Highlights of Our Investment Research
U.S. Banks & Why We Like Them

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Key Takeaways

- U.S. banks are a key asset for many investors, carrying unique return drivers and risks. Our analysis suggests that banks offer more relative value than the overall U.S. market.
- On our research, U.S. banks are better capitalized than previously, which supports our relative conviction, despite the potential for pandemic-related losses.
- We acknowledge that there are a wide range of outcomes expected, but the upside still appears to exceed the downside, on our analysis. Banks should benefit from the improving economic backdrop (especially the recent yield curve changes) and a reversal of loan loss provisions.

Following an internal deep-dive presentation on U.S. banks, we spoke to Nabil Salem and Doug McGraw to capture the key takeaways via a Q&A format. Here is what they had to say.

Question: How would you quantify the upside versus downside for U.S. banks as a whole – in a world with rising yields, rising inflation, but offset by high debt and potentially high loan losses?
To start, let's offer perspective. In the U.S. market, the banks (including regional, super-regional and money centers) comprise approximately 4.5% of the S&P 500. This is sizeable, yet these banks are also quite nuanced, with different return drivers and risks from many other assets.

Our focus is to value banks with a margin of safety, and to look through cycles at normalized net income. In this regard, we believe our valuation models indicate banks still look attractive relative to other sectors assuming they are able to grow at 1% in real terms over the long run. We assume loan losses will be much lower than the Federal Reserve initially expected at the beginning of the pandemic, as banks have benefitted massively from government stimulus and from a sooner than expected pickup in demand. But to be conservative in our valuation analysis, we incorporate room for additional provisioning for loan losses (even though banks have been releasing loan loss reserves in recent months).

To the upside, banks could benefit from higher net interest margins, and on the downside, we could face tax hikes, or higher than expected loan losses. There are a wide range of possible outcomes. Taken together, we are interested in banks primarily for valuation, but also for their fundamental outlook over the next couple of years.

So, do you agree that the fundamentals are supportive for U.S. banks right now?

On balance, yes. We would cite three factors which are supportive:

- First, with the rollout of COVID vaccines in the U.S., banks are not only taking fewer credit provisions, they are actually reversing some of the large provisions taken in 2020.
- Second, strong anticipated economic growth in the U.S. should create demand for loans, while also keeping loan losses low.
- Third, banks could soon be in a position to return capital to their investors in the form of share buybacks, which we assume will be welcomed and rewarded by the market.

The most plausible short-term risk to banks is that a COVID variant, which is not neutralized by vaccines, becomes widespread and returns economies to periodic shutdowns. A longer-term risk is the substitution of banks' services by non-banks, which could be enhanced via technological means.

What do you say to people who think U.S. banks have passed their prime? Can you offer your perspective on the back story?

To unpack this, we believe it's important to highlight four issues in addressing the opportunity for U.S. banks and their back story.

- First, we note that banks should be able to absorb unseen credit crises better than previously. This is partly in reaction to the Great Financial Crisis (GFC), where regulators increased the required capital ratios for banks. The Common Equity Tier 1 (CET1) ratio is a key metric to watch here, which measures equity capital in relation to risk-weighted assets. From a safety and soundness perspective, the higher the better, all else equal. In this regard, the CET1 ratio was 8% before the GFC, before bottoming at around 6% during the crisis, but from the bottom this ratio climbed to nearly 12% by 2014 and has generally remained at that level.
- A second development is the implementation of a new accounting standard, which affects the reserves held to absorb credit losses, from the Financial Accounting Standards Board (FASB). Many banks began reporting under this new accounting standard at the beginning of 2020. While a minority of banks lowered their reserve, most banks increased their allowance for bad debts. When we take issue one and two together, we see that, at the beginning of 2020, banks were in a better position than they had been for many decades to absorb credit losses, both through higher explicit credit provisions recognized, as well as through higher capital levels.
- A third trend to flag is the move to consolidation of the industry. In 2010, there were a combined 7,568 banks and savings institutions, but by 2020, that number was 5,001. We would expect this number to continue to decline. When one bank acquires another, especially where there is geographical overlap, cost efficiencies can typically be realized, which will bolster profitability.
- A final metric to consider is the downward trend of Net Interest Margin (NIM), which is a key determinant for bank profitability. As the 10-year US Treasury yield fell abruptly at the beginning of 2020, the fear was that this metric would compress quickly as the interest rates

earned on assets would fall with the Treasury yield curve, while banks would not lower their interest paid on deposits below zero. While 10-year Treasury rates have recovered to pre-COVID levels, they remain at decade lows.

Will the banks gradually lose market share to the technology giants? Are you expecting slower trend growth?

This is a risk that we account for in our range of valuation outcomes. The financial services sector has undergone a digital revolution over the past decade. However, in our opinion, U.S. banks appear determined to keep up with this technological revolution through increased investment in technology and expansion of offerings to compete with new firms.

This is especially true among the largest banks within the financial services sector. As an example, J.P. Morgan spent $11.4 billion on technology in 2019, and U.S. banks spent $67 billion on technology in 2019. We haven't seen banks lose market share yet to technology giants, and don't think this is inevitable (perhaps even unlikely, given the high investment).

There is, however, a risk that technological advancement leads to lower switching costs for customers, which leads to increased competition and fee erosion in certain areas of banking. In our base case valuations, we assume banks grow at a lower rate than the overall U.S. market, which is conservative relative to how banks have been able to grow their profits historically.

On balance, taking the positives and the negatives, do you think U.S. banks deserve a place in a portfolio today?

Our analysis suggests that U.S. banks' offer attractive relative valuations versus the broader U.S. equity market. In addition, we believe risks are skewed to the upside for banks in the next year or two, driven by the fundamental factors (solid economic growth, low loan losses, capital return) that we cited previously.

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