NASHVILLE NOTES

Strangest quarter

Tuesday, July 14, 2020 11:17 AM CT

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.

One of the oddest quarterly reporting seasons that I can remember gets underway this week with our world still in something akin to economic suspended animation.

As measured by the Nasdaq, stocks are at an all-time high, and are near an all-time high as reflected in the S&P 500. Yet, the bond market is messaging — actually, shouting — that deflation rather than inflation is the primary risk with the yield on the 10-year US Treasury around 0.60%. And high yield credit spreads have been inching higher in recent weeks after a huge rally during April and May.

This past week I heard a sell-side analyst describe the current downturn as an earnings recession rather than a balance sheet recession (i.e., too much debt). It is both. The initial hit was to earnings; now insolvencies are set to dominate for an extended period.

And how could it not be so?

Some 50 million Americans have filed for unemployment claims since mid-March and over 30 million received some form of unemployment assistance in the first week of July based upon the most recent unemployment claims data.

Chapter 11 corporate bankruptcies rose 26% in the first six months of 2020 versus 2019, but so far the filings seemingly have been limited to the likes of big name retailers that have been on the ropes for a long time, smallish energy companies and Hertz.

And in order to keep insolvency at bay, the federal government has borrowed trillions of dollars thanks to support from the Federal Reserve to provide funds to consumers, businesses and state and local governments. Lenders have provided an indirect liquidity buffer by offering 90/180-day deferrals to borrowers.

Yet Wall Street seems to view the economic downturn as a one-time credit hit to earnings based upon consensus bank estimates. Something is amiss.

Huntington Bancshares Inc. and Regions Financial Corp. are representative. Huntington reported earnings of $1.30 per share in 2019, while the consensus estimate for 2020 reflects a 62% reduction to 50 cents per share followed by a near doubling to 98 cents per share in 2021. Regions' consensus reflects a 52% reduction in 2020 earnings to 74 cents per share followed by a 69% rebound to $1.25 per share in 2021. The partial rebound in 2021 earnings reflects a reduction in provision expense, while NIMs are a lost cause.

Is 2020 really going to be about a big reserve build with future charge-offs funded from reserves? That is what the consensus implies, but massive job losses the past few months indicate we are not remotely close to dealing with the effects of the economic shutdown.

An alternative could be a much larger reserve build in 2020 than the Street consensus predicts. If so, 2021 earnings could rebound toward perhaps 70% to 80% of 2019 earnings and thereby validate valuations of roughly 8x to 10x 2021 earnings where many regionals trade.

That is possible, but if the reserve build is much larger than the Street envisions, then I expect dividend cuts that the

Street does not seem to want to project will encompass many banks rather than just Wells Fargo & Co., PacWest Bancorp and Great Western Bancorp Inc. among the few that have been forced to cut.

One aspect about the current economy that strikes me as indicating it is still early in the downturn is the lack of commercial real estate activity. Yes, transactions have continued to close, but many likely reflect transactions that were negotiated pre-COVID-19. Real Capital Analytics reports that commercial real estate transactions in the Americas was down 30% year-to-date through June 18 even though activity in the first quarter exceeded the first quarter of 2019.

Lenders have not been a source of transactions either because of widespread forbearance. Commercial Mortgage Alert reports CMBS investors are increasingly concerned that collateral managers are providing forbearance rather than declaring an event of default in order to avoid marking down collateral. When collateral coverage tests fail, cash flow typically is directed to senior tranche investors at the expense of junior tranche and equity investors.

The bigger picture I see is that price discovery for commercial real estate — which represents a big piece of regional banks' loan portfolios — has been on hold since March. At some point losses will have to be realized. Can the system stand the pain?

Sam Zell of Equity Commonwealth believes banks will move quickly to unload problem assets unlike a decade ago when problem assets lingered. He is quoted as saying banks want to "clean the books" quickly and avoid extend and pretend.

So far that has not occurred and probably will not occur until banks (and regulators) are confident that banks have enough capital to do so. I am in the camp that we are in a deep downturn in which COVID-19 was the pin that pricked a system that was fragile due to excessive leverage. Zell may be right, but it seems more likely to me that lenders will use an installment system to clear problem assets over an extended period.

Aside from a drawn-out credit cycle that I see, there is another outcome that is not reflected in Wall Street's consensus: someone develops an easy-to-administer vaccine for COVID-19. If that happens shares of banks, airlines, energy and other sectors waylaid by the pandemic will explode higher. Investors will not have time to buy the shares because an announcement would, I think, be reflected almost immediately.

This article was published by S&P Global Market Intelligence and not by S&P Global Ratings, which is a separately managed division of S&P Global.

Published with permission. Jeff K. Davis, Managing Director of Mercer Capital's Financial Institutions Group, is a regular contributor to S&P Global Market Intelligence, formerly SNL Financial. He can be reached at jeffdavis@mercercapital.com or 615.345.0350