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NASHVILLE NOTES

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Cain't be

By Jeff K. Davis

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I doubt most of you have heard of the rural Southern idiom "cain't be." The Urban Dictionary — which admittedly can be raw — defines cain't as "a cross between the Standard English contractions 'can't' (cannot) and non-standard English contraction 'ain't' (am not). This combination of contraction forms a powerful word encompassing 'cannot,' 'am not,' 'is not,' 'are not,' and 'have not.'" Hell no is the short version.

Peter Tchir of TF Market Advisors described the early bank releasers' results as a "yawn" on Twitter this weekend. Profitability is good for the large banks, but investors own equities due to growth prospects or a compelling valuation. Much of the sell-side is ~~spinning~~ explaining changes in the current quarter versus prior quarters due to seasonal items, first quarter 2012 entailed 29 days in February, loan growth was pulled forward into fourth quarter 2012, etc. The trend is and has been clear for some time: Revenue growth is close to nil and will turn negative for many smaller banks, while declining credit costs as a net income driver is about over and has been priced into the stocks for a while.

We are now in our fifth year of the Fed's zero interest rate policies (ZIRP) and the sixth since the Fed began cutting rates in 2007. One day the environment will change. Until then, competitive pressures are increasingly weighing on loan yields and are thereby creating a second element of NIM pressure beyond that of reinvesting bond and mortgage cash flows at much lower yields. There will be exceptions that hold the line on pricing (maybe M&T Bank Corp.) and sacrifice volume even though ZIRP promises very low credit costs for some time. Also, some markets such as south Louisiana, Texas and other areas of the energy- and ag-belts are poised for very good multiyear loan growth that may entail better-than-average pricing.

Yield/cost of funds at select big banks (%)

	JPMorgan Chase			Wells Fargo & Co.			Commerce Bancshares			M&T Bank Corp.		
	Q1'13	Q1'12	Change (bps)	Q1'13	Q1'12	Change (bps)	Q1'13	Q1'12	Change (bps)	Q1'13	Q1'12	Change (bps)
Commercial & industrial	NA	NA	NA	3.73	4.18	-45	3.17	3.52	-35	3.66	3.71	-5
Commercial real estate	NA	NA	NA	3.84	4.07	-23	4.17	4.57	-40	4.41	4.42	-1
1-4 residential mortgage	NA	NA	NA	4.29	4.69	-40	4.08	4.58	-50	4.09	4.60	-51
Total loans	4.78	5.14	-36	4.49	4.81	-32	4.49	4.95	-46	4.24	4.35	-11
Total securities (TE)	2.19	2.60	-41	3.70	4.19	-49	2.12	2.56	-44	3.33	3.54	-21
COF - IB deposits	0.28	0.38	-10	0.21	0.27	-6	0.25	0.32	-7	0.22	0.33	-11
Net interest margin (TE)	**2.37**	**2.61**	**-24**	**3.48**	**3.91**	**-43**	**3.07**	**3.45**	**-38**	**3.71**	**3.69**	**2**
30-Day LIBOR (Q1 average)	0.24	0.34	-10	<> base for C&I loans								
5 year swap (Q1 average)	0.97	1.17	-20	<> base for 5-year CRE loans								

NA = not available
TE = tax equivalent
COF = cost of funds
Sources: Company quarterly reports and the Federal Reserve's H.15 (selected interest rates-daily)

What results show from the early releasers — I think — is that the yield story is going to intensify in the second half of 2013 and 2014. As shown in the table, JPMorgan Chase & Co., Wells Fargo & Co. and Commerce Bancshares Inc. all saw year-over-year reductions in loan yields that exceeded the reduction in 30-day LIBOR and the five-year swap rate. Yet, these results do not reflect the increasing story of "high" 2-handle C&I and CRE pricing for quality credits that I am hearing about around the country. So far, low credit costs and still strong — albeit easing — mortgage banking mask the impact of NIM pressure in terms of earnings, but that increasingly will not be the case unless loan growth accelerates. And faster loan growth may require more pricing (and term/structure) concessions. Investors should focus on yields, not the second derivative NIM, in assessing how the revenue and earnings trajectory for a given institution will evolve this year.

Most investors view banks as early cyclical stocks — i.e., the shares tend to under- and outperform the market before the economy turns given the business model's leverage to change in asset quality. Overlaid is an aspect of an interest rate play whereby some banks are heavily levered to the rate cycle. Focused-commercial lenders such as Comerica Inc. benefit from rising short rates given a preponderance of loans that price off 30-day LIBOR and are funded with non-interest bearing deposits. Lenders that focus on CRE and multifamily loans, such as New York Community Bancorp Inc., are levered to a steeper curve because much of the asset base is priced off five-year U.S. Treasurys or five-year swap rate.

I think the group is now transitioning to one of a broad trading range as long as credit remains benign. Valuations are cheap enough to protect against a hard sell-off, but valuation is not overly compelling absent a catalyst as was the case in fourth quarter 2011. Investors face the same issue that banks do in terms of yield. That need may lead to notably better performance by banks with stronger dividends. JPMorgan has been a great trade since mid-2012 when "Whale" concerns drove the shares into the mid-$30s. The March CCAR process culminated with a 27% hike in the quarterly dividend to 38 cents per share.

Where from here? Think Commerce (2.3% yield; $35-$40 range) and Trustmark Corp. (3.8%; $21-$25), which sailed through the panic and recession compared to peers, but have tended to underperform as the credit recovery gained traction. Trustmark's recent acquisition of Mobile, Ala.-based BancTrust Financial Group Inc. may reinvigorate growth, however.

Periodic market breaks as occurred in third quarter 2011 will create the opportunity to build positions that entail good capital appreciation potential that the lack of revenue and earnings growth precludes. This outlook may pigeonhole most bank stocks as income plays, but income in a ZIRP world will become increasingly valuable. It also may mean that some bank investors will migrate to business development companies (BDCs) and perhaps commercial-focused mortgage REITs. Unlike banks, these entities do not have (stable) deposit funding and access to the Fed's discount window. But they make money and have some investment attributes that advantage them versus traditional banks as ZIRP and Washington's regulatory apparatus wreaks havoc on the bank business model.

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