SNL Blogs

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Falling bank valuations a throwback to the '90s

By Jeff K. Davis

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Sometime in early 2000, I got a call from a bank CEO who complained to me that our desk (J.C. Bradford & Co.) was not supporting his bank's preferred securities that we had underwritten. I asked him how he knew, and he said a trader at an Atlanta-based firm told him.

I doubt the CEO cared very much about how his institution's preferred shares were trading in the secondary market unless he had holders that needed to sell, or he wanted to issue more. I walked to the preferred desk within fixed income and asked one of the traders about it, and he picked up a handful of sell-order tickets and flung them at me. He said there was a lot of selling of good and bad issues; investors just want out. The not-so-obvious question then was: Why?

During the first quarter of 2000, valuations for banks, industrials and small-cap stocks generally were cheap. Two years earlier they were expensive. During the first half of 1998, the SNL Small Cap, Mid Cap and Large Cap U.S. Bank indices traded around 21x to 23x last-12-months earnings, and earnings were not then depressed. By the first quarter of 2000, the three indices were trading in an approximate range of 12x to 14x. It was a near coast-to-coast move from high to low valuation even though the industry's return on assets comfortably exceeded 1% each year, including the mild recession year of 2001.

Bank stocks were good if not great investments during much of the 1990s, following a severe downturn in commercial real estate values in the late 1980s. Earnings grew and price-to-earnings (and price-to-tangible book value) multiples expanded. The peak in public market valuations roughly coincided with several megamergers, including NationsBank Corp./Bank of America Corp. and Norwest Corp./Wells Fargo & Co., which were announced during the second quarter of 1998. The last year leading up to the peak seemed to me as if banks were trading higher because most were viewed as acquisition targets in a self-reinforcing loop that allowed buyers to pay higher nominal prices in transactions structured as stock swaps.

Select performance metrics for US bank indexes

	Median price/LTM earnings (x)						
	05/26/17	11/08/16	1 Yr	3 Yr	5 Yr	10 Yr	20 Yr
SNL Small Cap U.S. Bank Index	19.3	16.9	19.3	17.7	17.2	15.9	16.8
SNL Mid Cap U.S. Bank Index	18.8	17.4	19.2	17.9	17.5	17.1	16.9
SNL Large Cap U.S. Bank Index	14.5	12.7	14.4	14.8	13.9	13.8	15.2
	Median price/tangible book value (%)						
	05/26/17	11/08/16	1 Yr	3 Yr	5 Yr	10 Yr	20 Yr
SNL Small Cap U.S. Bank Index	195	166	188	165	164	161	208
SNL Mid Cap U.S. Bank Index	220	195	222	196	195	185	258
SNL Large Cap U.S. Bank Index	175	148	168	166	161	167	311
	Median dividend yield (%)						
	05/26/17	11/08/16	1 Yr	3 Yr	5 Yr	10 Yr	20 Yr
SNL Small Cap U.S. Bank Index	1.5	1.9	1.7	1.9	1.9	2.0	2.1
SNL Mid Cap U.S. Bank Index	1.9	2.1	1.9	2.1	2.1	2.1	2.3
SNL Large Cap U.S. Bank Index	2.0	2.4	2.1	2.0	1.9	1.9	2.3

Data compiled May 26, 2017.
Source: S&P Global Market Intelligence

Then an uneven selloff began. During August 1998, Russia devalued the ruble and defaulted on its debt. This was then followed in September by the failure of Long Term Credit Management that nearly brought a Lehman moment to Wall Street a decade early.

The reduction in bank valuations during the fall of 1998 was easy to explain, and should have occurred. Leverage cuts both ways — the second half of 1998 involved falling security prices as levered investors were forced to unwind. The Main Street economy was fine, perhaps even thriving.

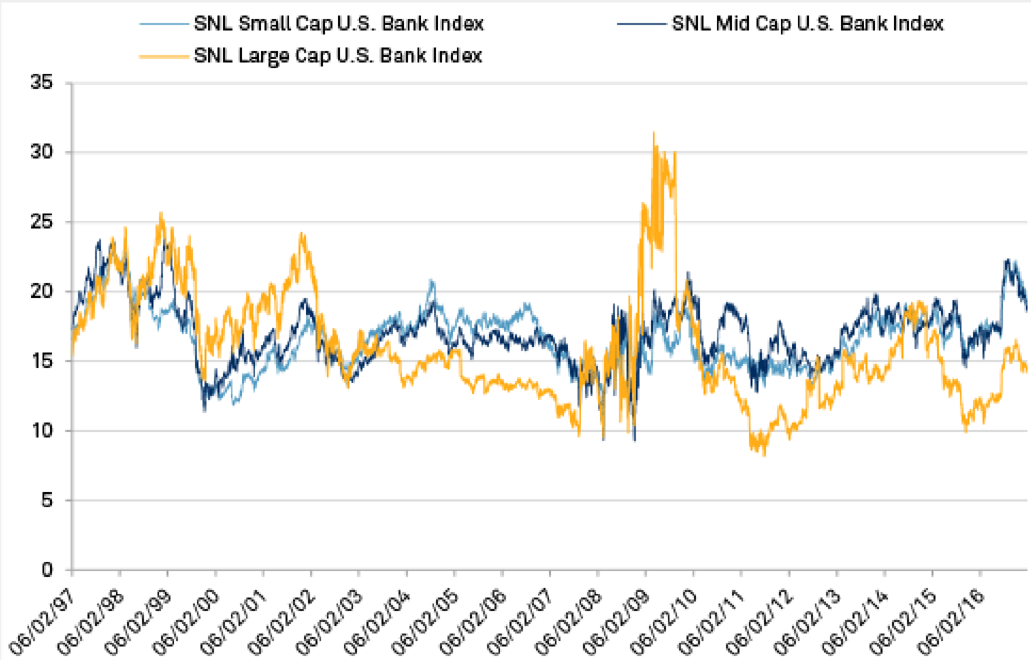
During the first half of 1999, valuations began to expand again following several Fed rate cuts in reaction to the crisis and its subsequent passing. However, beginning in mid-1999, bank stocks began to fall again even though results generally were fine. The bottom occurred during the first quarter of 2000 with P/E multiples off 40% to 50% from the 1998 highs. The question again was: Why?

There were multiple reasons. One was that investors were not so focused on asset sensitivity as is the case today when the Fed raised the Fed funds target rate from 4.75% in June 1999 to 6.50% a year later. By early 2000, the yield curve as measured by the spread between the yield on 10-year and two-year U.S. government debt inverted, a classic recession signal. Also, high-yield credit spreads had been trending wider since mid-1998.

A yield curve that is flattening and credit spreads that are widening is not a great environment to be in bank stocks. At the same time, we saw the final speculative run in technology stocks that caused funds to flow from "value" stocks to "growth" stocks. Investors may also have concluded that the earnings accretion from the megadeals that were then being announced was not going to happen. Nevertheless, like clockwork, the time to buy bank stocks was when the curve inverted and valuations were near their low point having made a move from expensive to inexpensive.

Banks did not move higher in a straight line over the next few years as the NASDAQ fell sharply, but the stocks performed well as capital flowed from tech and other growth stocks to value stocks. Bank fundamentals held reasonably well through the 2001 recession, primarily because real estate values did not implode as happened in the late 1980s and in 2008. Big credit losses never materialized.

Median price/LTM earnings for US bank indexes (x)



Data compiled May 26, 2017.
Source: S&P Global Market Intelligence

Fast forward to today. Valuations as measured by P/E ratios for small-cap and mid-cap banks are elevated relative to history. Large-cap bank stocks are slightly below the 20-year median. Had I penned this column a couple of months ago the variance would be even more notable in light of the recent pullback in prices, although first-quarter earnings were good. Maybe the FANG stocks (Facebook, Amazon, Netflix and Google) are pulling hot money that flowed into bank stocks following last year's presidential election upon realizing changes that should benefit bank earnings will not happen overnight, or to the same degree as initially assumed.

Nevertheless, the similarity of the relentless move higher of the FANG stocks is reminiscent of Qualcomm and other tech stocks that soared in 1999 when the conventional wisdom at the beginning of the year was that many of these stocks were overvalued. Those short tech stocks and long banks and other traditional value stocks were carried out on stretchers by the end of the year.

Valuation as a standalone proposition is not a catalyst, nor does anyone know what the future holds. But the set-up today could be like that of mid-1998 when multiples began an uneven grind lower. What could be the catalyst? Any number of events, just like faster economic growth or higher short-rates with a steeper curve could power earnings and keep P/E multiples elevated. Chris Whalen had a good post this week that highlighted the importance of rising asset values in the suppression of credit losses in the banking sector.

The phenomenon will not continue forever. That is not to say credit costs are going to explode, or that a recession is around the corner, but a return to "normal" or perhaps slightly "above-average" credit expense for banks could have a profound impact on elevated P/E multiples even if the impact on earnings is not draconian.

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