the edge of the earth. The salad, by the by, turned out far, far better than I expected. Let's hope the rest of the year is as good.