SNL Blogs

Monday, April 18, 2016 3:06 PM ET

Early-quarter read shows little change

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In a nod to the epidemic of grade inflation that is rampant in this country lest anyone be left behind, *The Wall Street Journal* ran a headline "Citi's Results Add to Banks' Upbeat Views." Citigroup Inc.'s net income fell 27% from the year-ago quarter and ROE was about 6%. I heard one analyst on Bloomberg Radio last week describe Citi as a problem child making Ds and Fs on its way to a C+ or B-. His comment was not about grade inflation; rather, the importance of change at the margin — if it happens — for investors. Expectations matter a lot in the short run, but not in the long run.

The *Journal* article recapped upside EPS surprises for Bank of America Corp., Citi, JPMorgan Chase & Co. and Wells Fargo & Co. Like Citi, the other three posted lower year-over-year EPS, as did PNC Financial Services Group Inc. Regions Financial Corp. posted good results compared to a year ago, but otherwise I would describe the current quarter as flattish relative to the past several quarters. Its ROE was about 6%, too. It is hard to get excited about bank stocks beyond trading propositions when ROEs are mostly in the single digits and the earnings cycle may be mid-to-late cycle.

It did not appear to me that much has changed based upon the results of the early reporters. The lending business is okay from a volume perspective, but the margins are very low. A few basis points of widening NIMs with a full quarter impact of the December rate hike has not changed the basic math. Credit losses are near what should be cycle lows and eventually will go higher beyond the impact energy lending has had so far. Investment banking revenues are down following several great years. Trading has structural issues. Managements are working hard to hack expenses; they have no choice.

Judging by the reaction of the shares, one might conclude that meaningful new information was revealed last week. The SNL U.S. Bank index rose 6.4% versus 1.6% for the S&P 500. Citigroup was up 11% for the week. Given negative sentiment that the *Journal* and other media outlets trumpeted in pre-release coverage, price gains last week were not surprising. As for the underperformance year-to-date, I attribute it to the fading dream of Fed rate hikes inflating NIMs and validating Street estimates that were being peddled last year. Also, equity investors are starting to raise questions about future credit costs beyond energy. Credit costs do not have to gap wider, just trend higher to forestall earnings growth — and earnings growth (and entry price) is the mother's milk of equity investing.

PNC illustrates the issue that some (or many) widely followed banks pose for investors. It had a mean estimate of $7.31 per share for 2016 as of April 17, down from $7.80 per share a year ago when 2016 was the "out-year" estimate. PNC's 2017 consensus estimate (i.e., the current out-year estimate) is $7.84 per share. Wall Street, in my view, has a propensity to push the out year estimate higher when the current level of earnings does not fit an earnings growth narrative. Also, I don't believe that Wall Street cares too much about history other than as it relates to trend, but history is instructive. PNC posted 2013, 2014 and 2015 earnings of $7.36, $7.30 and $7.39 per share. There may have been unusual and "non-recurring" items in each year's results that could lead one to argue that core EPS was higher; however, the reality is that EPS in recent years has been flat. So after reducing 2016 estimates over the past year to reflect expectations for another flattish year, 2017 as the out year reflects a sizable jump in earnings that is not consistent with PNC's recent history. And perhaps the trend will not be flat. Although one should never read much into one quarter's results, PNC's first-quarter 2016 earnings of $1.68 per share are well below recent history when annualized.

From an investor's perspective I see long-term EPS growth, dividend paying capacity (or ability to buy-back shares at non-boneheaded prices), ROE, the risks assumed to produce the return and entry price as key attributes that drive long-run returns. The Street narrative is often geared to "higher next year" and therefore a cheaper valuation than what current or recent earnings imply. When the credit cycle is turning for the better the narrative of higher EPS "next year" and a more modest P/E usually fits. I do not think that is where the earnings cycle is today for large banks. Investors will have to pick their entry points carefully and perhaps trade around core positions. Citigroup would have been a great buy April 8 given last week's 11% gain, but not so much if purchased at year-end because the stock is down 13% year-to-date.

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