I Like Big Banks and I Can Not Lie

I like medium sized banks, super regional banks and financials as well, but I couldn't figure out how to squeeze that into the title and still channel, for better or for worse, Sir MixALot 😊

Bank Earnings and Issuance

We head into bank earnings with Citi leading the way on Monday morning, followed by JPM and Wells on Tuesday. There will be a lot of information to digest, but I think banks have room to do well on both the equity and the credit side. Credit performance will be crucial as bank earnings are typically accompanied by bank bond issuance.

Let's start with the easy stuff, bank bond issuance

- Financials issued $534 billion of bonds in 2018, or about 50% of the market.
- That is down from $620 billion in 2017, $571 billion in 2016 and $549 billion in 2015.

Banks are issuing less debt for several reasons, and I expect that trend to continue because:

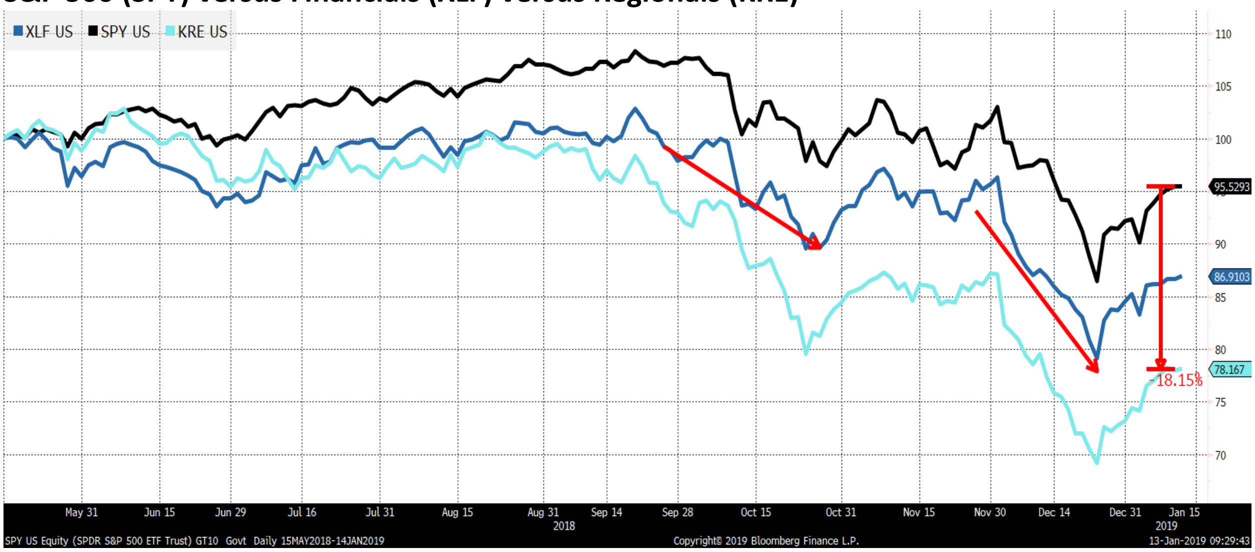
- **Regulations mandated that banks change how they finance themselves**. Longer dated debt became mandatory. Total Loss-Absorbing Capacity (TLAC) became an everyday fact of life for banks. Banks have spent years optimizing their balance sheets and much of that is done, reducing the need for banks to come to the bond market relative to recent years.
- **2019 as the Year of the Debt Diet** impacts banks as well.
- By my calculations about $370 billion of bonds issued by financial institutions will mature this year, so we could **see relatively low 'net' issuance.**
- According to the Fed, excess reserves from Depository Institutions fell from $2.1 trillion to $1.6 trillion over the course of 2018. Much of this will be 'neutral' for balance sheet requirements from banks as excess reserves are replaced by other interest-bearing assets, but I suspect, that some small portion of these lowered reserves just get repaid – reducing the size of balance sheets at the margin.
- In the second half of last year, it seemed, anecdotally at least since the data wasn't robust, that the average maturity being issued by banks decreased. That is likely in response to much of the longer dated funding required by regulations having been implemented. **We could see a return to longer dated issuance this quarter, as it seems to be a general trend, but going forward, it could become more difficult to source longer dated bank paper.**

From the 'supply' side, the story to buy bank debt is compelling.

Financials have Been Hit Hard. Too Hard.

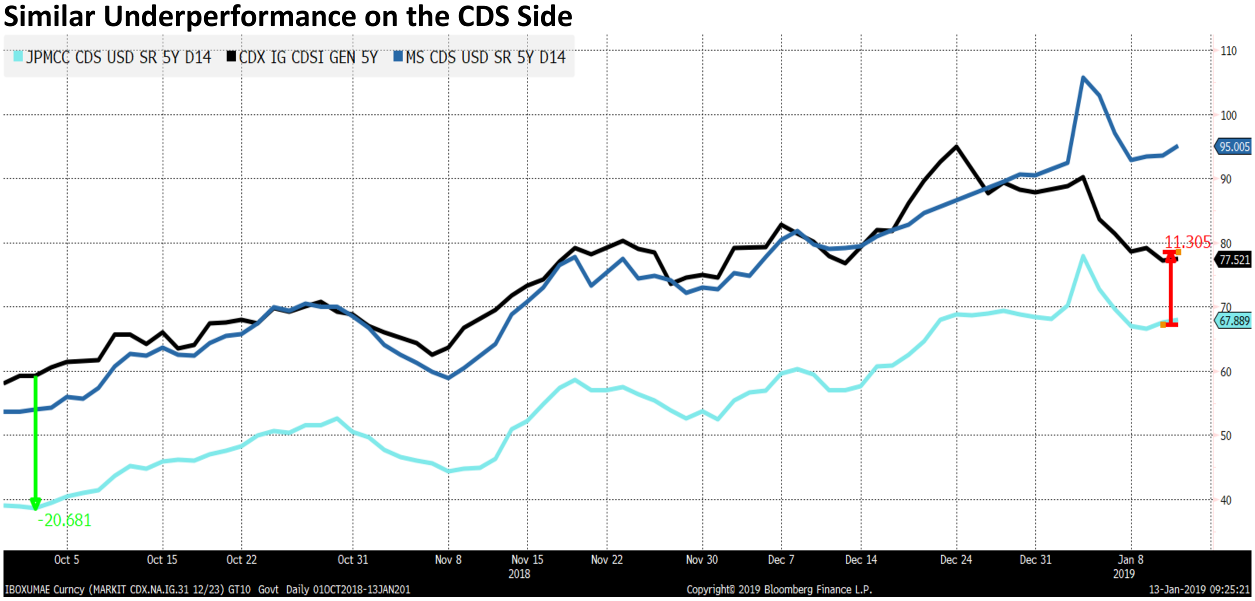
Bank stocks have struggled since the middle of May relative to broader indices. KRE, a regional bank ETF has done worse than either XLF (financials) or SPY (S&P 500), but **KRE performance is not entirely representative of the sector** as OZK dropped more than 50% from peak to trough and has a disproportionate impact on this index which is equally weighted. OZK has only a $3.4 billion market capitalization but is currently the largest holding of KRE. Banks like RF, STI, BBT, FITB and KEY, all with market caps ranging from 5 to 10 times greater than OZK, outperformed during the period. At least from a market cap perspective, how we usually think of equity indices, the ETF's returns are distorted (**a good warning, that what we think an ETF does and what an ETF actually does, don't always match**).

S&P 500 (SPY) versus Financials (XLF) versus Regionals (KRE)



Without a doubt, banks and financial stocks have underperformed.

Similar Underperformance on the CDS Side



The dramatic underperformance started later in the credit markets than in the equity markets. It really wasn't until late September that you start seeing the CDX index (dark line) outperform JPM (light blue) and MS (dark blue). The gap between JPM and the CDX IG Index has shrunk from

21 bps to 11 bps as JPM CDS lagged. MS, which had been a couple tighter than the index, is now 18 bps wider.

This underperformance represents opportunity.

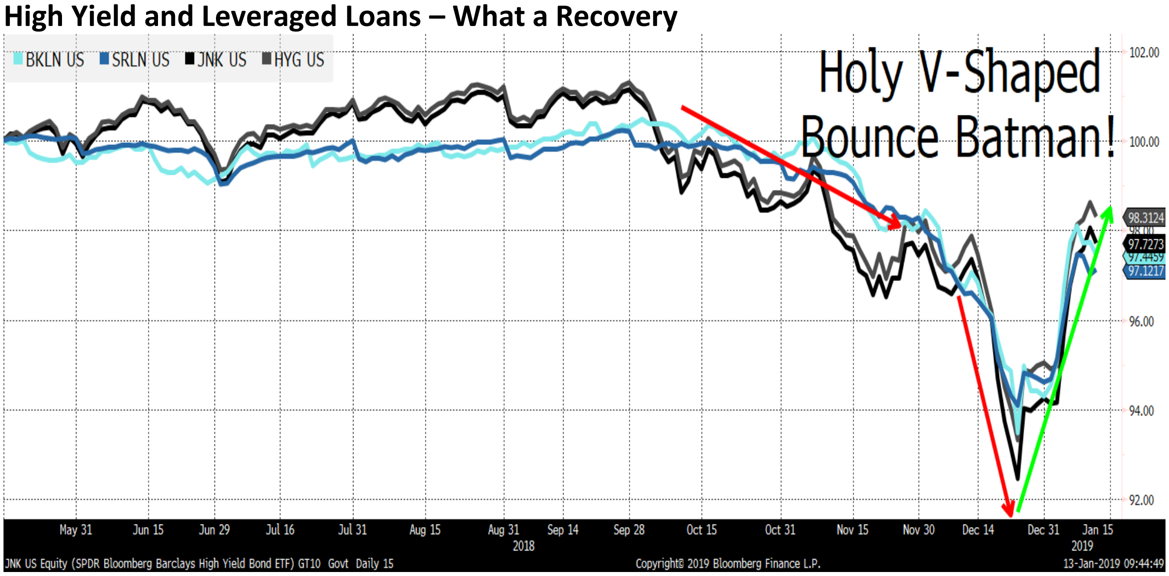
What is Driving the Performance

I think banks are being hit by four things:

1. ***Recession fears*** and its potential impact bank portfolios. This is impacting all stocks and probably explains the 'beta' of the stock market move rather than financials' underperformance but it still needs to be mentioned. **I think a slowdown is likely, but that Chinese stimulus and a trade deal, and some certainty over Brexit can be enough to prevent a global recession** – especially with central banks starting to make noises that the globally coordinated tightening of financial conditions might be slowing down.

2. ***Balance sheet concerns***. Too much corporate debt. Too much high yield debt. Scary leveraged loans. Lending to energy companies. Finance Twitter would cease to exist if it wasn't for story after story talking about how much dangerous debt there is and how everyone will have to pay the piper for these excesses. That trickles into banks. **I think this concern is completely invalid**. I am extremely comfortable with investment grade rated debt! (in fact, I prefer BBB bonds to A bonds here). High yield and leveraged loans concern me a little more, but banks don't have enough exposure to any of those sectors to be more than a blip on the radar screen. The energy sector fears are another overblown doom story. Firstly, oil has rebounded. Secondly, energy companies are in better shape than in 2015/2016. Thirdly, even then banks didn't rack up enough losses to hurt them materially.

High Yield and Leveraged Loans – What a Recovery



HYG, JNK, BKLN and SRLN – high yield and leveraged loan ETFs all fell hard into the black hole of illiquidity in December and have rebounded incredibly strongly (too strongly, possibly, but that is for another report). **Fears of bank balance sheets being in any danger**

are just overdone.

3. ***Yield Curves and Interest Rates***. I've never truly understood the fascination with 2s vs 10s as a benchmark for bank's potential net income. Sure, before the S&L crisis when an entire industry got into deep trouble for borrowing short and lending long, it made perfect sense, but it seems to me to be more of an old wives' tale than an effective way to look at banks NIM. Yes, banks lend long, on a floating rate basis where they can, and borrow shorter term, but more to capture the credit curve than the yield curve. So with 2s vs 10s still below 20 (they were 15 on Friday, up from 10 in late December but still well below the 30 they were at in October or the 50 they started 2018 at). I look at this and just can't get that worked up about it. What I suspect is that LIBOR continues to rise faster than interest paid on deposit or checking accounts. That less than 100% of every Fed hike makes its way into increased rates on deposit or checking accounts, so banks can earn more as they have net exposure to LIBOR on the income side versus other rates. That dynamic has been supported as the LIBOR vs OIS spread is increasing again. I think that LIBOR will rise into Asian year-end again (March 31st) as Asian banks have built up such a large U.S. presence and will have need for dollars coming into their year-end.
4. ***Transaction Volumes***. Whether it is bond underwriting, mortgage origination, refi's, or other forms of fee business, there is concern that we could experience a slowdown in these types of transactions. That's particularly true if we hit a recession. I'm not as worried about the transactional fee business as the bears, as I expect merely an economic slowdown rather than a recession. Additionally, with mortgage rates at multi-month lows we could see some positive surprises. However, this is the area where the bearish view seems most realistic.

Most of the reasons banks have done poorly relative to broad benchmarks are overstated or likely to be demonstrated as being wrong. As markets start pricing that in, look for banks to outperform.

What to Do with Bond Issuance

Buy longer dated bank bonds, or subordinated bank issues. Both seem relatively cheap and I fully expect that banks will resume their long-term trend of trading tighter than corporates. That relationship was violated with the financial crisis, but I see no reason why financials won't go back to trading tight relative to corporates (I won't rehash the reasons here, but it has been a multiyear view that's been working, and this hiccup creates an opportunity to add or reload).

I like LIBOR floaters in general. If ICE is going to combat the move to SOFR as the benchmark for floating rate paper, then they will have to do so by making LIBOR a market rate. Since LIBOR, by definition, should encompass a bank credit spread element, I think 'New' LIBOR if ICE ever gets it right, will trade much wider than 'Old' LIBOR making current levels of LIBOR + X attractive. I think LIBOR vs OIS will continue to drift wider. Evaluating the appropriate LIBOR/SOFR basis is become more important as SOFR bond issuance increases. I expect documentation standardization to continue. There will be alpha generated by either issuers or investors as the basis between LIBOR and SOFR evolved over time. **Buying SOFR bonds make sense at the correct spread differential.**

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