Chris Whalen: Are More Banks Going To Fail?

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Erik: Joining me now is Whalen Global Advisors founder Chris Whalen. Chris, it's been I think five or six years since I last had you on the program. So needless to say, long time, no talk. Let's get right into the grit of what's happening. We're speaking just after the FOMC statement on Wednesday afternoon. It was widely expected that they would hike 25 basis points and that's what they did. Is there anything unexpected that happened this week that people need to understand?

Chris: Now the Fed is sticking to the original script, the narrative is about fighting inflation. They don't want to talk about banks at all. And also, there's a big chunk of investors out there pension funds, everybody else who were also suffering as a result of the price change that occurred when they raised interest rates, you know, its bond market 101, that we're learning it all over again. It's like the 1980s. If I were to compare today with a past period, it's really similar to what Paul Volcker did when he raised short-term benchmark rates, you know, the government rates way above the banking system and left them all underwater. So we have a modern day version of that.

Erik: Let's take a step back from the FOMC action today and kind of look at the bigger picture of what's going on here. Because frankly, I don't mind admitting that I don't fully understand it. Seems to me like if we set the way-back machine to the last FOMC meeting six weeks ago, the story there was Silicon Valley Bank had just failed. Previous to that everybody was expecting maybe three more hikes this year. But then everybody who was anybody in finance, when that news broke they said okay, the Fed's never going to hike again, you know, it wasn't going to happen at the last meeting, it wasn't going to happen at this meeting was totally done. Except that they did hike at the last meeting. And they hiked again at this meeting. Now, everybody is saying it's totally done. That's it, it's got to be. The way to interpret this as clearly they're done. And I'm sort of thinking Chris, this is all the same people that said they were done last month that are saying it again, is it really done or is the Fed going to keep fighting inflation as long as there's inflation there?

Chris: I think in a sense, it's done, because I don't think any of the governors really believe you can take it much higher you know, a six point change in 18 months is a lot. And the US economy is slowing. That's the real sense I have talking to bankers because what have they all done in since Silicon Valley Bank failed right? They've all stepped back to raise cash. The easiest way for a bank to raise cash is to turn the lending down a little bit. And that's what they're all doing. So that itself is going to slow the economy. And then the fact that, you know, you're going to have fed funds, the other benchmark are about six. The effective rate from people that are doing business in the real economy is seven or eight. That's pretty hot for financing inventory and financing production. So that's going to slow the economy as well.

Erik: Chris, the other thing that is different or has changed is when we talked about this a month ago. The story was look, Silicon Valley Bank, special case, special situation, but it's over now. Don't worry about banking crisis. It is all done, nothing to worry about, nothing to see here. Then yesterday, we had First Republic fail completely. Clearly, it's not done. So what's really going on? If we take the CNBC and Bloomberg presentation of don't worry, nothing to see here. It's all fine. What's the real story? Is there a banking crisis on the scale of 2008 in the making that's about to happen or is this really ending?

Chris: Well no, I would say it's a different kind of situation, which is that the Fed changed interest rates rather dramatically in response to anything to institutional hurt of being caught wrong on inflation. And very publicly, they've also been in the midst of a debate among the economist profession in the monetary policy world who on the one hand, think a central bank should keep its size minimal, and not be as aggressive as the Fed. The Fed provided what they call a bundle of reserves, which included buying $9 trillion worth of securities and those purchases distorted the market very badly. So what's going on today is that you have some disclosure that's pretty ugly, especially going back to the third quarter for mark to market losses on securities, right? That's gotten better since because the bond market rally. If you follow the 10-year treasury, that's kind of your surrogate for the mark-to-market problem, and it's better now than it was in the third quarter last year. The issue though, is cash flow, which is that there's $25-$30 trillion worth of assets that were created during 2020-21 that have very low coupons. The average mortgage coupon in the US today is three and the median of that group alone is $13 trillion is well below three. So what that means is that the economy has, you know, assets that are 15-20 points underwater today if you tried to sell, it took a big loss. And so banks and also insurance companies and pensions, and everybody else have a problem, you know, which is that the FED just like the 80s with Paul Volcker has left them all underwater.

Erik: Let's talk a little bit more about the 80s and what lessons we learned there because it seems to me like what we're headed into is all something we've been through before, we got to a generational low in interest rates back in 1982 and as we came out of that generational low and all of a sudden, boy, everybody's mortgage goes up. And people started suddenly find themselves not selling their house that they want to sell because the next house they want to buy would come with a much more expensive cost of financing. So it changes all these dynamics and behavioral factors. But it all happened once before in the early 80s. So what did the 80s teach us that maybe would give us some insight into what's coming up?

Chris: Well in the 80s as you probably recall, it wasn't easy to get a mortgage, it would take well over a year. And you know, in those days there wasn't much of a secondary market for mortgages. If you got a loan to buy a house, the bank would keep it, they weren't going to sell a mortgage. Today, you have a very complex secondary market for mortgages, that in turn, you know, either helps or hinders the economy. And for the last year, because the federal reserve raised rates so quickly, the whole mortgage market, the secondary market as we call it was scrambled. The pricing made no sense. People were losing money on every loan. And so now that's settled down a bit. But overall, I think housing is going to be pretty quiet this year, in general, and it's going to contribute to a slower economy overall. But when you look at the 80s, it was very different. The S&L is what was left of the savings and loans were just decimated when Volcker raised rates. And the commercial banks at the time weren't even involved in real estate. Real estate was seen as too risky. They barely made loans on commercial properties. So things have changed a lot since then, the banks got involved. At the end of the 90s. The 90s were very quiet in the housing space after the crash after the cleanup. So, you know, it comes in long cycles. Housing is a 10 or 15 year cycle generally. And I think what you're going to see now is eventually the federal drop rates. You'll have a little mini boom in housing go for a year or two, and then we're going to probably have a significant correction, it'll take us back to 2020-2019 prices. Because you know housing prices today are still very strong. The bank numbers for defaults are very low.

Erik: Chris, as you say, I think it's likely that there will be a retreat of some kind by the end of the year. The Fed will eventually be backed into a corner and have to cut. Are we headed into maybe a dip that's going to be a funding opportunity dip? In other words, is this maybe what's coming up going to be your last chance to get low cost mortgage or low cost financing for other loans?

Chris: No, honestly, I think what will happen is when the Fed relents, and they do have to let rates go back down, you'll see mortgages eventually traced back down into the fives, below fives but probably not much more than that. And I think the composition of the market still will be predominantly for purchases as opposed to refinancing, because so much of the market today is below 3%. Think of what it would take to get short term interest rates down. So you could even think about offering those people refinance. They are four points out of the money. So that body of owners of homes is going to stay in place, I think they're going to have a big incentive not to sell over time. And eventually, of course, they will sell. There's many reasons people have to make a change, but still price wise. And by the way, the FHA mortgages, you can assume them. So when somebody buys a house, a starter house for example, they can actually convey the mortgage to the buyer. You know, that's something that people haven't done for years, but they're going to figure it out. That's a big selling point.

Erik: I had the impression that most of the securitized mortgages were not assignable in that way, am I missing something?

Chris: FHA are assignable. Okay, VA2 but not conventionals, not Fannie and Freddie.

Erik: How much of a percentage of the market are those assignable mortgages?

Chris: 20%

Erik: Okay, okay...

Chris: Government markets about 20% of the 13 trillion. Banks have about a quarter of it on balance sheet. And then the rest is conventional, some private label. So, you know, conventionals are almost a trillion now. They're a big chunk of it.

Erik: Let's step back to the bigger question of outlook for inflation and for Fed policy. A lot of people think that we're headed back toward 2% inflation. That this whole inflation scare has been a result of the pandemic. My view is not that at all, I think we've got a new secular inflation trends, which are going to probably going back down on inflation, but not back down to 2%. At least I don't think so. How do you see this? Are we headed toward back to 2% or is that a distant memory at this point?

Chris: I think inflation is much higher than the statistics suggest. And I think most Americans would tell you that cost of living, healthcare, you know, you name it, right? Housing has blown the inflation picture out of it, but they don't include it in the statistics. So you know, the Fed historically has doctored the view of inflation to suit the mandate. But I think in reality, they have to tolerate a fairly high level of inflation, in part because they are terrified of deflation. They're terrified of letting housing prices fall, for example. So you know, the system is now biased, I think towards inflation.

Erik: So we've got more inflation than the official story states. Let's take that and kind of compare it to the question of where the banking system stands. Because the story that we're officially being told, and of course, this is a confidence game. So the officials have some incentive to butter the story for us a little bit. But we're told look, don't worry about Silicon Valley Bank, it was a fluke, this whole first republic bank, surely it must not be related. I think most of the smart guys I'm listening to are all saying it is all related. It's the beginning of a banking crisis. And if the Fed pushes any harder than they already have, it's going to blow up in their face. Seems like if I'm interpreting today's statement correctly, we've kind of got a pause indication. They went ahead with their 25 basis points today. But they kind of hinted that that's probably it for a while. Is that really it for a while and is this enough? If we pause here and don't do any more hikes after today's? Is that going to be enough to allow the banking system to recover or do we still have a big crisis risk in front of us?

Chris: Oh, no, you have a significant crisis risk. You can track the optical risk, in other words, the mark-to-market on bonds, both available for sale and held to maturity, basically tracking the 10-year. So, if you think about really horrible back in Q3 of 2022, it was almost 4% on the 10 year. Look at where it is today. Now, it's not as bad, it's actually cut it in half. But the real issue is cash flow, these banks can't just sit there with these assets that are paying 2%. And the Fed, I think at some point is going to have to extend itself and offer to finance these assets at par at the coupon rate. In other words, if I bring them up, they're going to charge me 2% to repo instead of six, right? Which is the current market. And then, you know, when they finally drop rates, and these securities get close to par, they can say goodbye to the banks and unwind that trade. But other than doing that, which means give the bank's their cash back, let them reinvest it at 6 or 7% then they can slowly dig themselves out of the hole. But right now, you want to avoid a sale. You don't want to force these banks to sell these securities and these loans, because they're going to take a terrible hit. And what you see, you know, you got to remember, a bank is 15 to one leverage. One dollar of capital $15 worth of assets. If you start losing money on those assets, you very quickly wipe out the bank. So that's the issue here and the Fed created this problem. I think they didn't know. They didn't want to admit that when they did all that open market operations, when they bought all those buttons. They tied their own hands to it. Because the reality is, if I were running this, I would have raised Fed Funds up to three and a half maybe four, and then left it there. And I would of had the New York bank sell bonds and that's about it. Because the system can't take this. If we leave rates where they are, we'll have a problem. We will have more bank failures.

Erik: And now it seems to me there's two sides of that, because in the immediate sense, I see exactly what you're saying, which is the Fed can't push rates any higher. The Fed is probably going to need to start cutting pretty soon in order to avoid a problem but hang on, you know, inflation that's a real issue. If they cut and cut and cut and because they have too, in order to deal with some of the risks you're talking about. It seems to me that there's an inflation runaway risk as soon as they do that. Do we need to be worried about that or is the inflation runaway risk coming under control now that these other things are breaking?

Chris: Well, it's interesting, you know, your question I think is very typical which is, people are still thinking about this inflation, you know, growth trade off, and so it was 20-30 years ago. But I would tell you that inflation is now embedded in the system of because of the debt markets and just in general the expectations from the equity markets, you know, they're the people who are saying, Oh, look, the Fed has stopped and next week, they're going to say oh that is going to dip because they're pushing and pushing and pushing for a rate drop, to help equity returns. But you know, I think most credit people look at this and say well we're going to pay for lunch now, because they know that over the last few years, we've had a free run when the Fed boosted asset prices, they made everything go away in terms of credit. So you know in 21 you remember, you couldn't even lose money on a used car. You pay off the whole lot. So today, you still have home prices very strong. So there's no problem in residential mortgage, but in commercial there is. You're going to have a lot of pain in commercial real estate and banks have a good share of that they usually are senior but it still won't matter, because the losses on these buildings are going to be significant. So it is like the 1970s in Texas. No really, it'll be a lot like oil restructuring. Because these are big physical assets, what do you do with them? In some cases, you got to knock them down and build something else. That's expensive. It's very hard to convert a commercial building for residential, it's almost impossible. You just have to have different plumbing and services and everything else and it just doesn't work.

Erik: Chris, as I understand the commercial real estate argument. It's basically in the wake of the pandemic and everything, a lot of people continuing to work from home, we don't need as much office space. Is that going to eventually solve itself by people just don't build as much office space or do we have a structural problem where there's just going to be, you know, we've hit a peak demand and office space and it's going to keep going down because we're going to have more and more people over time working from home and so forth.

Chris: Well, my uneducated observation is that I think change was already baked into the pie to some degree because of technology and other changes but COVID enabled people to actually change their behavior. In other words, they had an excuse not to go into the office, and to work from home. And technology enabled this, if we had to do this 10 or 15 years before, it would have been much tougher to get this to work. But we had enough off the shelf tools, to companies just send everybody home. I mean, I'll give you an example, the world of housing finance which is huge, it's millions of people, they send everybody home, they never came back. So these companies are now getting rid of office space and parking lots and everything else, they needed to support that model. And they're going into a decentralized model, where people have a hotel kind of office arrangement they can go into if they need it. Some have to go into a main headquarters. But a lot of these companies have moved down south. They've gone to Texas, they've gone to Florida. And you know, there are some dramatic changes. If you look at office, and you know, low rise kind of commercial buildings in Texas, Florida, that whole arc in the southeast, it's still very strong with a lot of activity. So it really depends where you are. Real estate is always about location but more now than ever, I think.

Erik: Let's talk about translating some of the views that you've already shared into trading ideas. We've talked about what's likely going to happen with rates and inflation and so forth. Where are the trades today? What what are we actually buying and selling?

Chris: Well for my portfolio, which is what I talked about with the blog, I only own a couple of banks, I actually own Western Alliance because I know them very well. They were one of the best performing banks in the country in 2021 because the mortgage industry was so hot. It was an interesting wholesale bank, they bought a portfolio company from Apollo called Amerihome, which is one of the biggest conventional lenders in the country, competing head to head with PennyMac. So you know, that's really the only bank and I owe most of my other bank exposures and preferred because in 2020 I looked at what was going on with COVID and in the money markets and I said, let's rotate out. So, I have been buying some of my mortgage companies ironically, which are no longer the topic of conversation when it comes to risk? We're talking about banks now. But I own some Guild, which is one of the better mortgage lenders in the country very focused on purchase mortgages. And they're an interesting firm, because they're really good at expense management. They understand how important it is in an industry to watch your expenses daily, weekly, monthly, and they do a good job.

I've written recently about Pennymac and Mr. Cooper. I kind of liked Mr. Cooper better because they're looking at their portfolio servicing really as an investment. I think they feel and I agree that a lot of this stuff is not going to prepay anytime soon. So the duration of some of these assets could be 15, 16, 17 years which is extraordinary. The same assets, if we had been talking a couple years ago, during COVID would have had a duration of three years. So that's what the change in interest rates has done to things like mortgage servicing assets which is good! People making money on that side, right. But when you look at securities, they've gone down in price that much. And that's what makes banks right now so difficult to get into. Because how do you do fair value of the bank if they have a significant loan portfolio? It's going to be very hard. So the Fed has injected a degree of price uncertainty into a market that, frankly, has a lot of liquidity. You know, I laugh when people say there is no liquidity. I'm like no, there's plenty of money. It's just that people are not sure about price. And I think unfortunately, you know, the Fed has injected a degree of volatility and uncertainty. And it's only when the markets settled down a bit, are they going to come in and fix this problem? You know, we should have been able to solve all of these banks if we had time. But there was no time. And that's the key takeaway. When you're selecting assets, when you're thinking about asset allocation, you got to really say to yourself, how is this industry going to be affected by monetary policy over the next couple of years? It's going to be good or bad? Mortgage firms are bad right now because volumes are low. But that means they're cheap. So I kind of like to buy things when they're cheap.

Erik: You said earlier that there's still plenty of systemic risk of, you know, a credit crisis happening. But you also alluded that one of the biggest mistakes we make, because we tend to try to fight the last war instead of the next one. What's likely to be different about this credit event if people are sort of thinking back to oh boy, it's 2008 all over again. You're saying it's really not? What else is going to be different?

Chris: I think, you know, Chair Powell is a very smart guy, and he understands the markets, he understands duration. He needs to take a page from Jesse Jones book. Jesse Jones was the head of the Reconstruction Finance Corporation in the 1930s. He restructured all the banks that couldn't qualify for FDIC insurance after 1933. They had a bank holiday, Congress created the FDIC and you had to come in and prove that you were able to open basically. If you couldn't qualify for FDIC insurance, they closed you and restructured you. So in those days, they did a lot of other things that helped buy time. And that's what Powell needs to do. He needs to give banks a way of financing these assets, without forcing them into a sale which will be capitalized and it creates deflation. And, you know, the Fed did this because they're fighting inflation, that's great. But they have to be cognizant of how they impact the market. It's just a matter of basic sensitivity. I love to use that word in this context. But you know, come on, do you really want to tip over big banks now? Of course not and he's responsible for banks anyways. We should always remember that. But monetary policy comes first at the Fed and they are obsessively trying to recapture their credibility after having it damaged considerably by the inflation spike. It was not their fault now, it's COVID of course. And I think a lot of it is not due to monetary factors to your point. So it's going to take a long time to fix this and we should be willing to give the Fed that time, instead of being in such a hurry. You know, I think the Feds actually being rushed by the equity crowd who's saying ah it's time to pivot. And you understand why? These people make money on AUM. AUM is falling if you look at the industry. Why? Because stock prices are down. So no one likes to see that but you know, we had a decade of extraordinary performance for a lot of these banks, including the ones that failed. And now we're in a tougher environment. The outliers are going to be under a lot of pressure as a result,

Erik: The stock market is holding up awfully well if you consider how much you know, it's a credit event, the last big credit event was 2008. If people think back to that, you know, you could freak out and the markets not freaking out.

Chris: The mainstream names in financials has not really moved. You know, JP is at one and a half times book. So you know, in that sense no. The real, better, stronger banks... American Express I think four and a half times book, which is low for them. They're very productive bank, very high asset terms. So you can make that argument. But the ones with more vulnerability, perceived vulnerability had been definitely been punched. I mean look at Schwab. Schwab was trading over five times book. Now it's only three and a half. You know, I love the business, I think it's a great story, but it's going to get smaller. They didn't need that bank that big. It was like a sailboat with too many spinner crops, okay. And they were doing great, their credit performance is superb. But still, the market punished them for getting so big. And in fact, they have been shrinking since the middle of last year. The bank got up to you know, bigger than US Bancorp. It was the sixth largest bank of the country at one point. So, you know, all of these businesses that absorb the float from the Feds asset purchases are not going to see that liquidity leak. And it's a key thing for investors to understand what a bond matures on the books of the Fed and the Treasury pays them, a bank deposit disappears. Because the Treasury has to go out and sell that bond immediately. They have to refinance it. So somebody goes out and buys that bond, and the banking system gets smaller. That's the mechanics of quantitative tightening.

Erik: Now, since the Silicon Valley Bank event, the price of gold and other precious metals have moved back to the level where we're flirting with all time highs, has that been a result of the banking crisis? If so, how should we interpret the message?

Chris: The I suppose when you start to make people worry if their deposits in their bank are safe. That's a problem. That's why the way the Fed and the other agencies have handled this has not been optimal. I remember Sheila Bair during the crisis. She knew her main job was communications because during the crisis, the FDIC was the most important consumer agency in Washington. They were protecting people's money and they did it flawlessly. But in this case, nobody had any time. So they had to patch this all together. And I still think the regulators are struggling with a market that's A) moving as quickly and B) you didn't have investors willing to really step forward and bid for these assets. You kind of had a bid from PNC for First Republic but ultimately JP Morgan was going to buy the bank because they had a commercial relationship with First Republic. They had been selling jumbo mortgages and they were helping them finance them. There's a whole group of banks that are involved in this activity. A couple of big publicly traded REITs. So First Republic was a well known issuer and none of them wanted to see the bank fail, obviously. It would have been bad for the market. So you know, I think it was a surprise that investors were more willing to come and buy these assets. Other banks, you know, US Bank for example passed. They could easily have bought it. But you know, FDIC is interesting, even if you have a better bid from somebody else, they're most interested in having a depositors taking care of and putting it away. They don't want it back. If they give you a yes right? So if you buy a failed bank, they want you to take responsibility for it and that's how you have confidence, ultimately, right?

Erik: Speaking of confidence, how do we know really where things stand right now? Because it seems to me that the incentive of all of these institutions is to hide any problems they may be having to not fess up to them. How much more tolerance is there in the banking system for more pressure before things really fall apart and how can we tell where that risk exists?

Chris: Well you'll see it in stock prices. I mean it's a shame but you know, the reality is PacWest is at 0.35 of book. And that's bad. I mean, it's been down there for a while, but there's nothing inherently wrong with this bank. It just happened to get picked on and when stock prices fall like that you've forced the commercial customers and the bank to reconsider whether they want to keep doing business with you. Okay, so stock prices end up being a terrible bellwether for these businesses, because you're getting voted on every minute of every day the markets open and it doesn't help. So the shorts have identified these banks and they're gonna go after them one at a time. I think the Fed and the other agencies really need to reconsider their policy and if they're not willing to step up and help banks with this problem, then we're going to have more failures.

Erik: Tell me about the scope of that risk of more failures. Is it in just the US banking system? Is it International? Is it global? How big could this go?

Chris: It's global in a sense of anybody who owns dollar assets, it was buying assets like central banks or big buyers, US Treasury paper, they also love GinnieMae mortgage securities. So the buyers of that paper have a low yielding asset that is deep underwater. You know, Ginnie Mae threes this morning were trading at like 89. So it's 10 points under and the figure that probably paid 103 or 104 for when they bought the bond, because remember during 20 and 21, the Fed had their foot on short term interest rates. People were making money hand over fist in the bond market because spreads were very wide and the profitability was extraordinary. Now it's the opposite. Now that profitability is non-existent. And you know, investors and issuers too were having to try and navigate this market. So, you know, it's a very extreme fluctuation but for a relatively short period of time. If you think of 2019 on forward to today, there's been a lot of change! A lot of change.

Erik: And what do you see ahead in terms of how you expect this situation to resolve itself?

Chris Whalen
Well I think, if the Fed does get a little more creative, and how they're dealing with this bank problem, then we're going to have more failures. And they're going to have to deal with the blowback from that. I don't think members of Congress are going to be very happy if they see more failures. And remember, the industry stands behind the FDIC, not the Treasury. The industry is first in line in terms of loss and they will pay through higher assessments. So they're looking at $100 billion for the losses so far, on the three failures. And, you know, there's going to be a lot of political pushback on that as well.

Erik: Chris, I can't thank you enough for a terrific interview. But before I let you go, I want to talk a little bit about Institutional Risk Analyst, which is the name of the blog that you write. Tell us a little bit about that what our listeners can expect to find there. And there is a link in your research roundup email for our registered listeners to find that blog. Tell them what they can expect to find there, and also what services you offer to institutional investors.

Chris: Oh thank you. The Institutional Risk Analyst is actually a fairly old publication. It goes back to my original bank analytics firm with the same name. So we have a free version obviously. In the blog that covers the global capital markets. We also occasionally put up profiles of companies and banks. And then we have a paid premium service where we dig down a good bit deeper on individual companies. We cover banks, FinTech, and mortgage firms, of course. And then we have a quarterly roundup of the industry that's very popular, where we look at credit and try and track some of the trends in the industry in terms of profitability and operating efficiency. So our focus is to global capital markets. I don't really cover European banks that much occasionally, you know, Deutsche Bank or one of the others. We did follow Credit Suisse very carefully because of that firms role here in the US, but we are credit geeks and we have a lot of fun with it. We built quite a reader base, so we appreciate you guys given us this opportunity.

Erik: Patrick Ceresna, Nick Galarnyk and I will be back as MacroVoices continues right here at macrovoices.com.