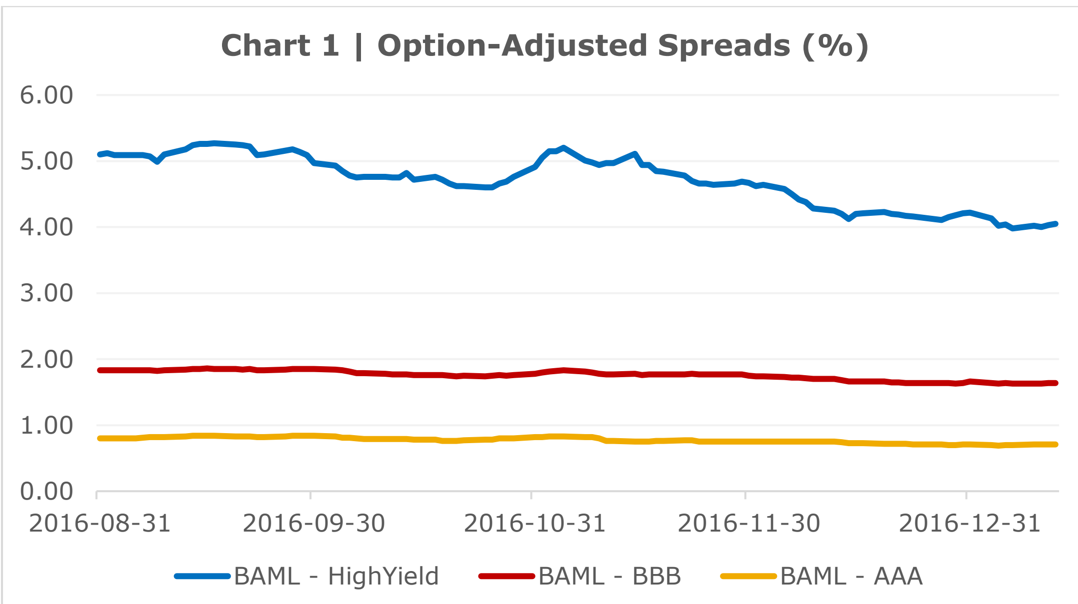
Spread Volatility, Slowing Mortgage Sector Depress Financials

Since the November election, the traditional laws of financial gravity have been scrambled to a degree that makes the previous eight years of quantitative easing and negative interest rates seem normal by comparison. Investors have taken market valuations up by a third or more based upon the expectation of what President-elect Donald Trump will do in terms of policy. Below Kroll Bond Rating Agency (KBRA) looks at several examples of the cognitive dissonance visible in the financial markets and ask the basic question: when will investor behavior start to coincide with market and economic fundamentals?

Macro: Spread Divergence

Benchmark interest rates have risen due to concerns about inflation, but corporate spreads have tightened. After an upward spike immediately following the election of Donald Trump, high-yield corporate spreads have been in a declining trend that has carried on through into Q1 2017 and the start of corporate earnings, as shown in Chart 1 below.



Source: BAML

The fact that high-yield spreads have fallen about 20% since October represents a significant bull indicator for the U.S. economy, yet it comes at the same time that yields on Treasury and agency securities have risen by a like amount, dampening activity in housing and related sectors. Since Election Day, the 10-year Treasury has backed up nearly 80bp in yield due to concerns about increased spending and decreased federal revenues resulting from tax cuts. Since peaking at a yield of 2.6% in mid-December, however, the 10-year bond has rallied to a yield of 2.36% last week, suggesting to KBRA that the urgent search for duration is starting to offset inflation concerns. As Marty Fridson told Barron's this week, high yield bonds are "extremely overvalued" based on economic conditions and interest rates.

KBRA believes that as investors come to understand that significant spending increases and tax cuts are months away, the likelihood of a rally in the Treasury bond market will grow. That said, the tenor of the Treasury market and the forward market for agency securities remains unsettled. Writing last week about the important "to-be-announced" or TBA market, which closely follows the movements of the 10-year Treasury bond, Adam Quinones of Reuters set the stage for Q1:

> "After extending to max hedge ratios versus mortgages in December, rates are attempting to establish a new trading range. Between 2.30% and 2.60% define that range for benchmark 10s. What happens in between is fairly inconsequential. Rallying into 2.30% and/or selling up to 2.60% requires little profile/energy. [Treasury] 10s could even poke and prod at 2.25% with little motivation. Breaking through 2.60% would however require a real commitment. That would be a newsworthy event as 2.60% is a key duration ledge. It's the trigger for snowball selloff #4. After that comes 2.84% followed by 3% followed by infinity and beyond…"

The message from the TBA market is clear: the bias of benchmark interest rates is higher, even if investor demand for assets and duration continues to press yields on corporate and especially high-yield bonds ever lower. Thus the reference to the prospect for "selloff #4" by Quinones. These two conflicting trends illustrate the confusion among investors that continues in the financial markets in the wake of eight years of Fed open market operations and the November election.

Bank Earnings Depressed by Mortgage Slowdown

Last week saw earnings reports from some of the largest banks, including Bank of America (NYSE:BAC), JPMorgan Chase (NYSE:JPM), and Wells Fargo & Co, (NYSE:WFC), whose senior debt carries an A rating from KBRA. In all cases, cost cutting dominated the corporate narrative for these large banks. In all three cases, credit costs continued to rise gently from the ultra-low levels seen in 2015, the trough for post-crisis banking industry losses. And in the case of WFC, KBRA's prediction of hedge losses from the Treasury market volatility in Q4 2016 were validated.

"[Wells Fargo] estimates that its hedges on long-term debt alone cost it $0.07 on GAAP EPS this quarter," notes Paul Miller at FBR. "On a positive note, Wells displayed its ability to take full advantage of its asset sensitive balance sheet in a rising rate environment by tacking on 5 bps to NIM while net interest income rose 3.8% quarter over quarter."

Significantly, the mortgage banking line for all three names was down sequentially due to the increase in interest rates following the November election followed by the Fed's interest rate hike in December. The silver lining in large bank earnings results was a substantial increase in the value of mortgage portfolios.

"Wells and JPMorgan Chase both reported mark-ups on the asset value of their servicing portfolios for 4Q 2016," notes mortgage industry maven Rob Chrisman. "Wells, the nation's number one ranked servicer, marked up its [mortgage servicing rights or] MSRs by an impressive 24.4 percent to $12.95 billion." Of note, lower gain on sale margins and rapidly shrinking pipelines for Q1 production were common features for all three top U.S. banks and are also in evidence at smaller institutions.

As KBRA has noted previously, the fundamentals of banks are unlikely to change dramatically or quickly as a result of rising interest rates. Gains in terms of net interest margin will be small and volatile quarter-to-quarter as the cost of funds for market sensitive money center banks also rise. Indeed, financials may suffer in the near term due to the negative impact of rising Treasury yields on the housing sector. As 2017 progresses, we expect that falling lending volumes for residential and commercial real estate will be a continued drag on volumes and earnings for financials.

With C&I and commercial real estate (CRE) lending also slowing from the torrid growth rates seen in 2016, the overall picture for bank earnings this year is less than inspiring. JPM, for example, sees growth in CRE decelerating sharply from 19% in 2016. Taken together, these factors beg the question: Why do equity investors continue to value commercial banks as well as mortgage banks at 30% plus above levels seen in Q3 2016? The answer in the near term is cognitive dissonance among investors, a condition that may not persist until Q1 earnings are released in early April. Stay tuned.

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