Are Junk Bonds the Next Bubble? Fed Has Pumped Up Risks and Prices

Not since the Federal Reserve (Fed) was formed in 1913 has the central bank taken such aggressive monetary action to stimulate the nation’s economy. They have reduced the funds rate to practically zero percent, pushed long term U.S. Treasury bond rates, adjusted for inflation, into negative territory, and bailed out non-banks, such as Goldman Sachs, with ultra-low interest rate loans. Rather than increasing borrowing and spending by consumers and businesses, it has pushed investors into riskier “junk” bonds. For example, U.S. junk-rated companies issued $46.6 billion of bonds in September representing a 59 percent increase over the previous month. Furthermore, the bond proceeds are going towards riskier ventures like mergers and acquisitions and to pay huge one-time dividends to private-equity owners. For example, private-equity owned Petco recently issued junk bonds, referred to as “dividend recapitalizations,” in order to pay owners outrageous and unjustified cash dividends. What will burst the junk bond bubble and produce massive investor losses? Just as the Fed inflated the junk bond bubble, it will also deflate it as it raises interest rates to combat higher inflationary pressures. As rates rise, bond prices fall generating potentially titanic financial losses for investors. Ernie Goss.

MAINSTREET RESULTS

Rural Mainstreet Index Soars: Bankers Expect 2.3 Percent Holiday Sales Growth

Tables 1 below summarizes the findings from the October survey with an index above 50.0 indicating growth and an index below 50.0 signifying weakness. [Index > 50.0 indicates expansion]

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<tbody>
<tr>
<td>Area Economic Index</td>
<td>52.9</td>
<td>48.3</td>
<td>56.6</td>
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<tr>
<td>Loan volume</td>
<td>57.3</td>
<td>70.2</td>
<td>44.2</td>
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<tr>
<td>Checking deposits</td>
<td>71.7</td>
<td>48.3</td>
<td>66.7</td>
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<tr>
<td>Certificate of deposits</td>
<td>44.9</td>
<td>38.4</td>
<td>42.0</td>
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<tr>
<td>Farm land prices</td>
<td>66.9</td>
<td>61.6</td>
<td>71.7</td>
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<tr>
<td>Farm equipment area sales</td>
<td>63.1</td>
<td>50.0</td>
<td>60.5</td>
</tr>
<tr>
<td>Home sales</td>
<td>49.3</td>
<td>58.8</td>
<td>59.8</td>
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<tr>
<td>Hiring in the area</td>
<td>56.4</td>
<td>50.9</td>
<td>51.5</td>
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<tr>
<td>Retail Business</td>
<td>49.3</td>
<td>42.9</td>
<td>48.6</td>
</tr>
<tr>
<td>Economy 6 months from now</td>
<td>50.0</td>
<td>43.0</td>
<td>50.7</td>
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October Survey Results at a Glance:

- Rural Mainstreet Index climbs to highest reading since June of this year.
- Farmland sales pushed the farmland-price index to its highest level since March of this year.
- Bankers expect holiday sales to grow by only 2.3 percent from last year.
- Approximately one-fourth of bank CEOs think a 2013 recession is likely or very likely.

After experiencing negative feedback from drought conditions over the last 3 months, the Rural Mainstreet economy soared higher according to the October survey of bank CEOs in the 10-state area. Overall: The Rural Mainstreet Index (RMI), which ranges between 0 and 100 with 50.0 representing growth neutral, rose to a solid 56.6 from September’s weak 48.3. It was the first time since June that the index rose above growth neutral. Our survey indicates that the negative impacts of the drought are being more than offset by the positives of very strong incomes from high agriculture and energy prices.

Farming: The farmland-price index soared higher. The October reading climbed to 71.7, its highest level since March of this year from September’s 61.6. This is the 33rd consecutive month that the farmland-price index has risen above growth neutral. Except for a brief period this summer, farmland prices have expanded at a pace that, in my judgment, depends too heavily on high agriculture commodity prices and record low interest rates. The farm-equipment-sales index expanded to 60.5, its highest level since May of this year, and was up dramatically from September’s growth neutral 50.0. Crop yields are down across the region with almost 70 percent of bankers indicating that 2012 yields will be lower than 2011’s. Approximately 18.8 percent of bank leaders are reporting 2012 yields are up from last year.

Banking: After expanding for seven straight months, loan demand unexpectedly plummeted for the month. The loan-volume index sank to 44.2 from September’s 70.2. The checking-deposit index advanced to 66.7 from September’s 48.3, while the index for certificates of deposit and other savings instruments rose to an anemic 42.0 from 38.4 in September. “The 2012 drought failed to increase the demand for loans from farming and nonfarming organizations in the region,” said Goss.

Hiring: October’s hiring index expanded to a tepid 51.5 from 50.9 in September. Hiring for Rural Mainstreet businesses is growing but at a snail’s pace. Bankers report that uncertainty surrounding healthcare reform, the elections and the “fiscal cliff” are restraining hiring even as the economy expands.

Confidence: The confidence index, which reflects expectations for the economy six months out, increased to a weak 50.7 from September’s 43.0. As the Rural Mainstreet economy turned upward for the month, so did bankers’ outlook. The turnaround in the housing market is an important factor boosting economic confidence. This month we asked bankers whether they expected the U.S. to suffer an economic recession in 2013. One in four bankers think a recession is likely or very likely next year. On the other hand, almost one-third, or 30.8 percent, of bank CEOs think a 2013 recession is unlikely, or very unlikely.

The November elections are seen as very important for some in terms of clouding the outlook. Casey Regan CEO of Premier Bank in Farmington, Minnesota said, “Forecasting how
things will look in 2013, especially business owner sentiment, will depend greatly on the results of what happens on the first Tuesday of November.” Michel Johnson, CEO of Swedish American State Bank in Courtland, Kan., said, “The recession question I believe will hinge on the November election.” Dale Bradley, CEO of The Citizens State Bank, in Milvotnale Kan., like many other bankers expressed concerns about the potentially large impact of the record tax increase slated to go into effect on January 1, 2013 and its negative impact on the economy.

Home and retail sales: The October home-sales index advanced to a healthy 59.8 from September’s 58.8. The October retail-sales index increased to a still weak 48.6 from 42.9 in September. As in the national economy, the Rural Mainstreet housing market is improving. On the other hand, the drought appears to be having negative impacts on Rural Mainstreet retail buying. Despite the upturn in the Rural Mainstreet economy and rising confidence, bank CEOs expect holiday sales to grow by only 2.3 percent from last year. More than one-fourth of the bankers, or 27.9 percent, expect either no change or a downturn in retail sales from last year.

Each month, community bank presidents and CEOs in nonurban, agriculturally and energy-dependent portions of a 10-state area are surveyed regarding current economic conditions in their communities and their projected economic outlooks six months down the road. Bankers from Colorado, Illinois, Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, South Dakota and Wyoming are included. This survey represents an early snapshot of the economy of rural, agriculturally and energy-dependent portions of the nation. The Rural Mainstreet Index (RMI) is a unique index covering 10 regional states, focusing on approximately 200 rural communities with an average population of 1,300. It gives the most current real-time analysis of the rural economy. Goss and Bill McQuillan, CEO of CNB Community Bank of Greeley, Neb., created the monthly economic survey in 2005.

COLORADO
After two months of moving below growth neutral, Colorado’s Rural Mainstreet Index (RMI) moved above 50.0 for October. The October RMI rose to 53.0 from 45.2 in September. The farmland and ranchland price index increased to 52.4 from September’s 48.4. Colorado’s hiring index for October was 49.8, up from 39.8 in September.

ILLINOIS
For the first time since May of this year, the RMI for Illinois moved above growth neutral. The October index climbed to 56.5 from September’s much weak 48.0. Farmland prices bounced higher with an October reading of 65.1 which was up significantly from September’s 54.6. The state’s new-hiring index increased to a still weak 45.8 from 44.0 in September.

IOWA
The RMI for Iowa for October advanced to 57.0 from 48.7 in September. The farmland-price index expanded to 70.2 from 62.8 in September. Iowa’s new-hiring index for October slipped to 49.1 from September’s 49.4.

KANSAS
The Kansas RMI for October climbed to 57.3 from September’s 49.5. The farmland-price index rose to 71.7, down from September’s much lower 62.8. The state’s new-hiring index increased slightly to 50.2 from 49.1 in September.

MINNESOTA
The October RMI for Minnesota rose to 57.2 from September’s 51.7. Minnesota’s farmland price index bounced to 76.3 from 71.1 in September. Minnesota’s new-hiring index dipped to 53.2 from September’s 54.9. Pete Haddeland, CEO of First National Bank in Mahnomen, said, “Our elevators are full, and they are dumping grain on the ground. Our Mainstreet business is improving.”

MISSOURI
The RMI for Missouri rose to 53.9 from September’s regional low of 41.6. The farmland price index for October increased to 51.2, a regional low, from 50.2 in September. Missouri’s new-hiring index inched higher to 48.5 from 48.1 in September. Don Reynolds, president of Regional Missouri Bank in Salisbury, reported, “Crop yields are better than expected, but still less than half of last year.”

NEBRASKA
For the first time since June of this year, Nebraska’s rural economy moved into positive territory. The October RMI rose to 56.1 from September’s much weaker 48.8. The farmland-price index advanced to 66.5 from 59.2 in September. Nebraska’s new-hiring index declined to a weak 46.6 from September’s 47.0. Cameron Mathis with Tilden Bank in Creighton, reported, “Dry land yields were very poor but irrigated yields were very good. Pastures are non-existent. Cattle producers could have real problems next year.”

NORTH DAKOTA
The North Dakota RMI for October advanced to a regional high 67.1 from 60.5 in September. The farmland-price index expanded to 82.3 from September’s 68.9. North Dakota’s new-hiring index rose to 77.5 from 68.0. Scott Tewksbury, CEO of Heartland State Bank in Edgeley, reported, “Much of our trade territory is reporting yield surprises on the up side. Although not universal, many farmers are reporting yields above long term averages on both corn and soybeans.”

SOUTH DAKOTA
The October RMI for South Dakota increased to 56.5 from 48.3 in September. The farmland-price index expanded to 68.4 from September’s 58.1. South Dakota’s new-hiring index for October rose to a still weak 47.9 from 46.3 in September. David Callies, CEO of Minor County Bank in Howard, said, “Crop yields were down, but higher prices helped offset this. Drought is a major concern going into winter.”

WYOMING
The October RMI for Wyoming expanded to 57.8 from 46.9 in September. The October farmland and ranchland price index expanded to 68.6 from 52.9 in September. Wyoming’s new-hiring index remained below growth neutral with an October reading of 48.1, up from 42.9 in September.

THE BULLISH NEWS

• The nation added 171,000 jobs for the month of October (ok but not satisfactory).

• According to the Case-Shiller home price index for August, U.S. home prices (year over year) increased for a third straight month.

• September retail sales increased by 1.1% from August and by 5.4% from September 2011. A lot this growth was due to vehicle sales.

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investments and hiring; notwithstanding the surprising drop in the unemployment rate to 7.8%. The pace of job growth remains too slow to generate strong increases in personal income, which is the main driver of consumer spending. In the near-term, we do expect the U.S. to partially fall off the ‘fiscal cliff’ as politicians allow the payroll tax cut and the extended unemployment benefits to expire at the end of this year. This will depress growth in the first half of 2013, lowering it to below 1%. However, we forecast that growth will rebound back to a slightly above 2% pace in the second half of 2013 based on the continued strengthening in the housing market, steady but slow employment gains, improving consumer balance sheet, and removal of some of the political uncertainty surrounding the upcoming election.”

• The ICBA Overdraft Payment Services Study “To help determine demand for these offerings, ICBA conducted a survey of 3,000 consumers (representing a random sampling of the U.S. banking population). This consumer survey revealed seven key findings:
  • Most consumers understand the potential consequences of returned payments and want important transactions paid by their financial institution (all fees being equal) even if those transactions result in an overdraft.
  • Consumers using overdraft payment programs are among the most knowledgeable of alternative services to avoid overdrafts.
  • Consumers who use overdraft payment programs prefer them to other short-term funding options.
  • Most consumers avoided overdrafts in the previous 12 months.
  • Frequent account monitoring does not deter overdrafts.
  • Consumers who use overdraft services are more likely to take out a payday loan.
  • A consumer’s choice of financial institution makes a difference”.


GOSS EGGS
(RECENT DUMB ECONOMIC MOVES)

• On Nov. 6, Californians voted for Proposition 30 which increases the sales tax by a ½% and elevates the income tax rate to 12.3% for those earning more than $250,000. This is a great economic development tool for neighboring states that will now be even more successful at recruiting California businesses and workers to their area.

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