Talking Banks

With Joe Fenech & Kevin Swanson
Sep 26th, 2024

In this Issue:

- We were interviewed in mid-July by S&P Global on our sector outlook (Podcast Link). Thanks to Nathan Stovall (Blog Post) for having us on.
- The yield curve is steepening; It's the positive inflection point we've been looking for.
- Bank stocks have turned higher, and we see further advances ahead
- M&A activity is picking up; It's a huge opportunity, but…it's complicated!
- Credit likely to deteriorate further, but it's increasingly a "rear view mirror" issue for stocks
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The yield curve is steepening following the longest and deepest inversion of the last 40+ years. Arguably the most significant overhang on bank stocks over the past few years has been the deep and prolonged inversion of the Treasury yield curve. The bank stock index peaked in January 2022, during a period of rapid yield curve compression. The spread between two- and ten-year Treasury yields inverted in June 2022, reached its peak inverted state in June 2023 (perhaps not coincidentally just after the bank panic that spring), and returned to a positive spread just this month (Click Here).

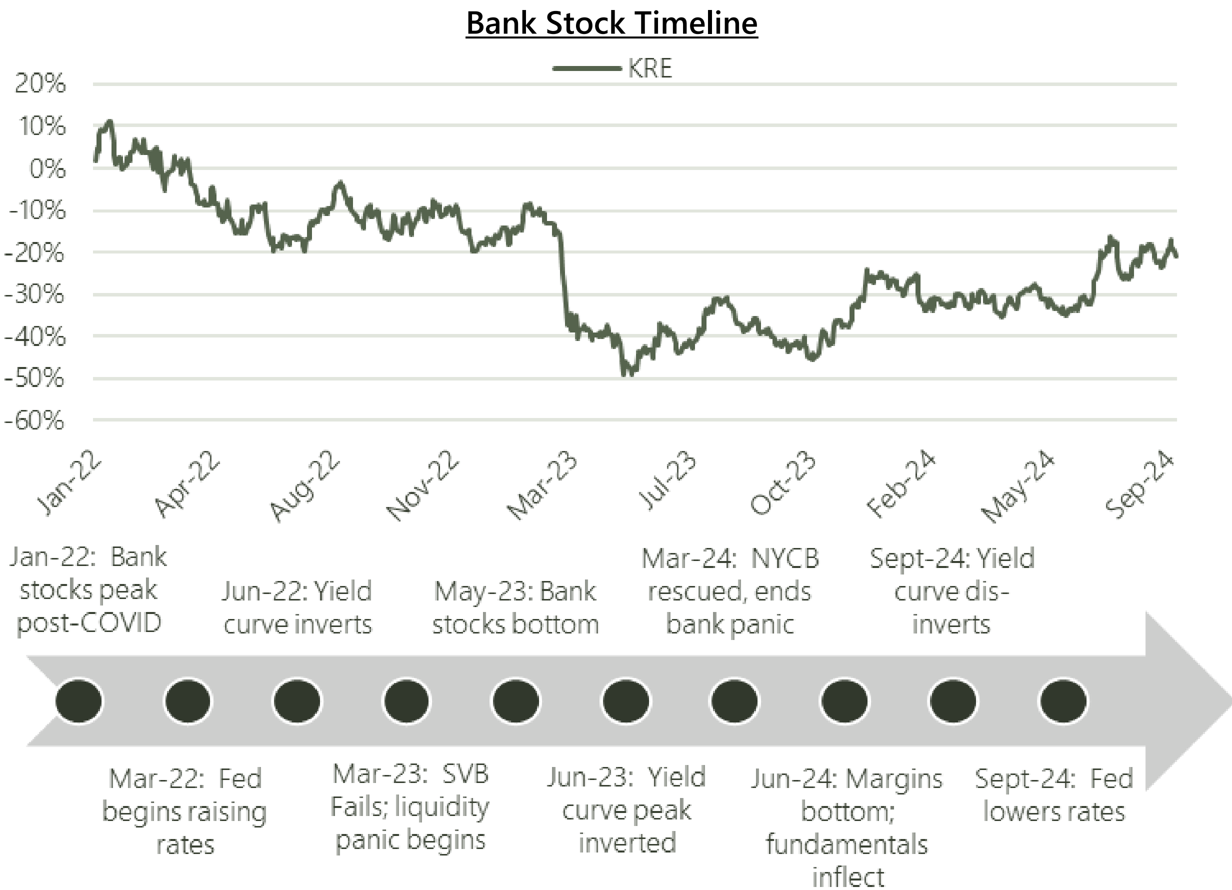
One must look back to the late '70's to find a period comparable to these past fifteen months. Interestingly, since "peak inversion" of the 2/10 spread (-106 basis points) in June 2023, the bank stock index has increased by approximately 40%. This situation is so far unfolding differently than prior periods of yield curve steepening, which were marked by turbulent and often-times disastrous performance for bank stocks. That's because those prior periods also tended to reflect punishing recessions and sharply higher loan losses for banks, as the Fed reacted to economic problems by aggressively lowering short-term interest rates, steepening the curve in the process. So in the past, while a steeper yield curve was undoubtedly positive for the sector, the process to get there was often very painful.

Treasury 2/10 Year Spread

Source: FRED; Data as of 9/20/24

This time, while a "soft-landing" for the economy isn't assured, the Fed is beginning to loosen monetary policy against the backdrop of a reasonably healthy economy, with no apparent credit crisis looming on the horizon. Moreover, we'd argue that bank stock valuations have already discounted a moderate recession scenario, suggesting the stocks are positioned to perform well as the rate environment becomes more accommodative and fears of a severe recession begin to fade. As has been the case throughout this unusual cycle, we think this time should indeed be different, as stimulus unleashed in response to the pandemic has effectively cushioned the blow to asset quality that we might otherwise have expected from higher rates.

But the hand-wringing over the recession scenario we think obscures the larger point, which is that a yield curve construct that settles out, say, in the 3.5%-ish range at the short-end and somewhat higher on the long end in our view would be the most favorable, and healthiest rate environment for banks in the post-2008 era. The long period of near-zero interest rates from 2008 to 2022 led to asset price distortions and compressed margins for many banks. By contrast, the rate environment seemingly just ahead is more akin to pre-2008, when banks with good quality core funding and responsible asset growth sported more robust net interest margins. Oh, and the stocks traded at much higher valuations too!



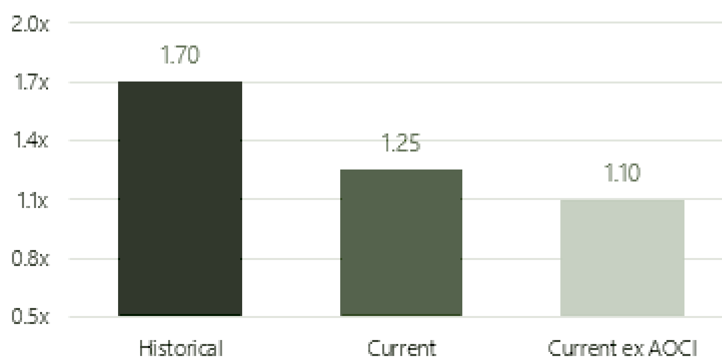
Source: S&P Global; Data as of 9/25/24

Bank stock valuations are historically attractive, even as fundamental and macro factors shift from headwinds to tailwinds. The significance of milestone events tends to be fully appreciated only in retrospect. Bank stocks now look to have *clearly bottomed* in May 2023, though it certainly didn't feel like it at the time. Since then, bank stocks are up about 40%. Similarly, Steve Mnuchin's rescue of NYCB earlier this year we think marked the *definitive end of the panic* that began last year, but here again, the near-demise of that institution felt to many at the time like the tip of the iceberg rather than the industry turning point from crisis to normalcy. Since then, bank stocks are up about 20%. Readers can probably sense where we're going with this.

The bottoming of industry margins in Q2 2024, followed by a now-rapidly steepening yield curve and the commencement of a Fed rate reduction cycle is a *fundamental inflection point* that is no less significant a milestone as those noted above. And yet, against this now more favorable fundamental and macro backdrop, bank stock valuations, while modestly higher now than they were, continue to trade at very attractive levels relative to history, and especially so given benign credit conditions and the industry's capital strength.

Bank stocks currently trade at 1.25x tangible book value, compared to the long-term average of 1.70x. The recent sharp drop in interest rates also calls attention to the potential for a more rapid recovery of bond portfolio values. Adjusted for AOCI, bank stocks trade at 1.10x tangible book value, *a 35% discount* to the long-term average. An extreme example of this disparity is Comerica Inc. (CMA), a large regional bank that "on paper" trades at 1.6x TBV but ex-AOCI trades right at tangible book value. According to a recent research report from Stephens Inc., 89% of banks under its coverage now trade below their 5-year average TBV multiple; ex-AOCI, it's an eye-popping 97%.

Price / Tangible Book Value Per Share



Source: S&P Global; Data as of 9/20/24

For those favoring a more earnings-based valuation construct, the situation is compelling, with the sector trading just over 10x forward earnings, about a 30% discount to historical trading multiples, and roughly half the broader market multiple. While we don't tend to focus quite as much on relative valuation analysis, given that the comparison subject is outside our area of expertise (who are we to opine on whether the stock market is over or undervalued?), it's nevertheless difficult to ignore the disparity.

We find ourselves asking a very simple question. What is the better risk/reward bet? On the upside, that bank stocks will re-rate from 10x to 13x as fundamental tailwinds shift in the sector's favor, or that the broader stock market, trading at 20x earnings will re-rate to 26x, a level rarely seen in history? Or on the flip side, that bank stocks have downside risk to 7x-8x earnings or that the broader market might correct back to its long-term average of 16x-17x forward earnings?

Green shoots of M&A yield potential opportunity…and some risks. Fifth Third's CEO, Tim Spence, at 45, the youngest of the nation's large regional bank leaders and someone we respect quite a bit, had this to say recently:

"In terms of what I'm most excited about, like I blame the financial crisis, but if you look at the entire industry, we're kind of missing a generation. We're underrepresented in a generation of leadership because it was pretty hard to go on a college campus and convince people that working at a bank was a good thing to do when banks were being blamed for every ill in the world. So there's going to be a lot of leadership succession across the sector over the next 5 years."

It's a point we hadn't really considered before in that context. Today, the average bank CEO is 61, Boards of Directors on average tend to be older than senior management, and just 7% of public bank CEO's are under 50. We've tended in recent years to ascribe aging management to what we'll call the "COVID factor", in the sense that there's been so much volatility during and post-pandemic, along with unique circumstances in this cycle (like rate marks and punitive regulation) that has resulted in muted M&A activity. So there is likely a considerable backlog of M&A activity, as those who may have wanted to exit in the past few years have been unable to do so. That's undoubtedly been a factor, but we hadn't really considered the succession question from the angle that FITB's CEO Spence discussed above.

So where does that leave the industry today? Per JPMorgan research, as of mid-September, there have been 84 bank deals so far this year, up 11% from last year at this time, but still well below the pace of about 250 deals per year in the decade or so leading up to the pandemic. We expect the pace of activity to continue to pick-up, more notably after the election, and as fears of a "hard-landing" economic scenario subside and the impact of Fed rate reductions (helping to improve "deal math") increasingly take hold. In short, we think the next few years could be among the most active for bank M&A that we've seen in quite some time.

But we also think it will look different than in prior cycles, which brings us back to the succession topic. In past cycles, anecdotally speaking, there were more buyers with the wherewithal, the management bench strength, the stock currency, and the "green light" from regulators to pursue acquisition targets. With that backdrop in mind, investors could be reasonably confident that acquisition targets with an attractive franchise, even those with subpar profitability, would command reasonable, if not substantial, premiums in a takeout scenario.

Today, with fewer willing and capable buyers, partly owing to succession challenges, but also to the relatively higher degree of regulatory scrutiny and other factors, investors will need to be more selective in allocating investment capital to the consolidation theme. This isn't meant to suggest that hefty premiums are a thing of the past. Indeed, even through the turbulence of the last few years, we think franchise value has been largely preserved, evidenced by multiples paid in select transactions (GABC's acquisition of HLAN at 2.1x TBV; AUB buying AMNB at 1.8x; and WTFC acquiring MCBC at 1.7x). We think the difference though is that these will prove to be the exception, rather than the rule.

More sellers than buyers, the need in some situations for M&A to serve as a form of succession planning, an elongated and more challenging regulatory approval process, still-elevated interest rate-related deal marks, and regulators' apparent desire to see any perceived capital holes filled immediately we think will suppress the average price paid in M&A deals relative to history, though, again, certain select situations will still command significant premium multiples. The bottom line is that it seems foolhardy to us to own potential acquisition targets simply on the premise that they *might* be acquired; we think it's important to own stocks on their stand-alone merits, with more nuance applied, vis a vis prior cycles, when considering the consolidation theme.

If the M&A cycle unfolds as we expect, the flip side of the equation is that there should be more opportunity for investors to play the buy-side of M&A than there's been in the past. As readers of this newsletter know well, we are admirers of SouthState Corp. (SSB) management for many reasons, including the company's recently announced acquisition of Independent Bank Group (IBTX). We thought SSB's CEO articulated the rationale for the deal, and the opportunity for other smart acquirors, quite well in recent comments:

"Our industry currently suffers from loans and investments that are underearning their potential because they're not yielding current market rates. That's a negative overhang that will last for years. But the positive is the industry enjoys the benefit of strong capital ratios. So the question for every bank management team is how to utilize surplus capital to reposition the balance sheet and unlock the earnings potential of these assets rather than waiting years. Many of our peers have chosen to execute a bond swap, and that's fine, but a bond swap never got us particularly excited as a capital management strategy. We looked at it as a dollar-for-dollar trade. You invest $1 of capital and you get $1 of earnings, but you accelerate the timing of the cash flows. That's fine from a financial engineering perspective, but it feels to us like a dollar-for-dollar trade. What we're doing with Independent is a more powerful use of capital. Just like the bond swap, we're unlocking the earnings power of the bonds at Independent, but it's not just the bonds, it's entire loan portfolio. Including both loans and investments, it's about a $17 billion interest rate swap on all earning assets. But here's the key. Rather than a dollar-for-dollar trade, the thing that makes this different is that we're utilizing the SSB valuation and currency advantage simultaneously with the investment of capital, which makes the swap much more powerful as a capital management approach. Layer in both the normal economies of scale we gain in a transaction plus the currency advantage and we see this as a far better use of capital than a vanilla bond swap. All $17 billion of earning assets moved to market rates and the rates are instantly locked in. Independent's NIM opens wide and the only rate movement going forward will be deposit rates. As we move into a period of likely lower rates, SSB should benefit as a more liability-sensitive balance sheet with Independent."

Measures of asset quality are modestly deteriorating, but it's not the problem one might think. Alongside the inverted yield curve and lingering concerns from the liquidity panic last year, fears around asset quality, particularly commercial real estate, have been a significant overhang on bank stock performance. It was arguably the most significant overhang in the first half of this year following the near-collapse of New York Community Bank, which prompted the subsequent hysterical claims by the Wall Street Journal that commercial real estate Armageddon was upon us.

More recently, Fed action to begin lowering interest rates has been interpreted by some to be a commentary on the state of the economy and concerns about asset quality more broadly. Our contention is simply that rates were higher than necessary, system liquidity is now in better balance following the massive liquidity injection during the pandemic, and moderating inflation has allowed the Fed some room to maneuver by lowering interest rates and slowing the pace of quantitative tightening.

In prior issues of this newsletter, we provided reams of data intended to show that CRE credit fears were overblown. We'll take a different tact this time and simply provide direct commentary from people and companies that we respect and that we think have the best "on the ground" insight on the state of the economy and by extension, overall asset quality.

Source: FRED; Data as of 9/24/24

Before we provide the commentary, we'll note our two conclusions on credit:

First, we think that asset quality metrics will continue to deteriorate but from near-record low levels of problem loans and credit losses. The reason why we don't see modest credit deterioration as an issue for the stocks is best explained by our friends at SSB (among others also below):

- *"The theory behind CECL is that you provision and recognize losses in advance. And if you look at our (reserve) build over the last 7-8 quarters, provision expense is up about $171 million net of charge-offs. And so it's possible moving ahead, if you start to see improvements in economic forecasts, we could potentially see reserve levels continue to come down even as you might see charge-offs tick up at the same time."*
- In other words, losses are likely to rise but they're already accounted for in the reserve, which is different from prior credit cycles given the new accounting rules known as "CECL", which force the industry to account for projected losses over the life of the loan at the time of origination and also to take into consideration macroeconomic forecasts. This is likely to result in potential releasing of reserves for many banks in 2025, even as asset quality continues to modestly deteriorate. For example, Bank of America notes that *"we remain reserved for an unemployment rate of nearly 5% by the end of 2025, compared to the most recent 4.1% rate reported."*

Second, on concerns about broader credit deterioration, we think the focus is misplaced and is less of a risk for banks than is perceived. Credit deterioration that we are likely to see, outside of office real estate, is mostly a factor of the underlying customer base rather than it is about specific loan categories. So for instance, borrowers across the lower income and credit score strata's are far more stressed than higher income borrowers, which we think is a function of two distinct phenomena in the post-pandemic cycle.

- Higher income borrowers still retain a good portion of the excess liquidity that's been sloshing around the system while this cushion has largely run out for lower income people. Bank of America's President of Regional Banking noted that consumers have 23% more funds in their checking accounts than they had pre-pandemic and "then more savings on top of that". We think this accounts for why credit issues

in consumer loan categories don't seem to be correlated by product but rather by borrower's economic class. This article isn't a perfect analogy but it's to that point and also interesting (Click Here).

- Asset price inflation helps…well, the people that own financial assets! Whereas inflation in general hurts the people that spend a much greater percentage of their income on necessities, like food, consumer goods, and rental housing, etc., prices of which have soared during the recent inflationary period. Not to digress, but this dynamic seems to be playing out politically, where the economy overall is performing quite well, though wide swaths of the working-class populace seem dissatisfied.

The reason why most banks aren't reporting material credit issues is because most of the problematic exposure discussed above has been pushed outside of the regulated banking system over the past 15+ years, through intensified regulatory scrutiny of these areas post the Great Financial Crisis, and commoditization of lower income strata consumer lending products. Where did most of it go? More lightly regulated consumer finance companies, fintech, and yes, to…(drumroll please)…private credit!

But don't take our word for it! Judge for yourself from the direct industry commentary below:

General Credit Commentary:

Wells Fargo's CFO (WFC): *"Most people are still doing well, whether it's on the consumer or commercial side. And when you unpack the consumer side, I think you're continuing to see the trend that we've talked about now for awhile, which is folks on the lower side of the income/wealth spectrum struggling more. As you go up the income and wealth spectrum, people are doing quite well. They still have more liquidity than they did pre-COVID. When you look through our credit portfolios, lending is fine, in our auto business, we tightened credit a couple years ago, so you're seeing loss rates come down there. And I think on the card business, you're seeing the confluence of two things: one is that slow deterioration coming off the lows of COVID…and then the maturation of the new vintages of product that we put on now for the last few years, and that's really behaving exactly as we thought. On the commercial side, same thing. Most customers are still doing pretty well.*

Office Real Estate:

Wells Fargo's CFO (WFC): *"In most of the cities we travel to and live in, older office buildings are doing much worse than newer office buildings. Newer buildings are fully-leased or almost fully-leased and older office buildings are the ones having the trouble. You see that stress consistently throughout the country, it's not specific to certain cities. We feel good about the allowance we have for that portfolio, (at) roughly 11%…"*

JP Morgan Chase's COO (JPM): *"Our credit card charge-off guidance is unchanged: 3.4% for this year; 3.6% for next year. We haven't seen any deterioration. From auto financing to mortgages, to small business to middle market to large corporates, we haven't seen any deterioration. Clearly, there are some challenges in CRE. We probably haven't seen the bottom of that. We have around $15-$16 billion of exposure, and we are very well-reserved for that. But as interest rates come down, that will benefit and make easier the ability to refinance. Multifamily, very little exposure to Type A. We are mainly Type C and Type B, where the demand is very strong. We haven't seen deterioration at all in multifamily, where the portfolio is $120+ billion."*

CVB Financial Corp. CEO (well-run West Coast community bank, CVBF): *Question from analyst: Industrial CRE in the Inland Empire has seen a pretty nice lift in vacancy rates to start this year. Curious what you are seeing in that market? Answer from CEO: So a couple things: I think the latest data I saw, when you go from a 1-2% vacancy rate to a 6-7% vacancy rate, that is a large percentage increase, but it's still very concentrated in the*

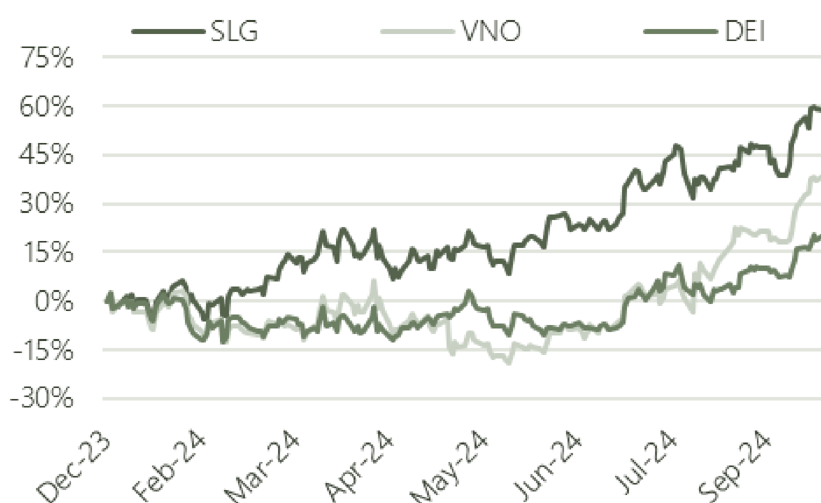
larger square footage size buildings, and it's impacted more when you have 2 million, or 3 million, or 4 million square foot building that goes vacant, that's not the type of deal that we're lending on. So we really haven't seen any changes in the industrial market with our customers. We've been very disciplined in how we underwrite it. About half of it is owner occupied. The largest classified loan in our industrial portfolio is a 15-year amortizing loan with less than a 30% loan to value, all payments being made. The operating company lost a little bit of money so we downgraded it. I feel very good about the credit quality."

Truist's CFO (TFC): *"We increased our office reserve to 9.7% from 9.3%. About 6.3% of the portfolio is currently classified, up from 5.5% last quarter. 90% of these balances are paying in accordance with the original terms. 22% of our office portfolio is housed within our community banking and wealth management segments where loan sizes tend to be more granular, guarantor support more prevalent, and overall loss is lower.*

Bank of America (BAC): *"We continue to aggressively work through our loans in our modest CRE office portfolio. We saw a decline in all the categories: a decrease in reservable criticized loans, a decrease in NPL's, and a decrease in NCO's. This supports our prior expectation that NCO's in the second of 2024 will be lower than the first half of 2024. Our commercial office losses went from $304 million in Q1 to $226 million in Q2.*

First Citizens Bancshares (FCNCA): *"We continue to be well-reserved with an allowance of 11.8% on the commercial bank office portfolio, covering NCO's by 2x.*

<u>Office Real Estate Stocks Continue To Outperform YTD</u>



Source: S&P Global; Data as of 9/25/24

Commercial Real Estate:

M&T Bank (MTB): *"Total CRE criticized balances declined $987 million in 2Q from the prior quarter, upgrades and payoffs of criticized loans outpaced downgrades into criticized. The decline was across multifamily, retail, health services, hotel, and construction, but we did see modest increases in office and industrial."*

Credit Cards: Asset Quality Trends:

Citigroup's CFO (C): *"All of the card spend growth is skewing from our largely affluent customer. These is a dichotomy if you will between the higher FICO score and lower FICO score customers."*

JP Morgan Chase's COO (JPM): *"I still feel like when it comes to card charge-offs and delinquencies there's just not much to see there. It's still normalization, not deterioration. It's in line with expectations. On spend patterns, you can see a little bit of evidence of behavior that's consistent with a little bit of weakness in the lower income segments, where you see a little bit of rotation of the spend out of discretionary into nondiscretionary. But the effects are really quite subtle, and in my mind, entirely consistent with the type of economic environment that we're seeing, which, while very strong and certainly a lot stronger than anyone would have thought given the tightness of monetary conditions say, like they were predicting a couple years ago, you are seeing slightly higher unemployment, moderating GDP growth. And so it's not entirely surprising that you're seeing a tiny bit of weakness in some pockets of spend."*

Private Credit:

Fifth Third's CEO on private credit (FITB): *"There isn't a great track record historically for people growing as fast as private credit is growing and completely avoiding mistakes. I also have a hard time figuring out what the competitive advantages are that are defensible if the model works."*

JPM's Jamie Dimon on private credit: *"I don't think it's a systemic problem. But it's growing rapidly. Anything that's growing rapidly, if you look at almost every financial crisis, it was new financial products, often around real estate, but new financial products almost every single time."*

C&I:

JP Morgan Chase (JPM): *"Not really seeing early signs of cracks in C&I. The C&I charge-off rate has been very, very low for a long time. In any given quarter, the C&I numbers tend to be quite lumpy and idiosyncratic. So I don't think that anything in the current quarter's results is indicative of anything broader and I haven't heard anyone internally talk that way.*

Tidbits

As discussed, succession is going to be a significant issue in banking over the next several years. This is a fascinating (and not in a good way) article on the topic at Disney (Click Here).

The first rule of the bull market is not to talk about the bull market! In all seriousness, this doesn't bode well for general market performance in the near and maybe intermediate term (Click Here).

We're seeing fewer "CRE Armageddon" articles in the financial press lately, as perceptions seem to be finally changing for the better (Click Here).

New York City approves a rent increase for rent-regulated apartments. Hey, at least it's something (Click Here)!

Always an eyebrow-raiser when Buffett sells stock so aggressively. But could this time be different (Click Here)?

Rate cuts could lower margins, but this argument risks missing the forest for the trees (Click Here).

This story has nothing to do with anything banking-related, but as a history buff, I found it amazing and surprised I hadn't heard of it before (Click Here).

Disclosures:
Of the individual stocks mentioned, our investment fund currently has long positions in Wells Fargo & Co. (WFC), Citigroup Inc. (C), Truist Financial Corp (TFC), Independent Bank Group Inc (IBTX – pending acquisition by SSB), New York Community Bancorp (NYCB), M&T Bank Corp. (MTB), First Citizens Bancshares (FCNCA), CVB Financial Corp. (CVBF), Comerica Inc. (CMA), and preferred stock in New York Community Bancorp, Inc (NYCB). Our investment fund currently has a short position in SL Green Realty Corp. (SLG). The authors have long-standing long positions in Citigroup Inc., and JPMorgan Chase & Co. in their personal investment accounts, an investment that pre-dates the launch of our investment fund.

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