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Bank stocks as early cyclicals

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Last month I had a post entitled "Liquidity is credit's handmaiden." Although I have periodically commented on credit and liquidity the past year, the post was apropos given the unraveling since then of the high-yield bond and leveraged loan markets. The freezing of redemptions by Third Avenue Focused Credit Fund sent shockwaves through the market on Thursday. Carl Icahn helped roil the markets on Friday, Dec. 11, by tweeting the "meltdown in High Yield is just beginning." He may be right. He, like Donald Trump, knows how to give the press a short, provocative quip that can move markets.

On the other hand, Fed officials talk too much, in my view. Worse, it is usually long-winded, two-handed economist speak that provides fodder for Street punditry. This week, Fed Chair Yellen will host a press conference after the FOMC meeting concludes on Wednesday, Dec. 16. In theory, the Fed is poised to sort of end its zero interest rate policy (ZIRP) if the Fed Funds target rate is raised as markets expect. I say "sort of" because an increase in the target rate to 0.375% or 0.50% should still qualify as ZIRP.

Chair Yellen has stated on a number of occasions that market participants should focus on the terminal rate and the pace to achieve it rather than when lift-off occurs. It is fair to assume the terminal rate is low — especially given a 10-year U.S. Treasury yield that is near 2% — and the pace to get there will be glacial. Widening credit spreads beyond high-yield energy and commodity credits may be signaling Chair Yellen faces a one-and-done scenario. Business cycles do not last forever.

A column that has proven not to be apropos was one that I penned a year ago where I opined that credit rather than potential changes in the Fed Funds rate would have a greater influence on bank stocks in 2015. My point was not that credit costs were poised to rise sharply, but that credit matters a lot more than NIMs and EPS as a result of hoped-for rate hikes. Most banks lever tangible common equity anywhere from 10-to-1 to 14-to-1. If asset quality is weakening, usually nothing much else matters.

The dominant market theme for 2015 has been widening credit spreads (and declining commodity prices). So far I have been wrong about the impact on bank stocks, though not BDCs. The SNL U.S. Large Cap Bank declined 1.8% for the one-year period ended December 11, while the SNL U.S. Small Cap Bank index jumped 9.3% as a result of a healthy M&A market, good loan growth for many smallish banks and, of course, the expectation of higher short rates and therefore NIMs. In comparison, the S&P 500 and Russell 2000 declined 1.1% and 3.7%.

Until recently, bank investors seemed to be mesmerized by the potential for Fed hikes to widen NIMs, while oblivious to what the grind wider in credit spreads implies. BDC investors have not been mesmerized. SNL's U.S. RICs Index, which includes BDCs, fell 14.7%. That may be because BDC investors cannot so easily ignore the corporate credit markets because the loan portfolios are subjected to fair value marking each quarter. I suspect year-end marks are going to be brutal, though arguably the drop in BDC stock prices reflects that even if BDCs (and banks) report little change in relatively low nonperforming loans.

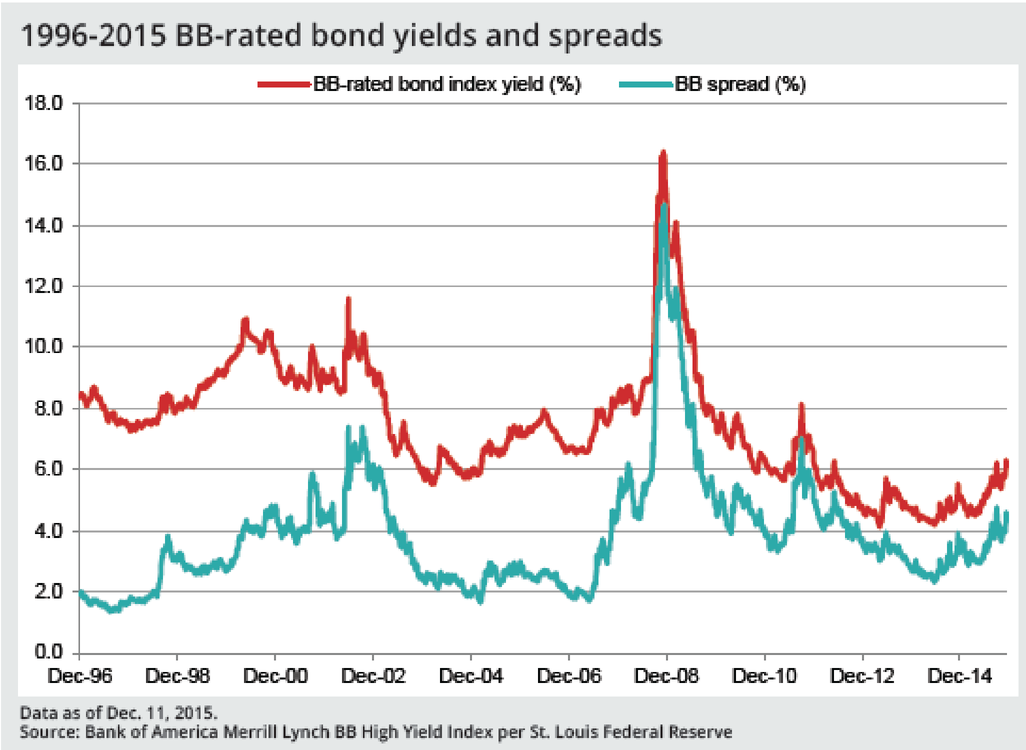
As for 2016 and bank stocks, no one knows for sure. Steady economic growth, a partial rebound in high yield and leveraged loan prices, and more than one or two Fed rate hikes should be a constructive scenario. With regionals and larger community banks trading in the vicinity of 15x to 16x last-12-months EPS, it seems to me the constructive scenario does not leave a lot of maneuvering room for investors. I would expect stocks to just track earnings rather than benefitting from EPS growth and multiple expansion. Alternatively, the EPS growth could materialize, but the stocks tread water, resulting in multiple contraction.

But it is the alternate scenario that I do not believe is priced into the stocks. It is the scenario that the Street's typical optimistic view of EPS growth is abnormally too optimistic because the Fed does little, if any, hiking, resulting in the continued slow grind lower of NIMs. This easily could be overlaid with a higher level of provision expense than the Street expects. In effect, banks report no growth or modestly lower EPS.

It is not a disaster scenario or even a mild recession scenario that I am referencing; rather, it is a return to normal credit costs at a time when multiples are elevated and Street expectations have been focused on revenue growth as a result of Fed rate hikes. A case in point is Citigroup Inc. Last week Citi CFO John Gerspach said the company will add $300 million to $400 million to loan loss reserves for energy credits in addition to a $300 million "repositioning" charge. Granted, the charges are not that big in the case of Citi, but directionally, surprises will have a propensity to be negative at this point in the cycle. It is upside surprises that drive stocks, at least in the short run.

Banks — especially Wall Street banks — are "early cyclicals," meaning the stocks turn down (and up) well before the economy and the industry's earnings turn down (or up). The stocks are not signaling a warning today. Maybe the stocks are telling us that credit issues will not spread beyond energy and other commodities. Also, perhaps bank stocks are no longer early cyclicals because the regulatory response to the 2008-2009 meltdown has transformed banks into risk-light financial utilities. (I doubt that.)

On the other hand, the steady decline in high-yield bonds, leveraged loans and BDC share prices may be signaling broader issues beyond energy and other commodities are brewing. That is not my assumption, but it seems to be Carl Icahn's. Bank investors should pay attention and think about downside scenarios. Most institutional investors will acknowledge that credit markets pick up on trouble well before equity markets.



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