B | S Perspectives

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2018 In Review

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HEADED SOUTH

When did everything head south? That was the thought that occurred as we sat down to write this piece. After all, the year 2018 had certainly begun on an optimistic note—the economy was experiencing its best rate of growth in a decade, the Trump presidency (in contravention to all the punditry) had not yet come off the rails, a new Fed Chairman was coming into place who would set right the environment of financial repression that had persisted since 2008, and all this positive news was seemingly set to result in a banner year for the American financial markets and the American banking industry.

Well, whatever happened to that good feeling? It’s hard to pinpoint the exact moment that the rosy scenario faded to gray, but it seemed to happen in late summer or early fall, when the markets began to figure out that Fed Chairman Jay Powell was serious in his campaign to “normalize” interest rates—no matter what the effects upon American capital markets might be in that campaign of raising rates and shrinking the Fed’s balance sheet. Indeed, some economic pundits ascribe the beginning of the market’s dive to Chairman Powell’s comments on October 3, when he said that rates were “a long way from neutral” and that indeed, an overshoot past neutral might be a possibility.

Oops. While Jay Powell and his colleagues at the Fed have spent hours trying to walk back that commentary and convince investors that the Fed will be “data driven” and will be responsive to financial conditions going forward, those reassurances have taken place against a background of growing global slowing, ominous profit warnings from tech companies, White House disarray, a potentially destructive partial government shutdown, a misplaced attempt by Treasury Secretary Mnuchin to reassure investors of the soundness of the nation’s largest banks, and on and on. In retrospect, it’s a bit of a surprise to us that the damage to the markets has not actually been more extensive than it has been, given the mood of extreme uncertainty and nervousness that prevailed in the final days of the year.

And the banks, being the eternal canaries in the coal mines of the global financial system, have indeed been hit hard. The KBW Bank Index declined 19.6% for 2018 versus the (bad-enough) 6.2% decline for the S&P 500, while the NASDAQ Bank Index (BANK) did a tad better, declining 18.4% for the year. But as bad as those collective declines were, they mask the depth of the damage to some of the industry's highest fliers—in our monitored list of 18 Southeastern banks, six declined more than 25% for the year—and the declines were not limited to banks with low returns or sketchy asset quality histories. Indeed, some of the community banking segment's best-regarded and highest-performing banks—**Pinnacle Financial Partners (PNFP)** and **South State Corp. (SSB)**, most notably—saw their stocks decline more than 30% for the year.

This dismal bank stock performance was especially ironic in light of an increasingly optimistic view of the fundamentals on the part of bank CEOs as we moved through the sequence of quarterly reports. The year admittedly saw some "headwinds" that had not been anticipated at the beginning of 2018—a more heated competitive environment for deposits and an elevated level of loan paydowns and payoffs that dampened overall reported lending volumes—but these were seen to be coming to an end in the third quarter, and management optimism was improving that the underlying strength of the economy would finally come to be reflected in bank earnings.

It will be interesting to see what happens to that environment of nascent optimism when 4Q18 earnings begin to be revealed and discussed in a couple of weeks. We had spoken with some Atlanta-area community bankers in the last weeks of December, and the volatility of the stock markets and the flow of negative economic news had not at that point been reflected in their customers' overall positive sentiment about their own growth prospects. These bankers made two very valid points—that the greater Atlanta economy is often out of sync with national economic trends (as in the wake of the Financial Crisis, when Atlanta took longer to recover) and that the small businesses whom community banks serve are often not materially impacted by global trade trends.

As 3Q18 trends showed us, the Southeastern banking industry is going into 2019 with some formidable ammunition. Both the region's largest banks and the banks in the large community segment continue to produce collective returns on tangible equity approximating 17% and returns on assets in the 1.40%-1.50% range. And while there was some minor deterioration (5 bps, to 3.89%) in net interest margins from 2Q18 levels in the large-community segment—which is the region's most competitive pricing sector—that trend should ameliorate as short rates continue to rise and the most recent round of competitive deposit pricing begins to tail off.

We would not expect to see dramatic changes in Southeastern banking profitability in the upcoming fourth quarter results, as any changes in business confidence or investment plans will not likely be immediately impacted by the turmoil that has been seen in markets globally and by the political antics in Washington. But we will be especially focused—as will all industry participants—on the management commentary concerning customer confidence and business conditions, and we would hope that CEOs and CFOs will be realistic in their guidance for earnings (to the extent that they give any) for this year.

We don't think that any bank will be rewarded for over-promising earnings in what is likely to be a tumultuous year, and management time will be better spent on talking about what they might do to strengthen balance sheets and improve infrastructure (i.e., technology) to prepare for more productive months ahead. Thoughtful—and let us emphasize that word—cost control is obviously going to be an ingredient of earnings success this year, and there are few banks on our monitored list that cannot do more to bring costs down. High levels of overhead are an especial problem for the $1 billion-$5 billion asset segment, and the recent posture of lessened regulatory scrutiny toward these banks should go some way toward remediating the high regulatory burden imposed on smaller banks.

Bank analysts have not paid much attention to asset quality in recent quarters, but we believe that that posture of indifference will likely change this year. The recent spate of negative news on the condition of the leveraged loan market—not an issue with community or even regional banks but possibly an issue systemically—has touched off concerns about the impact of rising rates on such diverse lending segments as commercial real estate, autos and credit cards.

Asset quality concerns, when they arise, seldom confine themselves to one segment of loans but tend to become diffuse throughout the spectrum of bank lending, and we expect to hear a lot of questioning on a lot of fronts in the coming weeks. But as with other aspects of banking results in 3Q18, asset quality remains—well, exemplary, to use a tired phrase—and it is indeed hard to see how these low levels of losses can persist in the face of rising rates and slowing growth (if that indeed comes to pass.) Net losses of 30 bps for the largest banks (versus 29 bps in 2Q18) and a negligible 10 bps for the large community banks (versus 8 bps in 2Q) stand starkly in contrast with the 100-bps plus level of losses that has been the industry standard during the business cycle historically, and "lumpiness" (and volatile credit quality metrics) are likely to be the norm over the coming year.

Our experience over 37 years now has been that banks lead the economy into recession, and then lead it out. That's why the concept of recession—no matter what strange gyrations the yield curve may make—seems so remote to us. We did not need Secretary Mnuchin to tell us that the banks have more than adequate liquidity and have the willingness and ability to lend to support continued economic activity, as that ability is readily seen in the strength of bank capital levels and in the robustness of bank profitability. But we do think that there are legitimate questions about a few areas of bank strategic direction that have arisen as a result of the recent decline in bank stocks.

What about the deposit wars—will they be aggravated again as banks see the need to lock in core deposits and customers in advance of an economic slowdown and lock in liquidity as the Fed continues to drain the system? Or will depositors—both retail and commercial—come to value bank stability and soundness (as they did in the wake of the Financial Crisis) and care less about a few extra basis points of interest? These are intriguing questions, and we suspect that the issue of funding will remain top of mind for bank stock investors in the coming year.

And finally—what about mergers? It stands to reason that the massive decline in bank stocks (of both acquirers and likely targets) would have some impact on the outlook for what has been a very lively M&A environment, and that the impact would be a depressive one. But we are not so sure that historical experience will prevail this time around. For one thing, the stocks of possible target banks and likely acquiring banks in most instances have shown declines of roughly equal magnitude, and in some instances the stocks of high-quality acquirers—like **TowneBank (TOWN)**, **Home Bancorp (HBCP)**, and **United Community Banks (UCBI)**, to name only three—have shown better stock performance than some of their likely merger partners.

But the bigger factor that may stand historical merger wisdom on its head is the fact that many of the smaller banks—those $1 billion-$5 billion in assets—continue to struggle with issues of higher funding costs and stubbornly high overhead that will likely only be aggravated in any economic downturn. Indeed, we believe that these banks may choose—in spite of the overall decline in bank stocks—to seek out merger partners now, with a longer-term view of valuations (and their eventual paydays) in mind.

The coming year will indeed be an interesting one for the banking industry, and we suspect that things may turn out wholly differently than anything that we can foresee right now. In any case, the Southeastern banks can take solace in one unalterable fact—that the Southeast remains the region for in-migration of population, for relocation of businesses, and for a brand of economic dynamism that is unrivalled in the nation. In an industry where demographics are destiny, and more and more Americans are headed South, it's hard to see anything but growth for the Southeastern banks.

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