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IS THE FINANCIAL CRISIS FINALLY OVER?

It's hard even at this point in a new year to look back on the year just past and speak with any kind of detached analytical voice and with much (any?) degree of objectivity. And in trying to look back at 2016—a remarkable year by any objective set of standards—that statement is inarguably true. What can we say about a year that was doubly surprising—in both the "yes" vote on Brexit in the United Kingdom and in the election of the least likely presidential winner in American history—except: Who knew?

Looking at the banking industry results for 4Q16 and for the full year 2016 seems to be almost an exercise in normalcy in contrast to trying to gauge what's going on within American society at large. And, if we remember correctly, that's how it's supposed to be. Banks in America have historically represented islands of stability and calm within the American economy, no matter what conditions might exist in American politics or what societal turmoil might be ongoing. That position of banking institutional certainty has deteriorated somewhat since the 1980s.

There was one thing that was abundantly evident in 2016, and that quality was especially pronounced in the 4Q16 earnings conference calls. That "thing" was industry confidence—a near-universal conviction that American banking is solid, it's lean, it's poised for stronger growth, and that the political climate has finally morphed in such a way that will allow banks to resume the traditional leadership role that they have held in the American economy. We would say, however, that we have not detected (well, not much, anyway) the swagger that marked banking in the years leading up to the crisis. (We would note that those swaggering CEOs are mostly no longer in leadership positions in the industry.) Instead, there seems to be a real conviction that much of the hard work has been done—and indeed, remains ongoing—in building capital, cutting expenses, refocusing business lines, etc.—and that the payoff for that diligence could be just around the corner.

We have read several analyses of 4Q16 results that characterize the quarter as lackluster, but we would be inclined to disagree with that assessment. Yes, there was little demonstrated progress on the issue of Net Interest Margin ("NIM"), which received scant aid from the December rate hike by the Fed.

The uniform indication from CEOs of banks both large and small was that they expect that this important metric has bottomed and will begin to climb throughout 2017 if the Fed follows through with the expected 2-3 rate hikes. The better part of the NIM story in the fourth quarter was that competitive conditions for loan pricing in the Southeast seem to have not gotten out of hand, and there have been few demands from either retail or corporate depositors for higher deposit rates—thus deposit costs are widely expected to remain static in the near-to-intermediate term.

As always, we find it more useful to look at the Southeastern banking industry from the bottom up rather than from the top down, and to look at the banks in discrete segments. With that approach in mind, it is easy to see why other observers might see the banking industry outlook as somewhat static, as Wall Street analysts tend to concentrate on trends at the very upper end of the banking size spectrum. The largest banks in the Southeast—both the "majors" and the large regionals—continue to show depressed NIMs (uniformly under 3% for the very largest banks on both an annual and a sequential quarterly basis) and very subdued loan growth for 4Q16 (2.1% sequentially, a slowing from the 2.3% rate of the third quarter.)

The profitability of these large banking companies overall remains subdued as they continue to support high levels of regulatory liquidity and must maintain the large branch networks that are not yet economic under the present Fed rate regime. Overhead ratios at these banks remain stubbornly over 60% and will be unlikely to decline meaningfully until these companies get some help on the revenue side from rising rates and better loan demand. But we would also note that **Bank of America Corp. (BAC)**—still the South's dominant banking presence—was the most optimistic about future trends, as CEO Brian Moynihan highlighted very strong growth in several of its important consumer lending lines and in retail brokerage assets and accounts. In our view, stability and growth at this important bank will bode well for bank earnings and market sentiment generally and will truly mark the end of the Financial Crisis.

It is the "large community" banking sector ($5 billion-$15 billion in assets) in the Southeast that has commanded the bulk of investor attention and investment in recent weeks, and with good reason. If there is a slowing of growth or a mood of management stasis in this group of companies, we are hard pressed to find it. While NIM trends are always hard to normalize in these companies, due to the ebb and flow of purchase accounting accretion, our numbers showed improving NIM trends sequentially at several of these banks; the group overall showed sequential quarterly NIM stability at 3.69%. As for loan growth in this group, the pace of mergers and portfolio actions (sales and purchases) make normalized trends difficult to discern, but we would say that low-mid double digit organic loan growth remains the norm for these large community banks.

Can these banks improve growth much under the new regulatory and tax regime that is anticipated to come out of the White House in coming months? Possibly, although we would be concerned (as would regulators, likely) should we see loan growth accelerate hugely from here. The bigger opportunity for these companies would seem to lie in the ability to grow beyond the mandated $10 billion-in-assets mark without a change to their designation as "community banks" and the damage to profitability that results from the loss of material debit card revenues and from the heavier burden of compliance expenses from DFAST, larger FDIC burden, etc. In short, a regulatory regime that recognized that community banks should be recognized by loan portfolio composition and funding sources would seem to us to be a greater aid to long-term profitability and stock valuation than some spending plan that boosts loan growth on a short-term basis.

The smaller Southeastern community banks are likewise performing well and showing metrics somewhere between their very large and large community competitors. The $1 billion-$5 billion banks continue to enjoy a net interest margin advantage—3.80% on average in 4Q16, also stable with 3Q NIM—and are similarly enjoying mid-double digit sequential loan growth rates.

But the regulatory and compliance burden for these companies is clearly evident in their overhead ratios—at 56.1% on average in the fourth quarter, versus 55.6% in the third—which is considerably above the below-50% overhead ratios regularly achieved by the larger community banks. These smaller banks will (in most cases) continue to grow through mergers partly in order to achieve needed scale and drive costs down and partly to diversify lines of business that now remain largely centered on lending.

Another and broader word on the topic of expenses. We have received inquiries from the press recently on the topic of expense control and whether the need to continue to push costs down will diminish if margins begin to rise and the regulatory burden is lessened. The answer to that question is short and succinct: NO. Kelly King, CEO of **BB&T Corp. (BBT)**, spoke in that company's 4Q conference call about the banking industry being at a "tipping point" when it came to the need to acquire branches, and his words spoke as much to the topic of expenses as it did to that of the changing distribution methods for banking products. We cannot now foresee a time when the banking industry will be comfortable enough—devoid of competition from both bank and non-bank sources, not under pressure from lower-than-historical interest rates, free from the vagaries of the credit cycle—to put aside the culture of expense control that has become so engrained in the years since the Financial Crisis.

We'd also like to address the issue of credit quality, although it is difficult at this juncture to know what to say. It goes without saying that the banking industry is experiencing an interval of exemplary credit quality that is historic in both its duration and in its lack of loan losses. The 33 bps in credit losses registered by the largest banks in 4Q16—up 2 bps sequentially—is an achievement that could scarcely be imagined only eight short years ago. And losses in the large-and-smaller community banks in the quarter—10 bps and 5 bps respectively—are equally remarkable and are little changed from the levels of previous quarters. It is tempting to ask—does the credit cycle still exist?

It is certainly difficult to see how credit quality normalizes from here and to come up with any credible numbers with which to model levels of loss that may be experienced in the different loan categories during a full business cycle. The 1%-of-loans loss levels that used to be predicted by companies like BB&T as reasonable guidelines no longer seem to be relevant, and even as we continued to hear regulatory cautions about deteriorating credit quality in the commercial real estate segment, those losses did not seem to be widely visible in 4Q16 results.

We would note, however, one metric that has appeared in the last few days and that gives us pause, perhaps because of the recent history of credit losses. That was the disclosure by the Mortgage Bankers Association on Feb. 15 that delinquencies in the subprime housing segment rose 72 bps in 4Q16, to 9.02%, off the lowest level of losses in that sector since 1997. (The offsetting good news was that only 0.28% of home loans went into foreclosure in 4Q16, which is the lowest level of loans entering that status since 4Q88.) Added to the experience of rising subprime auto loans first seen late last year, it's hard not to wonder if subprime consumer loans will be the first loan "type" to bite us once again. The good news is that these loss numbers are rising off historic lows, and that the economic backdrop of rising employment and increasing wages would not seem to support widespread deterioration, even in subprime loan categories.

So not, in our view, as dismal a quarter as lamented by some, and indeed the advance in the bank stocks in recent days—whenever the words "tax policy" are uttered by President Trump—would seem to indicate that there is even more upside in a group of stocks that rose 58% in the past year. Are the bank stocks now overvalued? That's a tough one to answer, and we must admit that we get nosebleed when we look at the valuations of some of the stocks in the "large community" segment, where the average stock price is now approaching 3x tangible book value. It must also be remembered that rising rates will depress book value (as we saw in 4Q16) in the near term, so it is indeed possible that valuations can look even more skewed as the rate climate normalizes.

As we are writing this, we have to hearken back to the third paragraph of this piece, in which we describe the confidence with which banking industry CEOs seem to be approaching the future. We also have to reference the singular event in the banking industry thus far in 2017—the merger between **Pinnacle Financial Partners (PNFP)** and **BNC Bancorp (BNCN)**—and our oft-stated conviction that this deal is a game-changer in its creation of a new "mega-community" bank that will go on (and grow on) to even more seriously challenge the competitive status quo in the Southeast. (And will soon be followed by several deals of a similar nature, we're sure.)

It will be great if President Trump turns out to be the change agent for the banking industry—and for corporate America generally—that many of us hope that he will be. (It will similarly be a waste of great promise if he squanders that opportunity for change on wars with his intelligence community and with the media.) But the good thing for banks—both large and small—is that they are not dependent on the kindness of strangers for growth in the environment that seems to be building in the wake of the end of the Financial Crisis, and they seem poised to do just fine on their own.

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