NASHVILLE NOTES

Looking for EPS Follow-Through

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By Jeff K. Davis

Jeff Davis is a veteran bank analyst. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of S&P Global Market Intelligence; Mercer Capital, where Davis is the managing director of the financial institutions group; or StillPoint Capital, where Davis is a registered representative.

As a longtime subscriber to Grant's Interest Rate Observer, I recently purchased coasters from the firm's "40th-anniversary store" to acknowledge our relationship. The coasters include images created by Grant's cartoonist, Hank Blaustein. On one, a young analyst is questioning the valuation of a stock. An old guy (a portfolio manager, presumably) retorts, "The market's going up. That's the valuation!"

The cartoon was published in 2003 but resonates now after a big run that began in the fourth quarter of 2022 for the S&P 500 and Nasdaq and the fourth quarter of 2023 for bank stocks.

The S&P 500 Bank Index rose 34% for 2024, paced by Wells Fargo & Co. and JPMorgan Chase & Co. with respective gains of 43% and 41%. The Nasdaq Bank Index rose 17%, while the KBW Regional Nasdaq Bank Index rose 10%. The respective gains from Sept. 30, 2023, were 63%, 46% and 37%.

The rally reflected multiple expansions rather than earnings-per-share growth. Aside from banks with big Wall Street operations, full-year 2024 EPS growth for most banks will be flattish versus 2023, following two years of modestly lower EPS in 2022 and 2023 due to declining net interest margins and sluggish loan growth.

Earnings are, of course, cyclical, but long-term earnings growth is the mother's milk of successful investing. The other component is the price paid, as reflected in the market saying, "bought right is half right." Counting on multiple expansions is tough versus long-term compounding of earnings, however.

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During the fall of 2023, banks were trading at about 8x to 9x 2024 consensus estimates, a level that most would consider "cheap," assuming analysts would not have to hack estimates in 2024 as occurred during 2023. Today, the range is roughly 12x to 13x consensus 2025 estimates, which I would characterize as average, but the range has been wide over the decades depending on investor expectations for the economy, credit and rates.

In the late 1990s, banks traded in the midteens based upon forward estimates, and high teens on trailing 12-month EPS, because the economy was humming, credit quality was good and M&A was an overriding theme.

While it was not a straight line higher, the 1990s were good for bank investors. Banks began the decade with mediocre earnings due to a shallow recession and hangover from the 1980s real estate bust and ended the decade far higher as earnings grew and multiples expanded.

The past seven years have been somewhat opposite of the 1990s. The Nasdaq Bank Index was trading for about 18x forward earnings in late 2016 after a run-up in bank stocks on the surprise presidential election victory of Donald Trump that November. By July 2018, the index had risen another roughly 10% but was trading for about 13x forward earnings as the hoped-for earnings catalysts of lower corporate tax rates, gradual Fed rate hikes and a more favorable regulatory environment all occurred.

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Ironically, mid-2018 was the peak for bank indexes. Over the next five-plus years, the indexes gyrated widely, with sharp downdrafts during March 2020 (COVID-19), spring 2023 (bank failures) and October 2023 (rate concerns). There were notable rallies in 2021 (economy reopens) and 2024 (Fed pivots to rate cuts, Trump election). The past five or six years have been great for traders but not so much for buy-and-hold bank investors. The index's year-end 2024 close was 4,407, about where it topped in mid-2018, though up 17% from year-end 2023 and 46% from Sept. 30, 2023.

Nobody knows how bank stocks will perform over the coming year. It is a declarative statement, but true or mostly true: Valuations do not drive stocks; long-term earnings growth does. Valuations create risk-reward frameworks in the context of the probability of outcomes, but valuations are not catalysts. Banks were inexpensive in fall 2023, but it was catalysts that were expected to drive earnings growth that supported the stocks. Had stocks been expensive, the rally probably would have been less pronounced.

I think the key will be estimate revisions, as the stocks are now in a "show-me" mode with investors. Consensus estimates vary depending upon the region of the country, balance sheet positioning and the like, but generally, consensus estimates reflect high-single-digit EPS growth for 2025 and low-double-digit EPS growth for 2026, which, if realized, will validate the rally in bank stocks in 2024.

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