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NASHVILLE NOTES

The rating agencies did not get Steinhoff right either

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By Jeff K. Davis

Jeff Davis, CFA, 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 or Mercer Capital, where he is the managing director of the financial institutions group.

I see four takeaways when thinking about the financial performance of banks this year — and presumably bank stocks — as long as the outlook for the economy remains constructive. One is a warning, two are obvious and one falls into the "do not overthink it category."

The warning from fourth-quarter 2017 releases relates to credit, the one factor that can decimate bank earnings and valuations. JPMorgan Chase & Co was the first of what will be many banks burned by potential fraud committed at South African-based retailer Steinhoff International N.V. by recognizing $273 million of credit expense to apply a fair value mark to a margin loan and build additional reserves. JPMorgan and the banks, including the corporate bond-buying European Central Bank, were caught flat-footed, as were the rating agencies. Steinhoff's low investment grade rating of Baa3 was affirmed by Moody's in June 2017. About six months later Moody's rated Steinhoff deep in junk territory at Caa1.

Who could have known? Not me, not the ECB, and maybe not the vast majority of investors, although Bloomberg had an interesting Jan. 12 article on Viceroy Research and its apparent non-consensus view of certain issuers, including Steinhoff. Viceroy, I think, has a rich universe to mine if it is focused on over-leveraged companies whose credit may not be as good as the consensus view thinks it is.

Obviously, the Steinhoff loss is not large in the context of JPMorgan's $41 billion of pretax, pre-provision income that was posted in 2017. JPMorgan is in the risk-taking business. Losses can and do unexpectedly occur that seem outsized when overall credit conditions are benign as is the case today. But, the warning I see is that big losses could quickly appear after many years of easy credit that has been egged-on by central banks. Lenders may become less willing to roll-over marginal loans and bonds because getting repaid takes precedence over the coupon.

The obvious relates to mortgage banking and asset management. Mortgage banking was a tough business in 2017. The last tough(ish) year was 2013 when long rates shot-up mid-year following former Federal Reserve Chair Ben Bernanke's off-handed comment about tapering bond purchases. There was no tapering reaction last year; rather, originators had to deal with a highly competitive market and the negative impact higher rates had on refinance volumes. Mortgage banking-related fee income declined 29% for the year and 35% from the year-ago quarter at Wells Fargo, while the comparable declines were 35% and 26% at JPMorgan. The business is, of course, highly cyclical that can turn quickly if the economy slows and rates fall; or, get worse if intermediate- and long-term rates rise sharply.

Asset management on the other hand had another great year given the big run in equity and credit markets in 2017. Although the business faces a structural challenge from the shift to low cost passive strategies from high cost active management, the business model is akin to commercial banking in which revenues accrue daily, but without credit risk and many fewer employees. As long as markets are stable or rising, operating leverage is high. BlackRock Inc.'s operating margin rose 120 basis points in 2017 to 42.2% as operating income rose 15%.

In the "do not overthink it category" is the current interest rate set-up for 2018, which is great for traditional commercial banks with a sizable amount of non-interest bearing deposits and variable rate commercial loans assuming the Fed hikes short-term rates a few times. Even banks that do not have out-sized non-interest bearing deposit funding and/or floating-rate loan portfolios should see decent net interest margin expansion as long as a sizable amount of the deposit base is comprised of low-cost retail and small business deposits. JPMorgan's CFO Marianne Lake noted as much when commenting on how little retail deposit rates have changed thus far in the tightening cycle. The corollary is that banks and nonbank lenders that rely upon wholesale markets to fund fixed-rate assets face a more challenging year given the flatter yield curve.

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Jeff K. Davis, Managing Director of Mercer Capital's Financial Institutions Group, is a regular contributor to SNL Financial. He can be reached at jeffdavis@mercercapital.com or 615.345.0350.