

NASHVILLE NOTES

Credit Spreads, Bank Stocks and the Margin of Safety

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

Howard Marks' latest memo, "[Gimme Credit](#)," released on March 6, examines high-yield bond spreads — the additional yield that investors earn for taking on riskier debt versus "risk-free" US Treasuries. He suggests a "normal" range of 400 to 600 basis points, yet the Bank of America High Yield Index stood at just 320 basis points on March 12.

Marks asks whether spreads today compensate adequately for anticipated losses, which is a more insightful question than whether credit spreads are too tight relative to historical averages. That said, when I glance at a 25-year chart of high yield spreads, very tight spreads have preceded negative events — for example, in early 1998, before Long-Term Capital Management blew-up, and late 2006, before everything blew up.

Other times "tights" preceded limited credit events, such as the downturn in the oil sector in 2015, when OPEC unsuccessfully tried to break the US shale industry, and early 2022, before the Fed dramatically hiked rates and broke three S&P 500 banks but did not break the economy.

Bank investors can ask a similar question: Do bank stock prices provide an adequate margin of safety for prospectively higher credit losses? The question arguably has more relevance since Treasury Secretary Scott Bessent said the US economy would undergo a period of "detox."

The short answer is no, if detox implies anything beyond a mild recession — though let's take the comment in the spirit of an unpleasant bumpy car ride on the way to rehab, rather than driving over a cliff to avoid rehab.

Do bank stock prices provide an adequate margin of safety for prospectively higher credit losses? The short answer is no.

For the four quarters ending in 2024, banks with assets between \$10 billion and \$250 billion reported average net charge-offs of 77 basis points, while those between \$1 billion and \$10 billion saw a modest 28 basis points of average net charge-offs according to the FDIC. The loss rates are roughly double those of 2020 and 2021, when the government and the Fed flooded the US economy with transfer payments and liquidity. They are comparable to the 2013 to 2019 period when rates were near zero, the years leading up to the Global Financial Crisis, and the mid-and late-1990s, a supposed golden era for the US economy.

Effectively, bank loss rates remain unremarkable in the aggregate while subsectors such as subprime consumer, equipment leasing and a few others are exhibiting varying degrees of stress. Commercial real estate, excluding office, seems okay, but I wonder if we have seen the full impact of refinancings at normal rates; CMBS delinquency rates [continue to tick higher](#), according to Trepp. Leveraged loan default rates are not alarming either, at 1.13% for the trailing 12 months through

February, though defaults exceed 4% when distressed exchanges are included.

Wall Street is not expecting much change, judging by 2025 and 2026 estimates. My cursory review of consensus analyst estimates for net charge-off ratios could be described as a horizontal line.

That said, charge-offs are a lagging indicator, whereas trends in past-dues and nonperforming assets are leading indicators for credit. Both ticked higher in the past two years but remain unremarkable from an industry perspective. Under the Current Expected Credit Loss framework, banks build reserves well in advance — sometimes several years before losses are recognized. Charge-offs are what really matter because a write-off reduces capital, whereas loan loss provisions to add to reserves are, as I think Jamie Dimon once said on an earnings call, an accounting entry.

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Following two years of gradually increasing losses since the end of COVID-era stimulus, the outlook remains consistent with history: It is uncertain. Bessent's detox comment implies that investors should assume losses will continue to grind higher. However, as Marks might suggest, the focus should be less on forecasting and more on preparation.

Marks sees credit as fairly priced offering 7% yields. That is, the margin of safety is OK, provided bond selection is not adverse in that big losers are avoided.

Banks seem reasonable, too, in that they are not pricing in much drama even though the S&P Regional Bank Index was down about 9% on the year as of March 13, following a great run in the second half of 2024. Valuations, from my perspective, are modest, around 10x to 11x 2025 consensus estimates.

If credit losses — or even credit leading indicators — were poised to move materially higher, I think the stocks would be trading a couple of multiples lower, as the stocks will move well in advance of estimate revisions.

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