NASHVILLE NOTES

What's Troubling Bank Stocks?

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The panic subsided in bank stocks about a month ago. It has since been a grind without much of a rebound, though Western Alliance Bancorp. and PacWest Bancorp have nearly doubled between lows posted on May 4 and May 19. The KBW Nasdaq Regional Bank Index is down 33% year-to-date through May 19 with a 35% reduction between March 3 and May 19.

Bear markets are opportunities because they do not last forever. The NASDAQ fell 33% in 2022, but has risen 21% in 2023 through May 19. That is an impressive gain, but the index would have to rise about 50% to get back to the year-end 2021 level. Timing matters!

I concur, not every bank has outsized funding issues or unmanageable credit costs on the horizon.

On May 18, S&P Global Market Intelligence hosted Street Talk: US Banking Liquidity Crunch to mull over the bear market in bank stocks with investors, investment bankers and policy makers. Two of the panelists, a sell-side analyst and bank-focused institutional investor, favored buying selected bank stocks. A couple of institutional investors told me the same thing the prior week at the Gulf South Bank Conference in New Orleans.

I concur, not every bank has outsized funding issues or unmanageable credit costs on the horizon. The entry price paid is a key determinant of return over a given holding period and it is the one attribute an investor has complete control over.

I put the same question to a successful Cleveland-based small- and mid-cap bank investor in early May in Nashville. I reminded him that when I visited him in Cleveland during 2009, he was buying bank stocks at the depth of the recession because he said there was no one left to sell.

Now, he is not buying because the stocks are not cheap enough for him in terms of tangible book value, rather than analysts' EPS estimates that probably are still too high. Instead, his funds are overweight industrials and to an extent insurance. He expects ROEs over the next several years to be in the low single digits due to a combination of higher funding and credit costs as the economy adjusts to a higher interest rate regime.

I think there is one event the stocks are not pricing: widespread common raises.

It never is entirely clear what is priced into stocks, which tends to overshoot fundamentals during bull markets and undershoot during bear markets. The fundamentals are changing for the worse now, though my cursory review of consensus estimates implies only modest deterioration that is at odds with the miserable stock performance. For now, the market seems to agree with my Cleveland friend that it is going to be a grind for banks due to some combination of higher-for-longer funding and credit costs.

However, I think there is one event the stocks are not pricing: widespread common raises.

I am not saying the industry faces a 2008-2009 scenario when there were widespread dilutive common raises, but stock price weakness points to the potential in my opinion.

Last fall I asked an investment banker acquaintance what he thought about the stocks and his business. He said he thought 2023 would be a big year for M&A or capital raises. So far, neither has happened. Weak stock prices have precluded most deal making, and banks have not felt the need to raise capital to cover unrealized losses in bond portfolios because unrealized losses are not counted against regulatory capital.

A separate issue for managements is whether they should restructure bond portfolios to reinvest in higher yielding securities with shorter durations if capital is okay after realizing the loss since investors presumably have factored in the unrealized losses and subpar interest income in valuing the stocks.

Common raises occur for many reasons. The best is to support organic growth, though First Republic Bank, SVB Financial Group, and Signature Bank tapped the markets regularly for growth capital. Many common raises that took place due to the 2008-2009 recession buried existing shareholders because they occurred at very low prices, resulting in immediate dilution to tangible BVPS and lower EPS in the future once credit losses subsided and net income rebounded.

Maybe that is what is troubling bank stocks, a market that is beginning to price-in common raises by some institutions to fund the restructuring of balance sheets and to cover credit losses that have yet to develop.

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