Why Commercial Banks Are a Disaster In The Making And What You Can Do About It

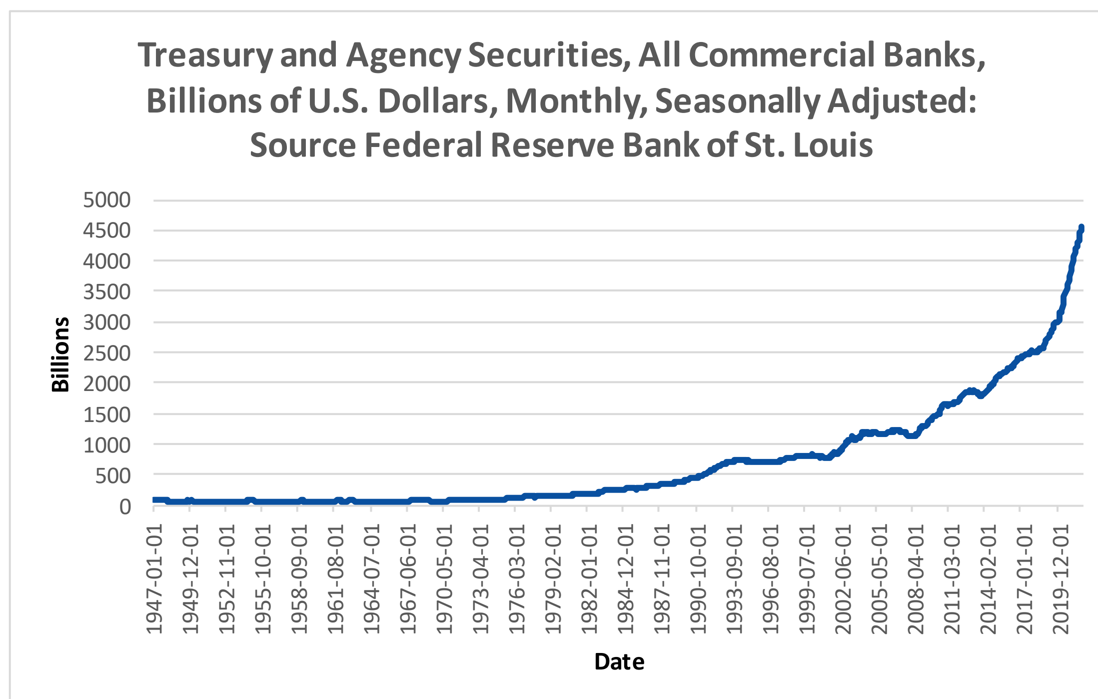
By Vineer Bhansali, Ph.D. | January 21, 2022

The following article was published here on forbes.com.

The famous Abbott and Costello skit “Who’s On first, What’s On Second, I Don’t Know is On Third” summarizes the current state of hot potatoes in the bond markets.

Of course we know who’s on first. Who? Exactly. The Fed. The Fed holds more Treasury bonds than any other Central Bank in the world. According to the Federal Reserve’s data, as of this month the Fed holds over 5 trillion dollars’ worth of Treasurys, compared to just over 4 trillion dollars held by all other foreign official buyers. As I have written before, the Fed also owns almost 25% of all TIPS (Treasury Inflation-Protected Securities), as they bought up more than the total issuance of TIPS to drive real yields negative in the last few years. And we also know that last month when pivoting Jerome Powell pivoted, the Fed essentially guaranteed that they would not be buying many more Treasurys in relatively short order; i.e. in March if you own TIPS you really better want to own them.

What's On second? Commercial banks. The St. Louis Fed's FRED ("Federal Reserve Economic Data") database shows that commercial banks own a whopping $4.5 trillion of Treasury and Agency securities (here). We also know from the most recent earnings report that one or two large banks (you know who, don't you? – sorry for the pun) have bought hundreds of billions of these Treasurys. Now why would large commercial banks buy up all those Treasurys at such deeply negatively real yields? One can only speculate, and the reason probably lies somewhere between being forced to, for various reasons, and because buying the bonds and selling them to the Fed in their "asset purchases" was too easy money to pass up.



Source: Federal Reserve Economic Data

The point is that now many of these banks are stuck holding bags full of low yielding Treasurys, maybe like that turkey I warned about (here). The non-economic buyer (Fed) will soon quit buying them, and in a few months will start to "run off" its existing holdings. Who will step up and at what price? Are there enough "greater fools" in the marketplace? Is it Thanksgiving for the turkey?

"The non-economic buyer (Fed) will soon quit buying them, and in a few months will start to "run off" its existing holdings.

Historically the marginal buyer of Treasurys has been a foreign entity; e.g. from Japan. For almost a decade, Japan has been able to print money freely and exchange the Yen for dollars, amongst other currencies, which then get recycled into Treasurys of all maturities. You can think of this as a US asset based "retirement plan" for Japan funded with their funny money. Yield does not matter, only principal redemption matters. So the hope would be that if Treasury yields rise just a bit more, they will likely step up again to buy them. Faith in strangers being willing and able to finance at negative real rates of return. Hoping for the return of the greater fool.

Back to the banks.

Massive bond holdings are not their only problem. As the frenzy of trading activity in stocks starts to cool, the banks who provide "financial services" naturally make less money from the lower velocity of transactions. So rising yields cut twice -- first by reducing the value of holdings, second by cooling animal spirits who want to trade. But aren't rising yields good for banks because they make more interest income? Not yet, in my view. Right now the immediate effect of rising yields is to impair balance sheets and create lower business income. Yield income takes time, price losses happen immediately.

Then there are astronomical compensation costs. I am sure you all read the eye-popping numbers regarding bonuses paid by banks. Part of that is funded by record profits in the middle of COVID-driven trading and deal-making frenzy, and another part is being funded by record issuance of bonds at historically low yields and spreads. No wonder bank bond issuance is soaring, and the more the bank debt is issued, the higher the spread, which means the higher the discount factor applied to future bank earnings. Which means lower commercial bank stock prices.

"Right now the immediate effect of rising yields is to impair balance sheets and create lower business income. Yield income takes time, price losses happen immediately."

By now you are wondering who is on third. Of course I Don't Know. But my guess is that it is various types of buyers who don't pay attention to yield. This group includes passive holders of bond funds who have seen their value soar over the last two decades, foreign private buyers who are looking for yield, and public pensions who are in an accounting regime where they have to buy risk-free bonds to manage liabilities. There's also systematic momentum traders who buy simply because at least in recent history bonds have only gone up, and quantitative investors seeking "risk-parity" who lever up bonds to the same risk as equities. This group might also include you – it certainly includes me and my bond fund that I had long forgotten. Who knew that "safe" investments could lose so much?

So what can one do?

As in baseball, the third has no choice but to pay attention to who's on first and what's on second. And those two are stuck. And because these two players are much bigger in their market impact, those on third would be well advised to steal home before they force an inevitable implosion in the bond markets. If banks are your thing, look to the regional banks – and make sure they (1) don't own too many Treasuries, (2) don't depend on trading volume to be profitable, (3) have low outstanding debt. You won't get the proverbial "toaster" for opening an account– that's reserved for choice customers - but your investment likely won't be toast.

Important Disclosures

Vineer Bhansali, Ph.D. is the Founder and Chief Investment Officer of LongTail Alpha, LLC, an SEC-registered investment adviser and a CFTC-registered CTA and CPO. Any opinions or views expressed by Dr. Bhansali are solely those of Dr. Bhansali and do not necessarily reflect the opinions or views of LongTail Alpha, LLC or any of its affiliates (collectively, “LongTail Alpha”), or any other associated persons of LongTail Alpha. You should not treat any opinion expressed by Dr. Bhansali as investment advice or as a recommendation to make an investment in any particular investment strategy or investment product. Dr. Bhansali’s opinions and commentaries are based upon information he considers credible, but which may not constitute research by LongTail Alpha. Dr. Bhansali does not warrant the completeness or accuracy of the information upon which his opinions or commentaries are based.

This publication is for illustrative and informational purposes only and does not represent an offer or solicitation with respect to the purchase or sale of any particular security, strategy or investment product. Past performance is not indicative of future results.

Different types of investments involve varying degrees of risk, including possible loss of the principal amount invested. Therefore, it should not be assumed that future performance of any specific investment or investment strategy, or any non-investment related content, will be profitable or prove successful. Nothing contained herein is intended to predict the performance of any investment.