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What does the 'mean' mean for bank investors?

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Growing up as a teenager in Lexington, Ky., during the 1970s, the world I knew in the Southeastern Conference was as monolithic as the late Soviet Union: Kentucky basketball and Alabama football; that was it, then and now. The periodic down year usually would be followed by a really good year, which sometimes would mean a national championship. A national championship is an infrequent event for even the best programs, but the mean — or at least UK's and UA's fans' view of the mean — is to be really good most years.

What does the "mean" mean for bank investors today, following a 25% gain in the SNL Small Cap U.S. Bank Index and 22% for the SNL Large Cap U.S. Bank Index from Nov. 8 through Dec. 16? The bank indices easily outpaced their comparative broad-market indexes as the Russell 2000 and S&P 500 rose 14% and 6%, respectively.

Merrill Lynch's legendary technical analyst, Bob Farrell, popularized 10 rules for investing that he observed over the years. His first and second rules come to my mind when thinking about bank stocks and means. First, markets tend to return to the mean over time. And second, an excess in one direction will lead to a subsequent excess in the other direction. My take on the second rule is that means are only statistics that markets traverse as they lunge from one extreme to another, as investor psychology swings to the negative or the positive. Over time, markets gravitate to central tendencies, at least when they are not so heavily influenced by central bankers as has been the case in recent years.

Since the beginning of the fourth quarter of 2015, bank stocks have exhibited a bout of enthusiasm, a bout of pessimism, and a move since Nov. 8 that Farrell might call excessive. The mean is somewhere between the bookends.

Bank stocks strengthened during the fall of 2015 as market confidence increased that the Fed would finally begin to raise short-term rates under its control. A modest correction that December turned into a rout during January and February of 2016 as financial conditions tightened with the collapse in oil prices and near-freezing of the high-yield bond and leverage loan markets. The Fed, of course, followed the market and did not hike again until last week. Bank stocks and other risk assets had a nice recovery that ran roughly from mid-February through mid-year.

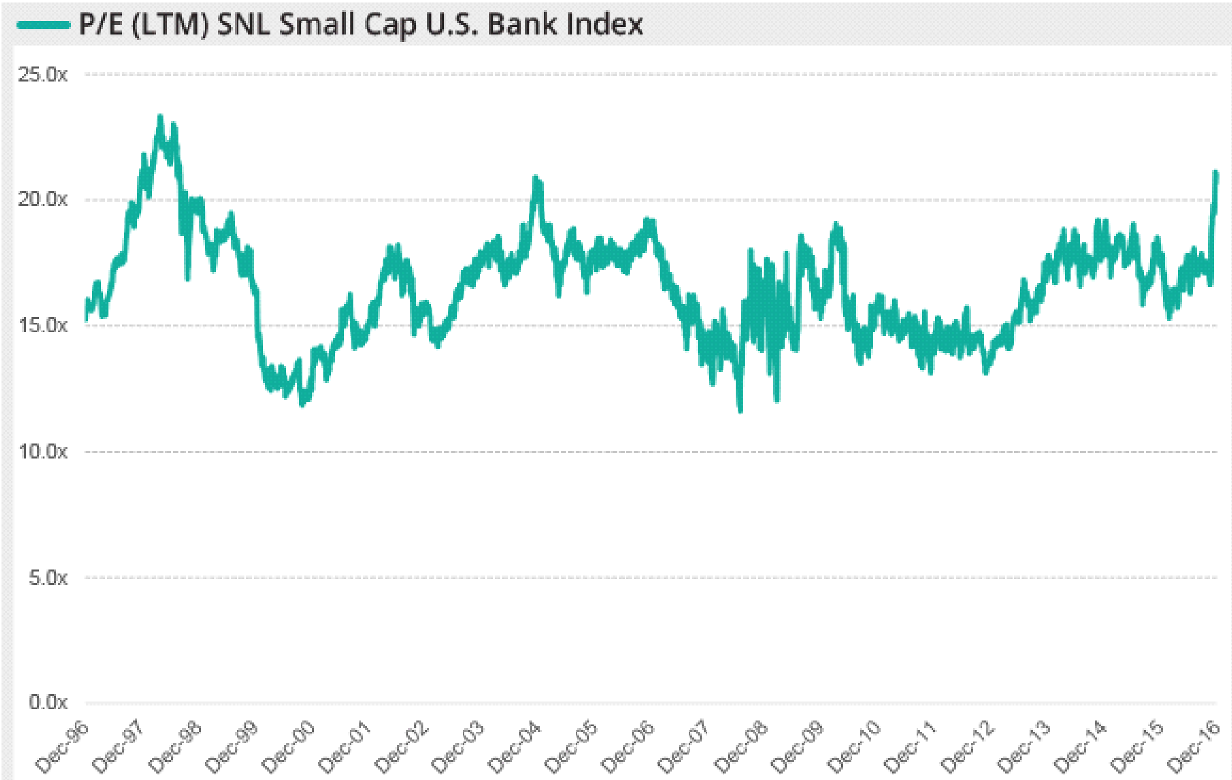
Since the election, bank stocks have gone vertical. Is the move justified?

Regardless of one's political views it appears the stars have aligned for a trifecta that should boost bank earnings: higher interest rates, a reduction in corporate tax rates, and reform (or rollback) of Dodd-Frank. The degree and timing of each benefit, if ultimately realized, is unknowable. All we know today is that the probability of directionally positive outcomes appears more likely than not. If the economy strengthens as some argue, then four factors point to better bank earnings.

The equity market has voted that earnings will be much better than anticipated prior to Nov. 8. Arguably the credit market has affirmed that vote, based upon high-yield credit spreads that have since declined. (Actually, high-yield credit spreads peaked in February 2016 around the time oil prices bottomed.)

So does Farrell's rule that markets tend to revert to means over time mean much for banks if a new (or old) profit paradigm is developing? I think it does, even though earnings rather than valuations drive stocks over long periods of time. Valuation usually is important over short-to-intermediate time frames as it can meaningfully impact returns as multiples expand and contract with shifts in an industry's profit cycle and an individual company's growth prospects. Buy when multiples are high for whatever reason (e.g., optimism around prospective earnings) and the potential for a disappointing return over the holding period increases if mean reversion occurs.

The current valuation of banks is instructive, I think, in terms of expected future profitability — or, absent that, Farrell's concept of excess as retail investors and institutional investors who are "generalists" pile into the sector. Over the past 20 years, the median P/E based upon trailing-12-months earnings is 16.7x for the SNL Small Cap U.S. Bank Index and 15.3x for the SNL Large Cap U.S. Bank Index. As of Nov. 8 the respective multiples were 16.9x and 12.7x. Small-caps traded near the long-term average, while large-cap banks were "cheap" on Election Day. By Dec. 16 the multiples were 21.0x and 15.6x. The revaluation of small-cap banks was especially notable in that the standard deviation based upon 20 years of daily observations was just 2.1x.



Data as of Dec. 16, 2016.
Represents price divided by earnings per share for the trailing four quarters for the SNL Small Cap U.S. Bank Index from Dec. 16, 1996, to Dec. 16, 2016.
Source: SNL Financial, an offering of S&P Global Market Intelligence

While markets tend to a mean over time, they periodically swing between extremes, too, as articulated in rule No. 2. Hancock Holding Co. illustrates this. Its shares closed at a multiyear low of $20.87 per share on Jan. 21, 2016, as the company announced weak earnings, primarily related to reserve building for energy exposure that had been preannounced in mid-December. Almost a year later, the company raised $259 million of common equity at $41.05 per share on Dec. 12, 2016. What changed? Not much. Hancock posted two lousy albeit profitable quarters (Q4'15 and Q1'16) when oil prices were falling. Management had enough sense to raise equity when optimism rather than pessimism was priced into the shares. I am not on a limb noting the best prospective returns for investors will be realized by those that bought shares a year ago.

Farrell's first rule does not mean small-cap bank stocks will retreat to trade around the long-term average P/E in the near future. Investors may wait to get a better sense of the earnings bump that appears to be coming as a result of the election. But over time I think Farrell's rule means the stocks will find the mean, or a multiple close to it, within the context of whatever profitability prevails.

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