# Bank Strategy Insights

FINANCIAL SERVICES GROUP | BALANCE SHEET STRATEGIES

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## Guest Contributor Series: Four Ironies Resulting from COVID-19

*Please see this week's **Rate Sheet** and **Yield Curve Opportunities**.*

Economic data in the weeks leading into Labor Day have underscored the uneven nature of our modest recovery. The U.S. trade deficit expanded to $63.6 billion in July, surpassing the $58 billion median estimate of economists surveyed by Bloomberg. The widening follows a narrowing in June, and is the highest number in 12 years, signaling the difficult road faced by economic progress. Meanwhile, initial jobless claims fell to 881,000 from 1.01 million. That number, however, reflects a change to seasonal adjustments, while the unadjusted number shows a rise of 7,591. Either way, the numbers underlying trade data and unemployment measures show that some recovery has occurred, but improvements remain very small or non-existent week-to-week, and activity remains depressed relative to pre-pandemic numbers.

This week, we're happy to present the second entry in our Guest Contributor Series, where Robert Albertson, Managing Director and Chief Strategist in the Financial Services group at Piper Sandler, shares his thoughts on the economic impact COVID-19 has had on the banking landscape:

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This is not your average recession by any stretch, whether it is ending early in a "V" recovery or an extended "U" or something else.  So far the pandemic has produced four, intuitively contradictive conditions largely separating it from virtually all previous economic crises.

**1) Deposits have gone from mission critical to surplus.**  Until COVID, deposit access was among other top priorities for the banking system.  Unlike past recessions, and probably temporary, deposit flows have been abnormally strong in part due to PPP loan proceeds parked in deposits as well as conservation tendency on both retail and business accounts.

Since the end of March, deposits have leaped 20% in U.S. banks and their aggregate loan to deposit ratios are down eight percentage points from 75% to 67%, a funding improvement that took the entire 2008-09 recession when deposits only rose 13%.  This has been mirrored in a personal savings rate that went from a 7.5% average to almost 34% in April.

**2) Interest rate predictability has seemingly tightened.**  It is always a question where interest rates will go, but there is little market doubt over the outlook for now.  The level of government debt has surpassed everyone's wildest dreams with no effect on Treasury rates.  The short end of the curve has been seriously anchored by the Fed wording their intent to have  likely low rates prevail for multiple years.

The most recent Treasury Borrowing Advisory Committee (TBAC) report is calling for a quarterly need of $947 billion, rising to $1.2 trillion in the last calendar quarter of 2020 with a cumulative budget deficit most recently reaching $4 trillion for the year, up fourfold pre-COVID. (Quarterly tax receipts were off 80% by this summer). Cumulative net private marketable borrowings are now estimated to total $8 trillion through FY 2022!  With these expectations it is hard to fathom the 10-yr U.S. Treasury barely above 70 basis points.  We are expecting the Fed to buy half the new issuance and foreign buying has begun to revive.

Another supply/demand miracle benefit, but domestic demand will nevertheless need to almost double as well. Presumably only an uptick in inflation (or inflation expectations) is likely to change the outlook, unless final demand remains moribund. That seems only short term likely with overall economic demand depressed both here and globally.

**3) Need for credit has nearly collapsed.** Whenever there has been an economic dislocation, crisis or recession the need for credit had always risen sharply. Government actions taken to date, with possibly more to come, have effectively pre-funded the “hole” with liquidity and direct lending topping $11 trillion, which is nearly half the U.S. annual GDP! The Fed’s balance sheet is currently $7 trillion, up $2.8 trillion in just five months. Overall government resources deployed is approaching $3 trillion, including nearly $600 million from the PPP alone. The level of loan deferrals has risen to an average 13% of bank loan balances, albeit already somewhat in decline. Underlying credit demand has been nonexistent and will remain so until the passage of time in a more mature economic recovery. At the moment, mortgage lending is the only hot spot.

**4) Bank allowances for loan loss reserves are well behind regulatory opinion.** Bank managements have scoured their loan portfolios for latent risks associated with COVID-19. They have identified sectors of particular pandemic risk including the obvious such as travel, accommodations, health care, restaurants, general recreation and energy. They have also released their level of discretionary deferrals. So far deferrals are down and losses are not up.

Banks’ median loss reserves are “only” 1.33% of loans while regulators are pointing to far higher losses through the current cycle. Late in their latest DFAST process the Fed added three new scenarios pertaining to COVID. As all three are recovery scenarios rather than the hypothetical worst case scenario, one of them has to be close to future reality. The cumulative loss range over nine quarters was specified to be between 820 and 1030 basis points depending on whether the recovery is a “V,” a “W” or a “U.” To be compliant with the CECL era philosophy that all future losses embedded in existing portfolios must be accounted for, loss reserve ratios should theoretically be about six fold their current level!

While past loss reserving by banks during recessions attempted to capture future damage as early as possible, neither the banking nor the accounting industry has made any effort to close this gap. The charge off “storm” is in the future and its severity remains an unknown.

The nature of this downturn is obviously unique. So will be the consequences. As has been repeatedly stated by all, this is foremost a health crisis. As such the final economic outcome will depend on public health alternatives as they materialize. This means manage for the worst but don’t exclude the opposite ends of the spectrum, including funding, credit losses and the course of interest rates. In other words, don’t assume current aberrations remain the norm.

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If any of these observations pique your interest, please contact your Piper Sandler representative or email us at PSbankstrategyinsights@psc.com. For derivatives, please email our affiliate, Piper Sandler Hedging Services, LLC, at FSG-Derivatives@psc.com.

**Other Thoughts from Around the Firm**

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If learning more about our recent work is of interest to you, please don't hesitate to contact FSG-Solutions at FSG-Solutions@psc.com for more information.

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