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Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

This morning, a co-worker and I were having a conversation about the Federal government shutdown, and how that could be impacting investor confidence. He, I will call him, I don't know, Jim Williams, asked me what I thought the single biggest concern of Oakworth clients is. To which I responded:

> "Jim, as an Oakworth associate, you are supposed to be taking care of our clients' concerns for them. "

We both laughed, and he asked me the same question, again, this time letting me know he was serious. So, I replied: "Jim, most people really want to know where they can get a decent, absolute rate of interest without taking too much risk."

It really is as simple as that. Hey, our deposit rates are as good as any in our market, but, in absolute terms our hands are tied by US monetary policy.

The Federal Reserve's overnight target lending rate, where banks borrow from one another, has been at effectively 0.25% since December 2008. Historically speaking, this is an extremely long time for this particular rate to remain stagnant. Going back over the past 40 years, the Fed almost always changes monetary policy, at least the overnight rate, at least once every 18 months. Obviously, sometimes changes are even more frequent than that.

So, to have the same overnight rate for going on five years is without precedent, at least in my lifetime. Unfortunately, there is a near perfect positive correlation between the overnight lending target and bank deposit rates. After all, why should banks pay depositors, say, 1.00% on transaction accounts when they can borrow as much as they want for 0.75% less?

Hey, banks aren't being greedy. It is what it is. The Fed will set a low interest rate to stimulate borrowing, lending, and consumption because it doesn't pay to keep the money idle. Period. The current monetary policy is an effort to get us, as consumers, to borrow and spend. We are NOT supposed to be hording cash, and wondering where we can get a few extra basis points on a deposit or other short-term investment.

But guess what Americans are doing? That is right, they are socking away cash.

In December 2008, US commercial banks claimed $7.264 trillion in deposits on their collective balance sheet, according to the Fed's weekly H.8 report. Overall liabilities were $11.137 trillion. As such, deposits were 65.2% of liabilities. In August 2013, a little less than five years later, deposits were $9.521 trillion out of total liabilities of $12.209 trillion, or 78.0%.

But so what? That is just simple growth in M2, right? Yeah, you are right, that is just good old-fashioned growth in the money supply. However, growth in the deposits ordinarily finances the growth in "loans & leases in bank credit." However, this hasn't really happened

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You want 21 percent risk free? Pay off your credit cards.

Andrew Tobias

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since the end of 2008, as loans & leases have grown less than $150 billion over that time frame. So what is all that money doing on bank balance sheets? Would you believe sloshing around in cash?

That is right; "cash assets" on bank balances, again according to the H.8 report, grew from $1.011 trillion in December 2008 to $2.379 trillion in August 2009. For grins, in December 2007, before all hell really broke loose in 2008, cash assets were, get this, $292 billion. Therefore, banks are sitting on over $2 trillion in cash today than they were before the financial system crisis.

In the end, deposits have mushroomed on the liability side of the balance sheet in the banking sector WHILE cash assets have exploded on the asset side. As such, the US financial system is chocked with short-term money looking to "earn a competitive rate of interest."

This is why the current 3-Month Treasury Bill has a yield of 0.02%. The 6-Month will pay you 0.04%, and the 12-Month gets you about 0.10%. Yes, you read those numbers correctly. IF you opt to invest $1 million (par amount) in a 12-Month Treasury Bill, today, you will make a shade under $970 on your investment.

This is a real problem for a lot of people. Historically, folks could go to the bank and buy a CD which matched their time horizon. Banks didn't sit on a ton of idle cash, so the rates could sometimes be pretty attractive if the loan portfolio was growing faster than deposits. If the bank on the corner wasn't running a special on some sort of CD, the one down the block probably was.

Shoot; a 4% 12-Month CD paid $4,000 on $100,000. That is pretty good when it comes with FDIC insurance, isn't it. But what about today? I have already told you what a 12-Month T-Bill pays, 0.10%. That works out to be, what, $100 on $100,000. By comparison, a competitive rate on a 12-Month CD is currently 0.40%. That is literally 1/10 the amount of interest you could have reasonably expected to "earn" on the same CD back in 2007.

But when is this going to change? Frankly, not anytime soon, even IF the Fed raises the overnight lending target next week. Deposit rates will continue to be paltry because there is just so much cash in the system financing nowhere near enough loans.

Over the past 12 months, loans & leases (of all types) have grown 2.5%. Over the last 3 months, they have grown at an annualized rate of less than 1.0%, comfortably less than 1.0% actually. Trust me; that is a near standstill by historical standards, particularly with the Fed dumping an additional $85 billion in cash, read supply, into the system each month.

Therefore, IF and when the Fed starts raising the overnight lending target, the banking system has so much cash chasing too few loans, meaning deposit and short-term investment rates will not increase anywhere near the same amount. In fact, the lag between the overnight rate and deposit rates WILL be one of the longest on record, if not the longest. As such, UNLESS something completely unforeseen happens, and I mean unforeseen, cash investors are facing yields less than the unofficial, historical rate of inflation (roughly 3%) for at least another 24-36 months.

Yes, things can change, and quickly, but at THIS pace and on THIS path, well, if you want an attractive ABSOLUTE rate of interest before the next Presidential election, you are going to have to put on your risk hat. You are going to have to be willing to accept some additional volatility, and the potential loss of principal, although you can minimize that.

Over the last 24 or so months, a good short-term bond fund would have produced very good results when compared to a cash deposit. As an example: had you purchased the Vanguard Short-term Intermediate fund on 9/30/2011, you would have had a 5.63% absolute rate of return through 9/30/2013. While nothing to jump up and down about, that works. However, due to the uncertainty over future monetary policy in the US, and over-

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all leadership in general, the bond markets have been far more volatile over the last several months that ANYONE can remember over the last 30 years during an otherwise relatively stable period of economic growth. Impressive or robust growth? No. Stable? I think you can call it that.

As such, had you invested in the same fund on 4/30/2013, you would have lost 0.34% over the next 5 months. Who wants that type of fluctuation from a short-term bond fund? No one I know.

Unfortunately, that is what the investment world holds for short-term investors moving forward. A little more volatility and continued so-so absolute rates of return. In other words, your money is going to work a heckuva lot harder over the next 24 months to generate the same return as it did the previous 24 months. You can blame it on Obama, the Congress, or the Federal Reserve; it doesn't matter.

Interest rates can't go much lower in absolute terms, so the only direction they can really go is up. However, with all the demand out there, as represented by the amount of cash sloshing about the financial system, there is no way interest rates are going to up on the short-end anytime soon. Regardless of what the Fed does, there simply isn't enough loan demand to soak up the cash on the asset side of the banking system's balance sheet. That really is about it.

Where the rubber meets the road, strangely enough, investors, retail and institutional (including banks), are going to have to increase their risk tolerance in order to generate return. As they reach for the proverbial "brass ring," they will drain cash out of the system which will increase the opportunities to generate return on the short-end of the yield curve.

In other words, investors have to decrease their demand for short-term returns in order to have any chance of getting them. How is that for mental gymnastics? It is almost like playing hard to get. Whew.

Funny, isn't it? Even with all the debt in the world, there is still more demand for it than supply. Sure, some of the demand might be from elsewhere, and the Fed might be manufacturing a goodly chunk of the rest; however, it doesn't matter how the pie gets eaten as long as it does.

...and that frustrates a lot of people.

Disclosure