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Curveball

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Well, it has not exactly been a wonderful year thus far for either the banking industry or for bank stocks. A year that began with the strong probability of rising rates (perhaps rising meaningfully) and with the assumption that strengthening business confidence would finally translate into higher credit line utilization and stronger loan volumes is coming (limping?) to its midpoint in a dramatically different state. The watchword at present is "uncertainty"—uncertainty about trade, uncertainty about the strength of economic growth, uncertainty about the starting date of the next recession, and political uncertainty galore—and in the background is a Federal Reserve Board trying to navigate its way through a minefield of competing constituencies and Presidential mayhem, all the while remaining "data dependent."

The numbers present a curious picture of the state of the bank stocks at mid-year. The bank index that we track—the **KBW Bank Index (BKX)**— massively underperformed the broader market in the 12 months prior to June 30, declining 5.7% versus an 8.2% rise for the S&P 500. The performance of the bank sector year-to-date is more measured—the index is up a noteworthy 14.2% in the last six months versus a remarkable 17.4% rise for the broader market, and indeed the BKX was up 4.7% in the second quarter versus a 3.8% rise for the S&P 500. That was not a result that we expected, and it seems to be mostly due to modest outperformance on the part of the large banks (up 5%, roughly) coupled with some strong bounce-backs in the community banking segment, with the stocks of **Ameris Bancorp (ABCB)**, **United Community Banks (UCBI)**, **Home Bancorp (HBCP)** and **SmartFinancial Inc. (SMBK)** all up 14% or better in the second quarter.

So—more contortions and distortions in bank stock performance than in the yield curve itself. So what gives? Indeed, the yield curve and its weird and wobbly intermittent inversion is the major driving force behind the bank stocks on a daily basis, with every change in the shape of the curve resulting in some new forecast of doom (or not) on the part of market pundits. Never before in our 37-year career have we seen so much angst result from every minor move in interest rates, and it's beginning to seem reminiscent to us of the reading of pigeon entrails by the soothsayers of ancient Rome. (Properly known as haruspicy, in the fascinating factoid of the day.) What does it all MEAN?

What it means is that the "policy pivot" on the part of the Fed has put a serious kink into the earnings plans of the banking industry and the spending and investment plans of its core customers, and we're all now going to spend a lot of time figuring out how that plays out in the months to come. We have spoken with several bankers in recent weeks on the subject and we feel confident in saying that many (most?) CFOs in the industry are still pondering the question of how to manage the process of asset and liability management in a yield curve environment that has few precedents and in an environment where hedging rates for future moves is just too expensive a proposition to contemplate.

It's pretty clear that we will be back to discussing a subject that we thought had been consigned to that of background noise—deposit rates and what both commercial and consumer depositors will accept. The task of taking down deposit pricing in the current environment has been made much more difficult by the fact that the "pivot" by the Fed (sounds so much better than "retreat") was made so swiftly and so completely and came at a time when the expectation of higher rates (especially for commercial customers) had just been baked into everyone's earnings expectations. We now have to ask the question of how these banks—especially the community banks, where the battle for funding is especially fierce—will persuade their customers to accept lower deposit rates at a time when many of them had just negotiated new and higher deposit pricing.

And then there is that old reliable strategy to offset an uncertain revenue outlook—cutting operating expenses. This time around that will be a harder task to enact, as the first round of branch closings and consolidations (with the natural reductions in associated personnel) has pretty much passed through the banking industry and the need remains to invest in the mobile and digital technology to keep those branch customers engaged. While we may have reached "peak fintech" in terms of banking competition, it seems to us that banks at this juncture need to remain especially vigilant in the areas of product innovation and branding to keep up the battle for the Millennials and to stay abreast of whatever may be coming down the pike in the areas of blockchain, digital currencies, and other nascent technologies.

Thank goodness this period of rate craziness and Federal Reserve confusion is taking place against the backdrop of a rudely healthy banking industry—as just demonstrated by the results of the stress tests and the estimated 100%+ of net income that will be returned to shareholders by the nation's 18 largest banks. While these results cannot always be extrapolated to the industry as a whole—there are still mid-sized regional and community banks that are facing issues of loan concentrations and deposit competition—we still feel safe in saying that the great majority of American banks are both very well capitalized and well funded and are ready to face whatever challenges may be looming.

A final couple of things to think about. First, if you are a small-ish community bank and have not yet entertained the thought of merging with another bank, it's time to do so. It strikes us that what is being signaled by the yield curve—the lack of inflation, the prospects for low growth in coming years, and the willingness of investors to accept low returns in exchange for safety—are not conditions that will diminish in the near term but are here for some time to come. As we said earlier, cutting expenses (and gaining market share) will be even more important in the future, and sensible mergers present the best prospects for doing both those things. But we would also caution that this erratic environment and the prospect of subdued bank revenues do not lend themselves to sky-high deal premiums, and valuations should be considered accordingly.

A final thought—every well-capitalized bank that is not laboring under some massive credit quality or revenue issue should be returning capital to shareholders. Period. The time has passed for the "we're not utilities and don't want to be considered as such" and the vanity that that statement signifies. Banks may not be utilities, but they need to have the devoted shareholder bases that hold their stocks for the long term and deserve to be rewarded accordingly, and a hefty part of that reward needs to be a dividend as opposed to a repurchase of shares. A growing stream of dividends signifies health in any company, but especially in banks, and the chances are good that there is not a higher and better use of that capital.

So the banking industry has been thrown a curveball, indeed, and by more than just the yield curve. The game has changed—mid-inning—and there may be more jolts to come, depending upon the outcome of the election in 2020. Time to dust off Plan B—and maybe a couple of plans beyond that—or better get one, and soon.

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