The Baker Group

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Hindsight, Foresight, and Insight: Market Conditions in 2018

As we transition into a new year, it's important for bankers to take note of some positive differences from twelve months ago. For example, we have new leadership at the Federal Reserve, including a chairman and vice chairman who are more supportive of regulatory relief for smaller banks. The US economy also comes into the new year with greater momentum and potential for faster growth on the heels of recently passed tax reform. As for the banking system, loan demand is healthy, cost-of-funds remains low, asset quality is solid, and we have stronger capital positions generally than we've had in years. The bottom line is that banks are producing the best returns for the industry since the last recession began ten years ago.

All of this is decidedly good news. Still, we must keep our eye on potential risks lurking in the current environment. Liquidity, for example, is much tighter than it has been, and pricing power on loans is weak due to competition for good credits. The Fed Funds rate is 3/4 percent above its year-ago level, but earning asset yields are sticky at lower levels and the yield curve is flatter than it's been in eight years. It should also be borne in mind that the economic cycle itself is getting old. Weak though it has been, this recovery has also been quite lengthy by historical standards, and may be due for a setback. Not necessarily another "great recession," but a cleansing pullback at least. Remember, the magnitude of the bust typically mirrors the magnitude of the boom… and the boom hasn't been very loud for this recovery. Nonetheless, Fed policymakers may find themselves having to go slower with their rate hikes than they previously planned if they want to keep the party going. And this brings us back around to the yield curve issue.

In the last four years, the shape of the yield curve has flattened substantially as the Fed has raised short-term rates while long-term rates have remained sluggishly low due to weak growth and a dearth of inflation. This effect is not lost on some policymakers. Dallas Fed President Robert Kaplan recently noted that the flatter yield curve has a limiting effect on Fed flexibility, particularly with respect to how far and how fast they can raise rates without choking too much growth out of the economy. In essence, policymakers must be cognizant of what the market is telling them about their policy stance and whether it's appropriate for the underlying conditions. They ignore market signals at their peril. As Kaplan said, "The history of inversions is such that it has tended to be a pretty reliable forward indicator of recession. Now, this time may be different, but I wouldn't count on it." Kaplan is certainly not alone in sounding this alarm as the very same concerns have been expressed by his colleagues James Bullard in St. Louis and Neel Kashkari in Minneapolis. Still, the expected policy stance of the Fed is to raise rates three or four more times in 2018, presumably bringing the Funds rate to 2.25-2.50%. Now, if the yield on the 10-year US Treasury Note remains close to its late 2017 level of around 2.45%, then we'll be facing a curve that's flat as a pancake. At that point, it wouldn't take much of a rally lower in the 10-year yield for the inversion to have begun, and Fed Funds will have reached its terminal rate for this cycle.

So, we seem to be sitting at a point in the cycle where there's plenty of good news coupled with plenty of future risks. It feels like it did in the beginning of 2007. Back then, mistakes were made on credit quality, funding choices, and security selection in the investment portfolio. Investment officers who were hungry for yield were sold high-risk private label mortgage-backed securities, TRUPs, and preferred stock, all of which ended badly in the crisis. Hopefully some lessons were learned.

As always, today's performance reflects yesterday's decisions, and the returns we enjoy tomorrow are determined by the choices we make today. Like a chess match, bank management involves cautious and thoughtful consideration several moves ahead. At The Baker Group, we like to say "Anticipate, don't predict."

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