HOW VULNERABLE IS THE US BANKING SYSTEM?

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The contrast between 2008 and today could not possibly be more obvious. Simply put, while the financial health of the banking sector in 2008 was the weakest in decades, it was the strongest in decades at the start of this year. The actions of bank managements and regulators over the past decade have resulted in an exceptionally sound banking system. Since 2010, commercial banks have aggressively deleveraged their balance sheets, significantly added to capital and liquidity, and adopted extremely conservative underwriting standards in lending practices.

Summary and Major Conclusions:

- The near collapse of the banking system in 2008 was a major factor accounting for the depth and longevity of the Great Recession. A healthy banking system is vital for establishing a solid foundation for healthy and sustained economic growth.

- Perhaps more than any other industry, commercial banks are heavily dependent upon macroeconomic trends. Unsurprisingly, bank stocks have responded negatively to the recession, declining to their lowest levels since 2016.

- In stark contrast to today, the financial health of the banking sector in 2008 was the weakest in decades. Following ten years of conservative management, the banking sector was the strongest in many decades at the onset of this recession.

- The exceptionally strong health of the banking system can be evaluated through various key balance sheet metrics, including capital and liquidity ratios, loan growth, nonperforming loans, and core deposits.

- Regularly scheduled bank stress tests conducted by the Federal Reserve provide reassurance that banks are able to survive under extremely harsh economic conditions. These stress tests are effective means for regulators and investors to gauge the risk of bank failures, both at the macro and individual bank levels.

- The recession puts bank earnings at considerable risk in the short term. Earnings for the banking industry declined by more than 30% in the first quarter and could fall by more than 25% for all of 2020, the result of a sharp rise in provisions for future loan losses.

- Assuming a return to GDP growth in Q3 and Q4 of this year, banks are unlikely to cut their dividends. Exceptionally strong balance sheets, relatively low payout ratios, and a low likelihood of losses in net income suggest that dividends will be maintained.

- Bank stocks appear attractive for long-term investors, based upon a combination of much improved fundamentals and compelling valuations. Over the next five years, I expect earnings per share (EPS) to increase at an annual rate that exceeds that of the S&P 500, providing support for superior relative stock performance.

- Valuations for bank stocks are extremely attractive, and at multi-decade lows. The price-to-earnings (P/E) ratio for the bank index has plunged to 7.5x normalized EPS, down from an average of 12x in recent years and 17x for the S&P 500.

- The most reliable valuation metric for banks is the price-to-book ratio, which has averaged 1.4x in recent years. Currently at only 0.75x, this ratio has fallen below 1.0x for the first time in nearly five years.

- Banks would be at maximum risk in the event of a protracted recession, which would increase the level of nonperforming loans and bring about a corresponding rise in loan loss provisions, causing a further reduction in reported earnings.

- In an elongated recession, a prolonged period of high unemployment would trigger a spike in loan losses on credit card, auto, and residential mortgage loans. Similarly, the likely increase in business failures would also accentuate loan losses on commercial and industrial loans.

- Although the short-term outlook for bank stocks is unfavorable, investors can expect a sharp rebound in bank stocks later this year and in 2021. I expect bank stocks to outperform the broad equity market over the next three years.

"Call it a reverse run on the banks. Companies and consumers flooded US banks with a record $1 trillion of deposits in the first quarter, when markets went haywire. More than half of it went to the four largest banks. The $590 billion in deposits they gained in the first quarter is nearly double the previous quarterly record of $313 billion for all banks, according to the Federal Deposit Insurance Corporation.

The massive growth in deposits shows how different this crisis is from the last one. In 2008, America's biggest banks were the bad guys that nearly destroyed the economy. Now, they are a refuge for jittery businesses and consumers who are waiting out the shutdown. Much of the $1 trillion in deposits flowed into the banks during a two-week span in March, as companies were frantically drawing down on their credit lines and stockpiling cash in preparation for the next recession."

David Benoit
The Wall Street Journal
April 24, 2020

The financial health of the US banking sector has been a focus of my weekly reports over the past decade, with one basic purpose in mind: *The near collapse of the banking system in 2008 was the major factor accounting for the depth and longevity of the Great Recession*. *A healthy banking system is imperative in creating a solid foundation for healthy and sustained economic growth and prosperity*. This week's *Economic Perspective* provides an update of the US banking sector in response to the current economic and financial crisis.

HOW VULNERABLE IS THE BANKING SECTOR TO THE CURRENT ECONOMIC CRISIS?

Perhaps more than any other industry, commercial banks are heavily dependent upon macroeconomic trends. Loan growth and fee income are closely linked to economic growth; net interest margins are primarily determined by interest rate trends and the shape of the Treasury yield curve; and credit losses are greatly influenced by trends pertaining to corporate earnings, cash flow, and unemployment. Unsurprisingly, bank stocks have responded negatively to the recession, declining to their lowest levels since 2016 (see chart 1).

Chart 1: Bank Stocks Have Collapsed Since February
KBW US Bank Stock Index
Source: KBW Research

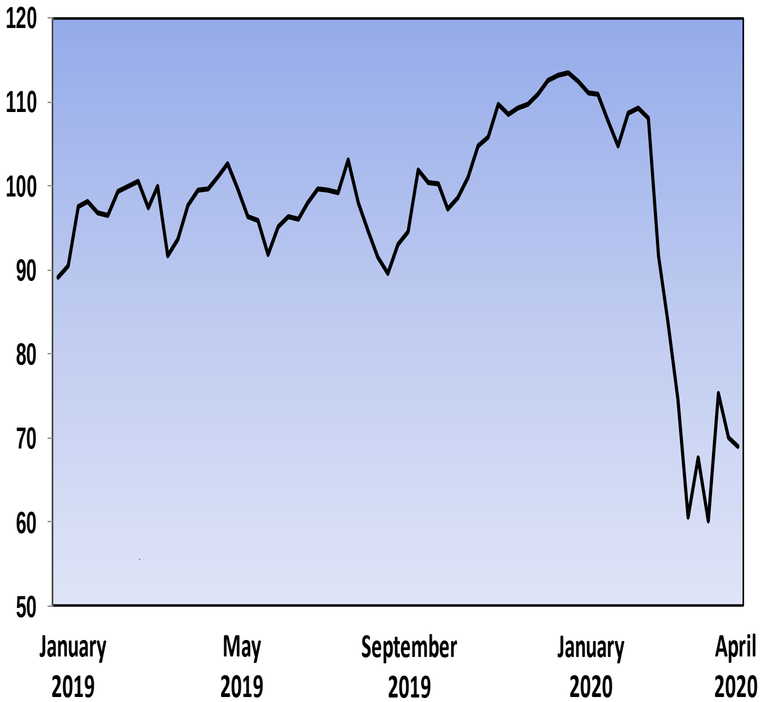
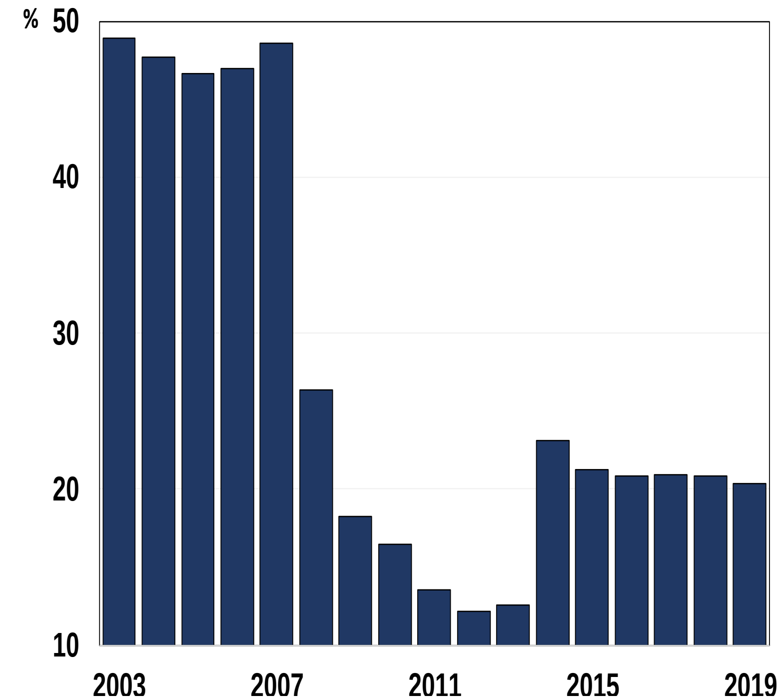


Chart 2: Banking Sector Has Deleveraged Massively Since 2010
Debt as a % Share of Total Bank Assets
Source: Bloomberg



HOW WOULD YOU COMPARE THE CURRENT FINANCIAL HEALTH OF THE BANKING SYSTEM WITH THAT PRIOR TO THE 2008 FINANCIAL CRISIS?

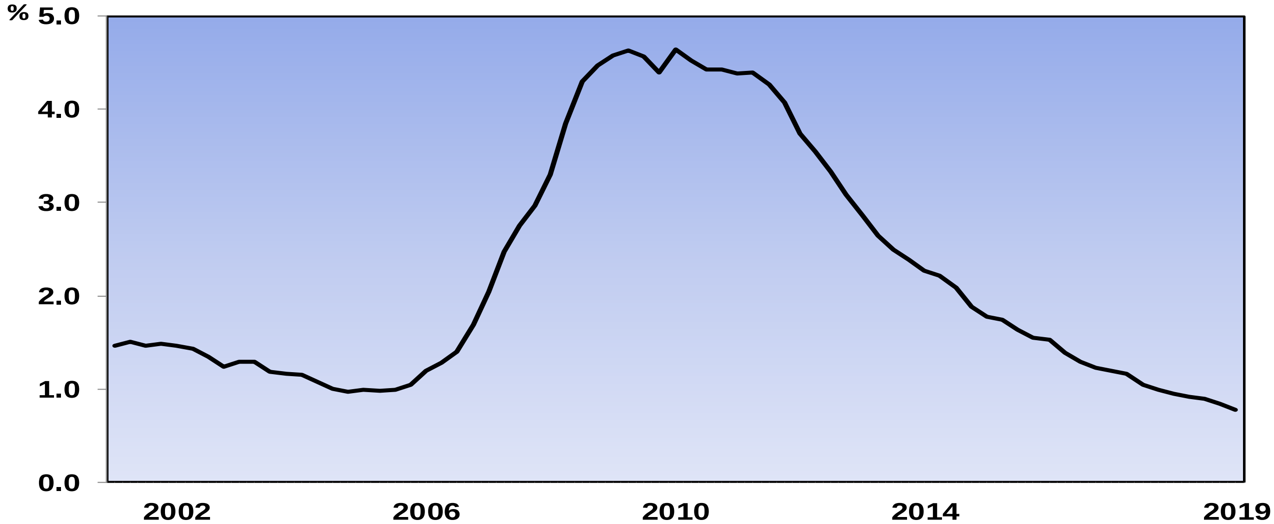
There is no comparison. The contrast between the two periods could not possibly be more striking. Simply put, *while the financial health of the banking sector in 2008 was the weakest in decades, it was the strongest in decades at the start of this year*. The actions of bank managements and regulators over the past decade have resulted in an exceptionally sound banking system. *Since 2010, commercial banks have aggressively deleveraged their balance sheets, significantly added to capital and liquidity, and adopted extremely conservative underwriting standards in lending* (see chart 2).

WHAT METRICS ARE YOU USING IN YOUR COMPARISON?

There are several basis measures to assess the health of the banking sector. These include capital and liquidity ratios; the ratio of loans to deposits; the level of loan losses leading up to the crisis; and the level of reserves for future loan losses. Each of these measures of financial strength is the most favorable in many decades:

- Core capital ratios for banks are the strongest since 1985. The *common Tier 1 Equity Ratio is at a multi-decade high of **13.2%***, providing a strong cushion against loan losses.

Chart 3: US Banks Entered the Recession in Excellent Health
Foreclosures as a % Share of Total Loans
Source: Mortgage Bankers Association



- Banks entered the crisis with exceptionally high liquidity ratios. The combination of cash, US Treasury bonds, and US government agency bonds comprise **30%** of the total assets of large banks, an all-time high and up from only 12% in 2010.

- Bank assets are supported by safe bank deposits, which comprise nearly 90% of total bank liabilities, the highest on record. The loan-to-deposit ratio for large FDIC banks has fallen to only **63%**, down from an aggressive 90% in 2007.

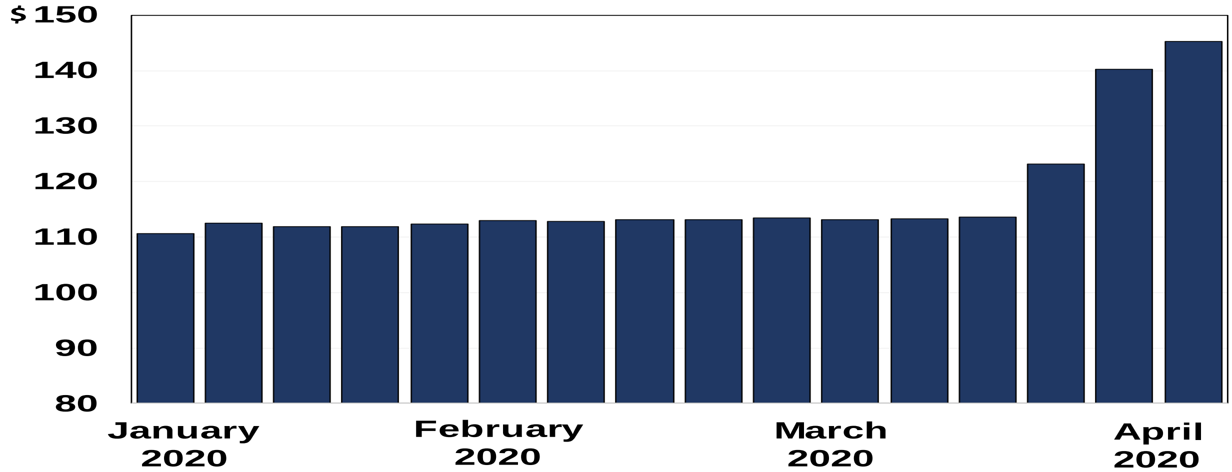
- Banks exhibited unusual caution in lending over the past decade. *Total bank loans increased at a meager annual rate of **3.8%** since 2010, the slowest of any expansion cycle since 1945*. For all expansion cycles, the average annual growth in loans was 10%. Sluggish loan growth reflects exceptional conservatism on the part of bank managements and the protracted deleveraging cycle over the past decade.

- Nonperforming loans fell to less than 1% of total loans at the end of last year, well below their long-term average of 2.2% (see chart 3).

WHAT IS THE OUTLOOK FOR BANK EARNINGS?

According to FDIC data, banking sector net income rose to an all-time high of $235 billion in 2019, fully 60% above the previous cyclical peak in 2007. The recession puts bank earnings at considerable risk in the short term. Earnings for the banking industry declined by more than 30% in the first quarter and could decline by more than 25% all of this year.

Chart 4: A Sharp Increase in Bank Loan Loss Reserves
Provisions For Future Bank Loan Losses ($ Billions)
Source: FDIC



<u>In principle, bank earnings are dependent upon five primary factors</u>: Loan growth, net interest margins, fees and other noninterest income, credit losses, and operating expenses. Of greatest importance are provisions for future loan losses, which are immediately deducted from net income.

The sharp decline in first quarter earnings can be attributed mainly to a steep rise in provisions for loan-loss reserves on the expectation of large losses on nonperforming loans. Another factor was the steep decline in yields on new loans, caused by falling interest rates. Both of these factors will be lingering depressants on bank earnings in the next two quarters, before bank earnings begin to stabilize in the fourth quarter.

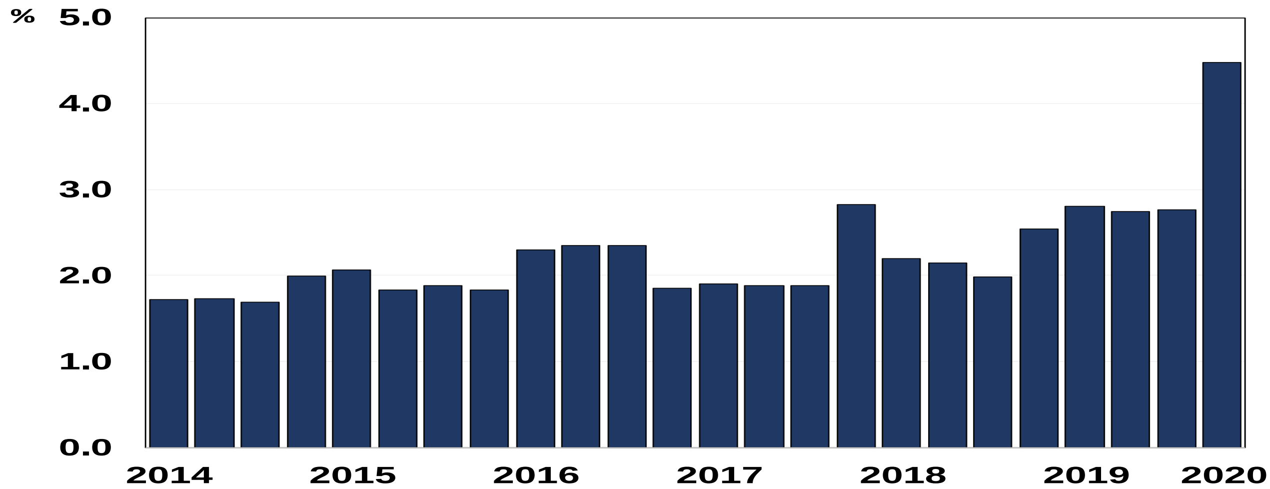
WHAT IS THE LIKELIHOOD OF OUTRIGHT LOSSES IN BANK EARNINGS?

A 100% decline in banking sector earnings in 2020 is highly unlikely. For that to happen, it would be necessary for bank loan losses to increase to unprecedented levels. Loan loss provisions in 2019 were $55 billion, far less than 1% of average loans outstanding. It would take loan loss provisions of $300 billion — the equivalent of 3% of loans — to generate losses for US banks, a fivefold increase from yearend 2019 levels (see chart 4).

<u>A comparison with the 2008 world financial crisis provides some perspective</u>. Loan loss provisions spiked to 3.3% of average loans outstanding in 2009. However, there are four major differences between now and 2009:

- Banks entered the 2008 recession in very poor financial health.
- The 2008 recession was one of the longest recessions since 1945; I expect the 2020 recession to be one of the shortest.

Chart 5: Banking Sector Dividend Yields Have Doubled Since February
Current Dividend % Market Yield
Source: Bloomberg



- While the Bernanke Federal Reserve moved aggressively to support the financial system, the Powell Fed has moved far more aggressively, providing trillions of dollars in support for credit markets and the economy.

- The quality of assets serving as collateral for loans is far superior to that in 2008.

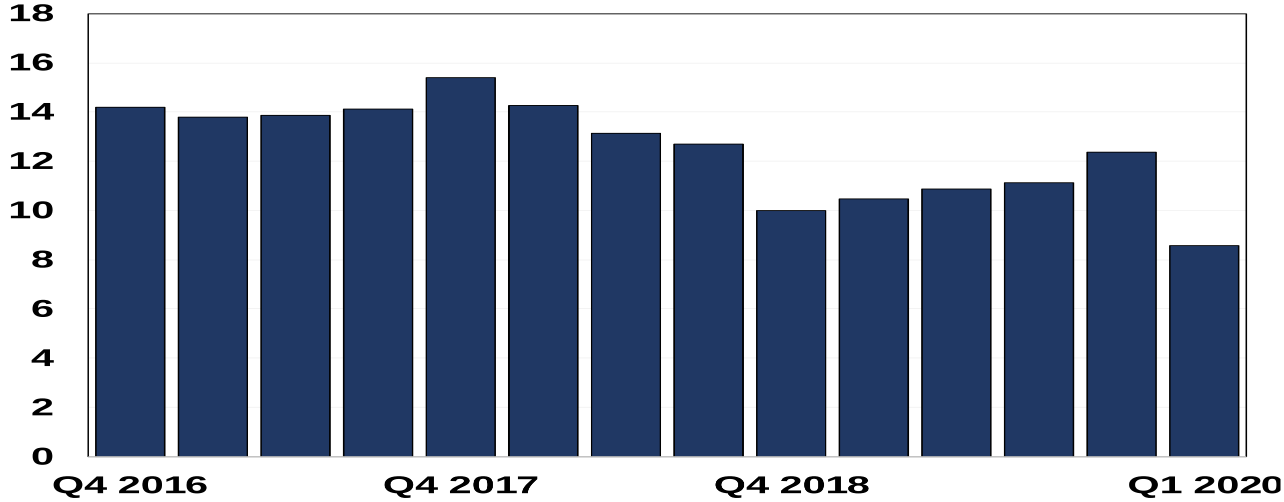
To conclude, bank earnings are unlikely to sink into the red, even under more disastrous economic and financial conditions. *As an additional reference point, bonds of the largest banks are no longer flashing red*. Option-adjusted spreads (OAS) have narrowed significantly in recent weeks.

ARE BANK DIVIDENDS AT RISK?

The steep decline in bank stock prices has pushed dividend yields to nearly **4.5%**, up from an average of 2.5% over the past year, and more than double the 2.2% dividend yield for the S&P 500 Index. The dividend payout ratio has averaged 33% over this period, well below that of the 50% average for the S&P 500. Banks have increased dividends per share at a 16% annual rate over the past five years, more than double the rate of the S&P 500.

Assuming a return to GDP growth in Q3 and Q4 of this year, banks are unlikely to cut their dividends. Exceptionally strong balance sheets, relatively low payout ratios, and the small likelihood of losses in net income suggest that dividends will be maintained. Banks have been aggressive buyers of their stocks in recent years, but share buybacks have been appropriately suspended for this year. The primary risk to bank dividends would be a much more prolonged recession, which is certainly possible, but unlikely (see chart 5).

Chart 6: Bank Valuations Are Exceptionally Attractive
Price-to-Earnings (P/E) Ratio
Source: Bloomberg



WHAT ARE THE PROSPECTS FOR BANKING SECTOR STOCKS?

Bank stocks appear attractive for long-term investors, because of a combination of much improved underlying fundamentals in recent years and compelling valuations. Although return on shareholder's equity (ROE) could decline to the low single digits this year, the average 12% ROE in most recent years is the highest in 15 years. I expect a gradual return to the level of ROE just prior to the crisis. Over the next five years, I expect earnings per share (EPS) to increase at an annual rate that exceeds that of the S&P 500, providing support for superior relative stock performance.

COULD YOU QUANTIFY THE DEPRESSED CONDITION OF MARKET VALUATIONS?

Valuations for bank stocks are extremely attractive, and at multi-decade lows. The price-to-earnings (P/E) ratio for the bank index has plunged to **7.5x** normalized EPS, down from an average of **12x** in recent years and **17x** for the S&P 500. The most reliable valuation metric for banks is the price-to-book ratio, which has averaged 1.4x in recent years. Currently at only 0.75x, this ratio has fallen below 1.0x for the first time in five years (see chart 6).

WHAT IS THE GREATEST RISK FACING BANKS?

The banking sector would be at maximum risk in the event of a protracted recession, which would increase the amount of nonperforming loans and bring about a corresponding rise in loan loss provisions, causing a further reduction in reported earnings in future quarters. *In an elongated recession, a prolonged period of high unemployment would trigger a spike in loan losses on credit card, auto, and residential mortgage loans*. Similarly, the likely increase in business failures would accentuate loan losses on commercial and industrial loans.

INVESTMENT SUMMARY

Because of its broad exposure to macroeconomic conditions, the banking sector is uniquely vulnerable to recessions and other adverse economic scenarios. A sharp increase in loan losses will result from spreading business failures and consumer defaults on credit card, auto, and mortgage loans. Bank earnings are expected to decline by more than 50% during the first half of this year. The S&P 500 Bank Stock Index has declined by nearly 40% from its recent peak in early February.

In sharp contrast to 2008, the banking sector entered the recession in excellent financial health, with multi-decade highs in capital and liquidity ratios. The implication is that the banking system will not exacerbate the current recession as it did in 2008 and 2009. Moreover, absent the massive deleveraging and recapitalization cycles following the 2008 recession, the banking system should support a solid recovery later this year and in 2021.

The banking sector appears attractive on a valuation basis, selling at a P/E ratio of only 7.5x, based upon normalized earnings, down from a recent average of 12x in most recent years and a steep discount to the P/E of 17x for the S&P 500. The current dividend yield on the bank index is 4.5%, more than double that for the overall market. Although the short-term outlook for bank stocks is unfavorable, investors can expect a sharp rebound in bank stocks later this year and in 2021. I expect bank stocks to outperform the broad equity market over the next three years.

Robert F. DeLucia, CFA, was formerly Senior Economist and Portfolio Manager for Prudential Retirement. Prior to that role, he spent 25 years at CIGNA Investment Management, most recently serving as Chief Economist and Senior Portfolio Manager. He currently serves as the Consulting Economist for Prudential Retirement. Bob has 45 years of investment experience.

Bloomberg Barclays U.S. Treasury Inflation-Protected Securities (TIPS) Index: Measures the performance of rules based, market value-weighted inflation protected securities issued by the U.S. Treasury. It is a subset of the Global Inflation-Linked Index (Series-L).

CBOE Volatility Index: An index of implied equity market volatility, reflecting the market estimate of future volatility for the S&P 500 Stock Index over the next 30 days, using options.

MSCI Emerging Market Index: An index of equity market performance for developing markets, primarily in Asia, Latin America, and Eastern Europe. The index tracks both large-cap and small-cap stocks and is weighted by market capitalization.

MSCI World Ex US Index: Measures the performance of the large and mid-cap segments of world, excluding US equity securities. It is free float-adjusted market-capitalization weighted.

Russell 2000 Small-Cap Index: Is an index measuring the performance of approximately 2,000 small-cap companies within the United States.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

State Street Investor Confidence Index: measures investor confidence or risk appetite quantitively by compiling actual buying and selling patterns of institutional investors.

US Trade-Weighted Dollar Index: An index that measures the value of the US dollar in relationship with other currencies, statistically weighted on the basis of importance to the US as trading partners.