NASHVILLE NOTES

Underwhelming is priced into bank stocks

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I am not plowing new ground in noting that equity markets today feel like the late 1990s, when value stocks languished while tech and other growth stocks powered higher. My recollection is that there was a lot of hand-wringing in early 1999 that growth stocks were destined to fall after the Nasdaq rose 108% between year-end 1995 and year-end 1998.

Consistent with the maxim that the market inflicts the most pain when conviction is one-sided, the Nasdaq defied the shorts and rose 86% in 1999 and then increased 24% by March 10, 2000, when the index peaked at 5,049. It was a huge run in which "growth stocks" as represented by the Nasdaq rose 380% from year-end 1995, compared to 126% for the S&P 500 and 91% for the Russell 2000. Banks posted a positive but underwhelming performance in comparison. The SNL Large Cap and Small Cap Bank Indexes rose 59% and 56%, respectively.

I do not remember a definitive catalyst that caused the market to crack in 2000, other than perhaps the utter decimation of short sellers and narrowing market breadth as fewer shares were rising even though the broader market indexes continued to do so. I do remember the dam breaking. I came back from lunch at the Arcade in downtown Nashville on March 10 as buy orders surged for banks, REITs, industrials and other value stocks at JC Bradford, where I then worked.

Over the next year the Nasdaq fell 59% and would fall another 35% by year-end 2002. Having been previously left for dead (Bill Gates used a dinosaur analogy), banks rose by over 30% by March 2001, helped in part by Fed rate cuts that unwound a flat-to-inverted yield curve that prevailed in early 2000.

Maybe the recent failed IPO of The We Co. will mark a turning point in the current cycle in which growth has outperformed value over the past decade.

Today, bank stocks are priced to underwhelm, although they are not priced for a disaster either. Given the moderate valuations that exist today, investors have priced in net interest margin compression from the inverted curve and declining level of rates that devalue core deposits, especially non-interest-bearing deposits. The amount of credit deterioration that is priced into the shares is debatable, however.

In 2000, the market correctly surmised that the coming recession in 2001 would be relatively shallow and credit losses would not be too bad. Bank earnings did not crater in 2001 and 2002 even though a recession occurred, because credit quality frayed but did not implode since real estate performed reasonably well.

As of mid-October 2019, markets seem to be at a similar junction as was the case in early 2000. Growth stocks — at least some high-profile companies with negative earnings — are on the defensive, yet banks and other financial stocks have not broken higher in a similar fashion as occurred in March 2000.

The unease is understandable with a bond market and more recently money markets in the U.S. that could be forecasting "issues" to come.

Nonetheless, it seems to me that after the wipeout of 2007-2009, real estate probably will perform OK in whatever slowdown the market is forecasting, with the caveat that luxury residential real estate and retail commercial real estate are in trouble. Other pockets of weakness include non-investment-grade energy companies, restaurants and some areas of healthcare.

Further, reams of Wall Street research have been produced about how large the lowest tranche of investment-grade debt is relative to prior decades, meaning that in a recession the amount of "junk" debt would explode as BBB-/Baa3 rated companies were downgraded.

These are general observations that I believe are widely recognized on Wall Street.

One credit area that is not, I think, and is worthy of analyst and investor questioning this earnings season is the amount of enterprise value-based lending by banks and nonbanks. Lenders normally rely upon cash flow as the primary source of repayment except for specialized asset-based lending. With the rise of private equity (and credit) in the past decade, I suspect there has been a significant increase in the amount of lending in which there is heavy reliance upon a firm's enterprise value — meaning that if the company cannot meet its obligations it can be sold for a high enough value that lenders can be repaid even if the equity is impaired.

The We Co. may be an extreme example of investor and lender exuberance, but it may not be a one-off either. If liquidity tightens generally and evaporates for highly levered companies and businesses with dubious business models, then I expect there will be many more "one-off" credit issues that surprise investors over the next year.

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