NASHVILLE NOTES

Dimons are investments too

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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; Mercer Capital, where he is the managing director of the financial institutions group; or StillPoint Capital, where he is a registered representative.

Last week I pinged a friend who is president of a small bank to congratulate him on a "great quarter." I meant it, which is not always the case when an analyst offers it to executives during the quarterly earnings call to review how numbers moved up and down over a 90-day period.

His response was something to the effect, yes but 2022 is going to be tough because PPP fees — lagniappe for banks in 2020 and 2021 — will be over and taxes will be higher. The chairman chimed in that it is not as easy as it appears. My retort is that is easy in spreadsheets and PowerPoint.

It is not clear to me how much credence the Street has put into the idea that 2022 may be a challenging year based upon my cursory review of 2022 estimates. When the pandemic hit in March 2020, the industry was staring at two downside variables of unknown magnitude and duration: net interest margin compression and credit losses.

Fifteen months later significant credit losses have been avoided other than pockets of retail and travel and leisure related credits. Hilltop Holdings Inc. notes it may make provisions later this year after releasing reserves in the four prior quarters to clean up lingering hotel credits that remain challenged. Yet one of the oddities of the recession is that it was not a cathartic event that flushes excesses from the system because the Federal Reserve and the federal government flooded the economy with money.

The adoption of CECL at the beginning of 2020 by publicly traded banks resulted in a greater amplification in reserves when the environment changes than under the old incurred loss method, but from my perspective that is OK. Loan loss provisions are an accounting entry; net charge-offs are an economic loss. The flood of money from the government and Fed preempted losses at a cost of elevated inflation and soaring asset prices.

Unlike credit losses, the revenue outlook remains murky. PPP-fees and mortgage banking income that supported 2020 and 2021 earnings will fade. For those in the economic reflation camp, these fees are supposed to be a bridge to a shift in the cycle in which loan growth resumes later this year and the Fed begins to raise short-term policy rates in 2022. Perhaps that scenario remains plausible based upon current economic growth, but significant household and corporate liquidity combined with the drop in long-term US Treasury yields implies it is less likely than in the spring. The Fed seems indifferent to soaring inflation, but then so does the bond market assuming it is not forecasting a slowdown.

The unfolding environment for banks is not a terrible one so much as an environment of lower returns and maybe stagnation, but then again earnings growth is the mothers' milk for equity investors. Nonetheless, there remains a small subset of banks that seem poised to continue to grow through a combination of strong local markets, great execution and in some instances differentiated business models.

One aspect of second-quarter earnings that I think is notable is how some banks are harvesting unique investments made in years past that provide some means to mitigate a challenging revenue environment. Some of these include KeyCorp (corporate-investment banking), Live Oak Bancshares Inc. (fintech investment in Canapi Ventures), Pinnacle Financial Partners Inc. (Bankers Healthcare Group), and Signature Bank (banking services for digital assets).

And then there is JPMorgan Chase & Co. Jamie Dimon does not need the money and probably does need an inducement to delay a retirement that I suspect he may not like away from the action at the pinnacle of global finance, but why take a chance. JPMorgan has sought to secure its anchor investment in Jamie Dimon with a 1.5 million option grant that is separate from his "regular" compensation package. The company's performance under Dimon speaks for itself.

Top three market share in many of its businesses and, importantly, the avoidance of big losses and the issuance of loads of common equity at low prices during tough times like some of the bank's competitors.

It is not clear what will happen the next few years for US banks — it never is. The revenue environment is going to be tough for most banks until the lending and interest rate cycles turn, while it is hard for me to assume that intervention by the Fed to fund massive government deficit spending and to prop up asset prices will not have its comeuppance one day. Some banks are better positioned than others to deal with it.

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