GRANT'S
INTEREST RATE OBSERVER®

Vol. 38, No. 6b 233 Broadway, New York, New York 10279 • www.grantspub.com MARCH 20, 2020

To your health!

Evan Lorenz writes:

If a nice hot summer ends up snuffing out the Covid-19 pandemic, so much the better for humanity and for humanity's virus-infected investment portfolio. Now in progress is a speculation on a return to something like normalcy, including old-school interest rates whose first digit begins to the left of the decimal point, rather than to the right.

Our picks to click comprise a pair of banks, Popular, Inc. (BPOP on the Nasdaq) and Wells Fargo & Co. (WFC on the New York Stock Exchange), and an exchange-traded fund that's better known by its ticker, IVOL, than its polysyllabic given name, Quadratic Interest Rate Volatility and Inflation ETF. Listed on the NYSE Arca, IVOL is a play on volatile interest rates and a steepening yield curve.

Investment bargains are few and far between in this era of nonstop QE. Even last week, when the S&P 500 was quoted 27% below its February high, the blue-chip index was priced at 16.3 times trailing net income. And never mind those smiley-face, pre-crisis forward-earnings estimates—the Street is about to feed them into the wood chipper.

Nor is corporate debt as cheap as it looks. Junk-bond yields, expressed as a premium to Treasury yields, may have more than doubled this year, to 8.4% from 3.6%, but that dislocation is nothing compared with the 2008 credit upheaval. And as we mark the 129th month of the post-2009 business expansion (until the cyclical scorekeepers wave their arms, it remains intact), you'll search in vain for the covenant language that formerly helped to shield creditors of speculative-grade borrowers from the consequences of impairment and default. The decade-long yield famine has served to obliterate that protective fine print.

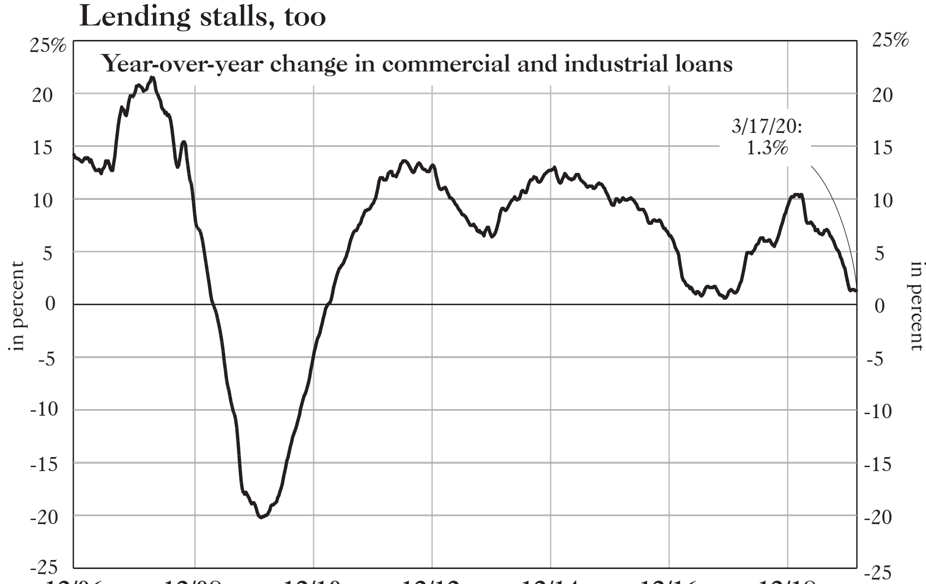
Altogether, today's valuations offer scant defense against what Srinivas Thiruvadanthai, director of research at the Jerome Levy Forecasting Center, aptly calls the "unknown-unknown" of the novel coronavirus.

Which leads us to our featured stocks. Admittedly, banks may not jump first to mind as ports in this economic hurricane. Optically cheap many may be, but they suffer, in general, from shrinking net-interest margins and burdensome regulation. Nor are lending margins imminently poised to improve. Not waiting until Wednesday, the Federal Open Market Committee cut the federal funds rate close to zero on Sunday.

Not that zero is the clearest and most troubling danger. The bigger risk to bank profitability is the wrecking ball of negative nominal yields. In Europe, sub-zero interest rates have helped to push the Euro Stoxx Banks index to a 30-plus-year low. It's quoted today at 33% of book value and 6.3 times trailing earnings. Perhaps the Bank of Powell has noticed.

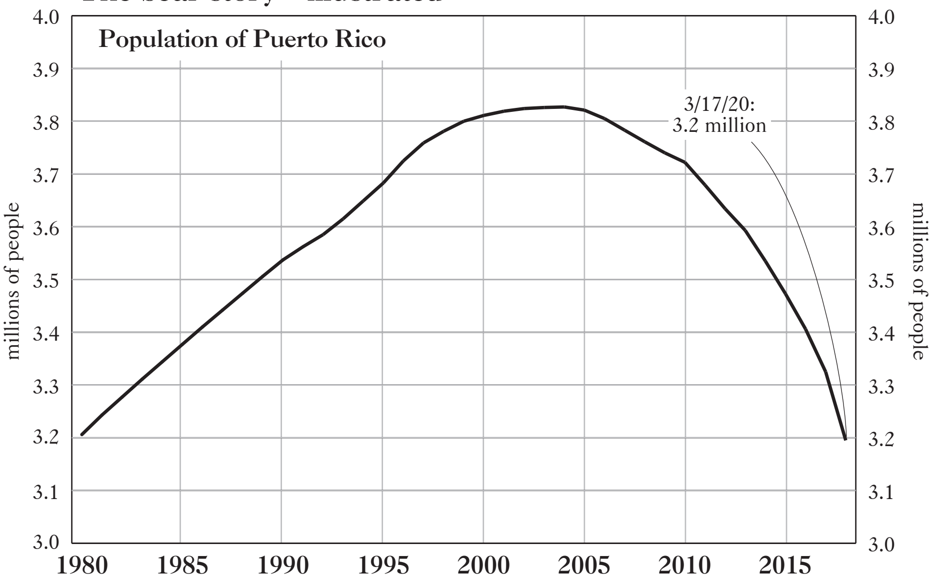
Asset growth is another concern—apart, that is, from the land-office business now raging in mortgage finance. According to the Mortgage Bankers As-

Lending stalls, too



source: Federal Reserve Bank of St. Louis

The bear story—illustrated



source: Federal Reserve Bank of St. Louis

sociation, applications for mortgage refinancings surged by 479% in the week ended March 6 compared with the year-earlier week, sending the MBA's refi index to its highest level since April 2009. "I would predict that in the first quarter, mortgage is going to be a very significant plus for the business," says Christopher Whalen, publisher of *The Institutional Risk Analyst*. "However, we are also going to see a big write-down of mortgage-servicing assets because probably 80% of the total corpus of single-family loans today, almost $11 trillion, are in the money."

Non-mortgage lending is another story. Business loans—a.k.a., commercial and industrial loans—have contracted at a 0.8% annual rate over the past three months. A recession could provide a temporary spark in business-credit demand, as it did in the early going of the 2007–09 slump (*Grant's*, March 8, 2019). News last week that The Blackstone Group, Inc. and The Carlyle Group, Inc. were advising their portfolio companies to draw down lines of bank credit while the drawing is good is proof enough that robust credit demand isn't necessarily bullish.

Credit costs were climbing even before the coronavirus kicked down the economic door. According to the Federal Deposit Insurance Corporation, bank provisions for loan losses increased 5.5% year-over-year in the fourth quarter, to $14.8 billion, above the cyclical low of $5.8 billion set in the third quarter of 2013 and outpacing the 3.6% growth in overall loans and leases. It's hard to imagine that the cessation of everyday commerce will improve matters. As to the regulatory treatment of the looming new crop of slow loans, federal bank regulators issued a statement on March 9 that points to leniency. "[F]inancial institutions should work constructively with borrowers and other customers in affected communities," said the multi-agency release. "Prudent efforts that are consistent with safe and sound lending practices should not be subject to examiner criticism."

All in all, comments Dick Bove, a 50-year observer of financial institutions, on behalf of Odeon Capital Group LLC, "the American banking system is both liquid and reasonably well-capitalized.... One must really believe that a Covid-19 pandemic is about to shut down world economies to make the case that bank-asset values are inflated."

Not the least of the investment merits of Popular, Puerto Rico's No. 1 bank, is the home territory in which it operates. It's a tropical managerial obstacle course. As Paul Cardillo, Popular's head of investor relations, says, running down the list of the Commonwealth's late afflictions—a decade-long recession, government default, population exodus, 100-year hurricane, 100-year earthquake—"We are a bank that has lived a stress test." And, in 2019, a bank that produced record-high earnings. So it's not wholly surprising that BPOP trades at 4.5 times earnings and 46% of book value.

It's not because BPOP is under-capitalized that investors steer clear. The year-end balance sheet shows a core equity Tier 1 ratio of 17.8% (12.9% is average for American banks with assets of between $1 billion and $10 billion) and a loan-to-deposit ratio of 62% (87% is par for the course). On the same Dec. 31 statement date, 75% of BPOP's loans were issued to Puerto Rican borrowers, the balance to mainland clientele. Commercial real-estate loans (28% of the total) were the biggest bet in the loan book, followed by mortgages (26%), consumer loans (22%) and C&I loans (17%).

At last report, 1.9% of the total were nonperforming, 20 basis points above the 1.7% loan-loss allowance. One would prefer fewer slow loans and a greater loss provision, but there are mitigating circumstances. "Most nonperformers have to do with mortgages in Puerto Rico," says Cardillo. "There is a much higher home-ownership rate and bias toward home ownership, but it is also a judicial state [i.e., foreclosures take a long time]. So, if something goes wrong with a mortgage, they know that we can't foreclose on them and take away their home for a couple of years." Cardillo reports that 60% to 70% of slow loans eventually become current again, most within two years.

Meanwhile, management is returning capital to shareholders. A $500 million accelerated share repurchase began on Feb. 3. For a sense of scale, at the end of the fourth quarter, book value stood at $6 billion. Even if, as expected, those open-market purchases reduce the Tier 1 capital ratio to the mid teens, Popular would still fit the conventional description of "over-capitalized." More impressive, then, is the 11.8% return on this superabundant equity that BPOP logged last year.

Then, too, the Enchanted Island's many travails are not without their compensations. Following the devastation of hurricanes Maria and Irma in 2017, the federal government allocated $40 billion for rebuilding, equivalent to 40% of the Puerto Rican GDP, and the money remains largely unspent.

It's conceivable that even Covid-19 has a silver lining, as the pharmaceutical industry contributes more than a quarter of Puerto Rico's annual output and half of its exports. "Though coronavirus has only begun to show up in America, it's already exposed the nation's serious overreliance on China for pharmaceutical production," *The New York Post* editorialized on March 7. "As Washington looks to address that, it should consider killing two birds with one stone by using the issue as a chance to give Puerto Rico a leg up. After all, the island was for decades a central hub of U.S. drug manufacturing. It would do the commonwealth and the mainland a world of good to restore that preeminence."

Of course, with Puerto Rico's luck, something could still go wrong, as the market does not need to be reminded. Assume, for instance, a 200 basis-point parallel decline in interest rates, both to assets and liabilities: Management puts the cost of that event at $131.9 million. Now double the $165.8 million that BPOP set aside last year for credit losses: so, $331.6 million. Adding $131.9 million to $331.6 million gets you $463.4 million. Adjusting for taxes and subtracting that sum from 2019 net income of $667.4 million leaves $291 million, or $3.35 a share. Plugging in today's stock price gets you a new hypothetical price-to-earnings ratio of 8.8. Even then, you wouldn't call PBOB expensive.

"They are buying back 8% to 10% of their shares this year, and they are going to do it every year forever," says Joe Stilwell, founder and general partner of Stilwell Value Fund, with a flourish of bullish license. "And if Puerto Rico is so bad, what happens if it is not so bad?"

Over the past 12 months, insiders have sold a net 48,590 shares for net proceeds of $2.7 million at an average price of $56.02, or 90% above the current share price. All six analysts who cover BPOP rate the stock a buy; 1.2% of the float is sold short.

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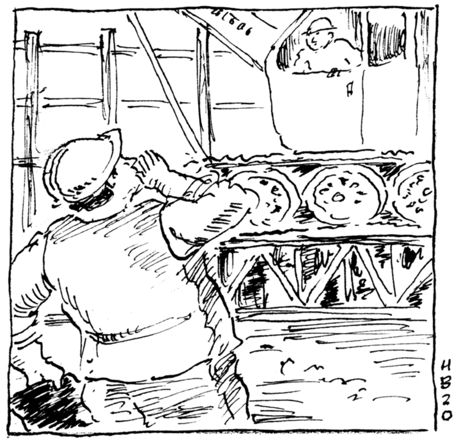
Wells Fargo, America's fourth-largest bank by assets but the undisputed leader in unwanted regulatory attention, trades at 7.1 times trailing earnings and 74% of book value and offers a 6.9% dividend yield. It's amply funded (loans foot to 72% of deposits) and more than adequately capitalized; as of Dec. 31, core equity Tier 1 capital represented 11.1% of the $1.9 trillion asset base. As a percentage of the loan book,



"No, Mulcahy, you may not work from home tomorrow."

nonperformers comprised 0.59%, provisions for nonperformers, 1.09%. Oil and gas credits made up 1.4% of the whole.

Wells Fargo was rightfully put in a penalty box following the 2016 revelation of its falsified customer accounts, but Charles Scharf, the new CEO (he took over in October), is saying the right things to mollify the right people. "We have not yet done what is necessary to address our shortcomings," he testified before the House Financial Services Committee last week.

How will Wells Fargo weather this time of adversity? As with Banco Popular, let's take down interest rates by 200 basis points, double the 2019 loan-loss provision and subtract the sum from 2019 net income. Result: a hypothetical reduction in earnings per share to $1.49 from $4.05, which would lift the p/e multiple to 19.8 from 7.1.

But Wells is not standing still. On the managerial agenda are fewer branches and a lower headcount, as regulatory costs start to recede. On the Jan. 14 earnings call, Bank of America analyst Erika Najarian noted that Wells Fargo's "head count is similar to another peer that is producing about $40 billion more in revenues than you." To which Scharf commented, "We will focus on efficiency."

Besides, federal minders have spent the past four years going over the shamed bank with a fine-tooth comb. They are perhaps as sick of Wells as Wells is of them. And it seems a fair conjecture that there are no consequential missteps left to discover. At some point, Wells Fargo will satisfy even the government that it intends to sin no more. At which point, the regulators will lift the punitive cap they imposed on asset growth. Perhaps the share price, too, will rise.

Over the past 12 months, insiders have bought a net 175,796 shares for net proceeds of $4.7 million at an average price of $26.69, or 10% below the current share price. The Street gives a cold shoulder to Warren Buffett's former favorite bank: Five say buy, 17 hold and seven sell. Short interest foots to 1.2% of the float.

Tumult and confusion in the Treasury market is what the previously mentioned IVOL exchange-traded fund is in business to hedge against. As you may recall, the fund owns Treasury inflation-protected securities (85.6% of the portfolio), cash (8%) and options, the value of the latter being connected to inflation expectations and bond-market volatility: The more of each, the better for the shareholders (*Grant's*, June 14, 2019).

Turmoil, inflation and a steepening yield curve (however the steepening occurs) are what the shareholders either root for or hedge against. Nor does it hurt that, since the fund's launch in July last year, management has distributed 30 basis points a month, amounting to a highly contingent 3.6% annual dividend.

On March 9, Ben Breitholtz, data scientist at Arbor Research & Trading LLC, arrived at a striking observation (informed by a somewhat technical calculation) that "investors are pricing in a 94% probability U.S. headline CPI will drop below 0.0% year-over-year and stay there for the next two years!"

Two days later came news of a 2.3% uptick in the CPI for February. Succeeding days brought news of massive continuing attempts at monetary and fiscal stimulus by governments and central banks worldwide. Maybe all the lending and borrowing and spending will lead only to deflation, as the market implicitly seems to believe—or maybe not.

For the derivatives-enabled professional investor, the purchase of a 10-year option on the 20-year swap rate is one way to bet on higher future inflation. Think of the trade as buying the right to purchase the 20-year Treasury bond 10 years from now. When last described in the issue of *Grant's* dated Oct. 19, 2018, a $10 million notional 10-year forward 20-year payer swaption with a 4.5% strike price cost $367,640.

The explosion in volatility in 2020 notwithstanding, a $10 million notional 10-year forward 20-year payer swaption with a 3% strike costs $375,000 today.

"The current 20-year swap rate is about 0.75%," Harley Bassman, the author of financial commentary at ConvexityMaven.com, relates by email. "What is rather amazing is that the 10-year forward rate is also 0.75%. Usually when the Fed jams down the funds rate, the curve steepens as the market anticipates growth that increases the demand for money, and thus raises its cost (the interest rate is the price of money)."

Consider this a bet that the law of supply and demand in credit will still be working a decade from now.

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