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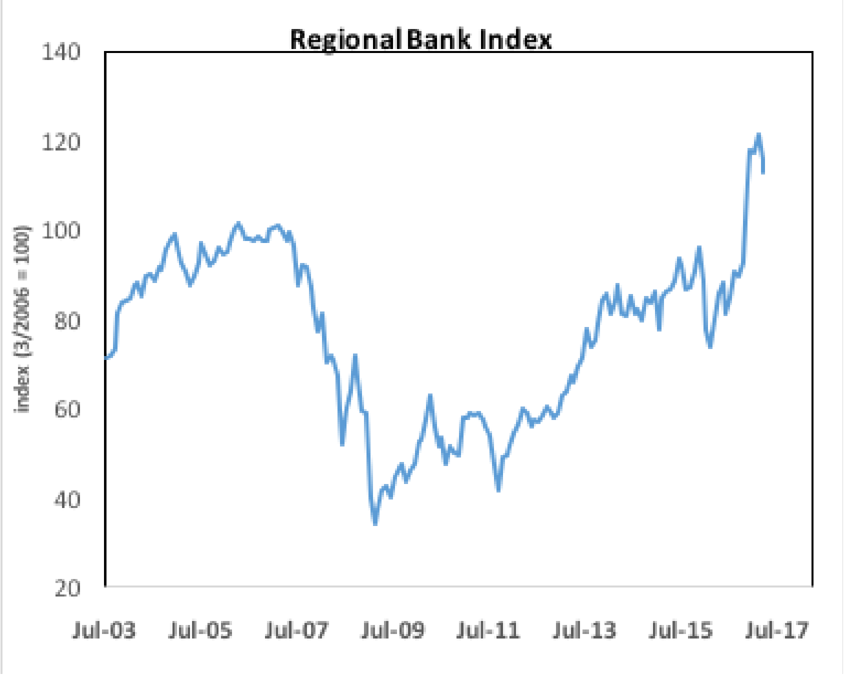
State of the Markets: Trade Commentary

Regional Banks Are Cheap Because They Are Fair

The banking sector has surged since early November, up over 20% even after the sell off in the last few weeks as shown in Figure 1 below. Investors are concerned that the rally is purely driven by hopes about Trump's economic policy given the timing of the rally. Banks would then be vulnerable to a sustained selloff if these policies are not implement sometime soon. Banks look even richer given that they have now exceeded their highs from the credit boom era in 2004-6. My view is the opposite.

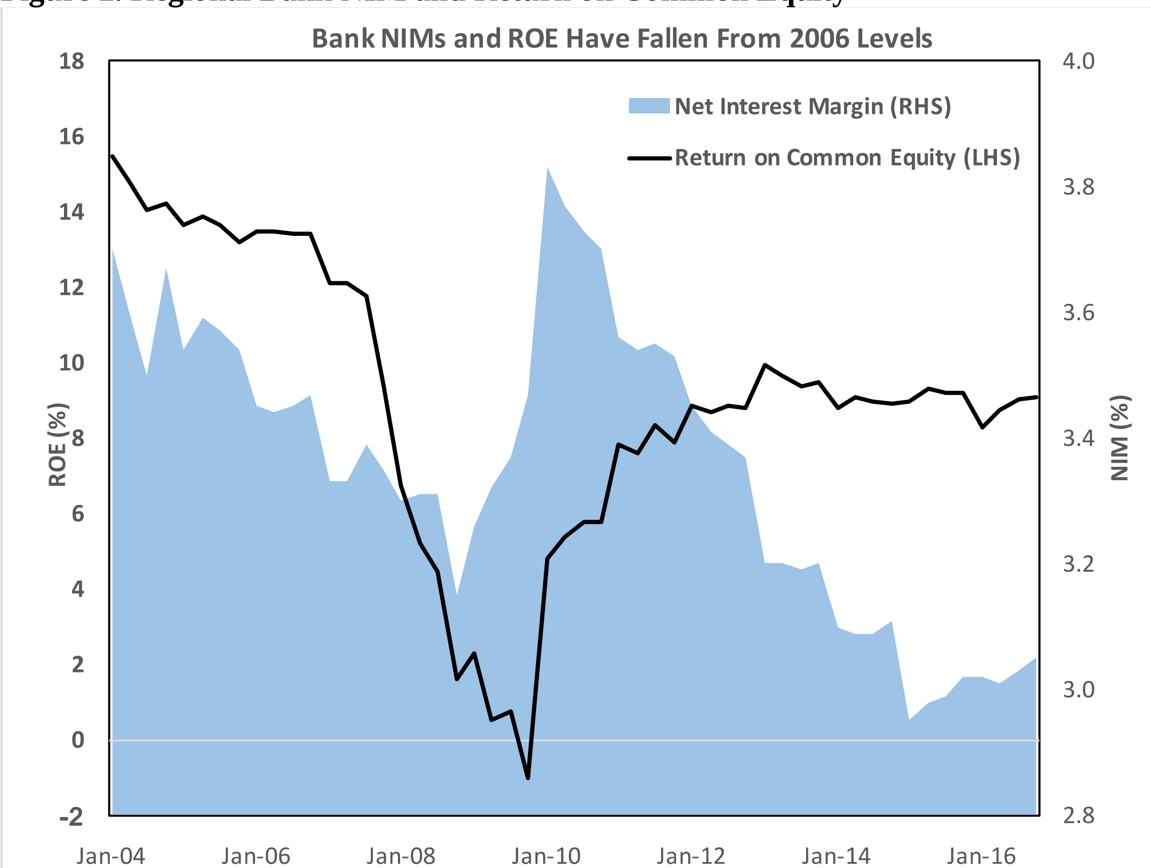
- The rally in bank stocks mostly reflect recent and projected Fed rate hikes rather than the prospect of Trump policy moves. After accounting for the impact of interest rates on future earnings, banks are fair to cheap versus historical pricing.
- A Trump corporate tax cut to 15% could push bank valuations up 20-25% from current levels. Regional banks would be one of the sectors that would benefit most from a cut given that they have 100% of earnings domestically and pay close to the full statutory 35% rate.
- Trump reform of Dodd/Frank could also push up valuations of the bank sector by 20-30% by allowing banks to increase leverage. Banks could have even further upside form DF reform from lower regulatory costs, more lending of higher margin loans, and potential M&A activity.

Figure 1. Bank Prices Have Surged[1]



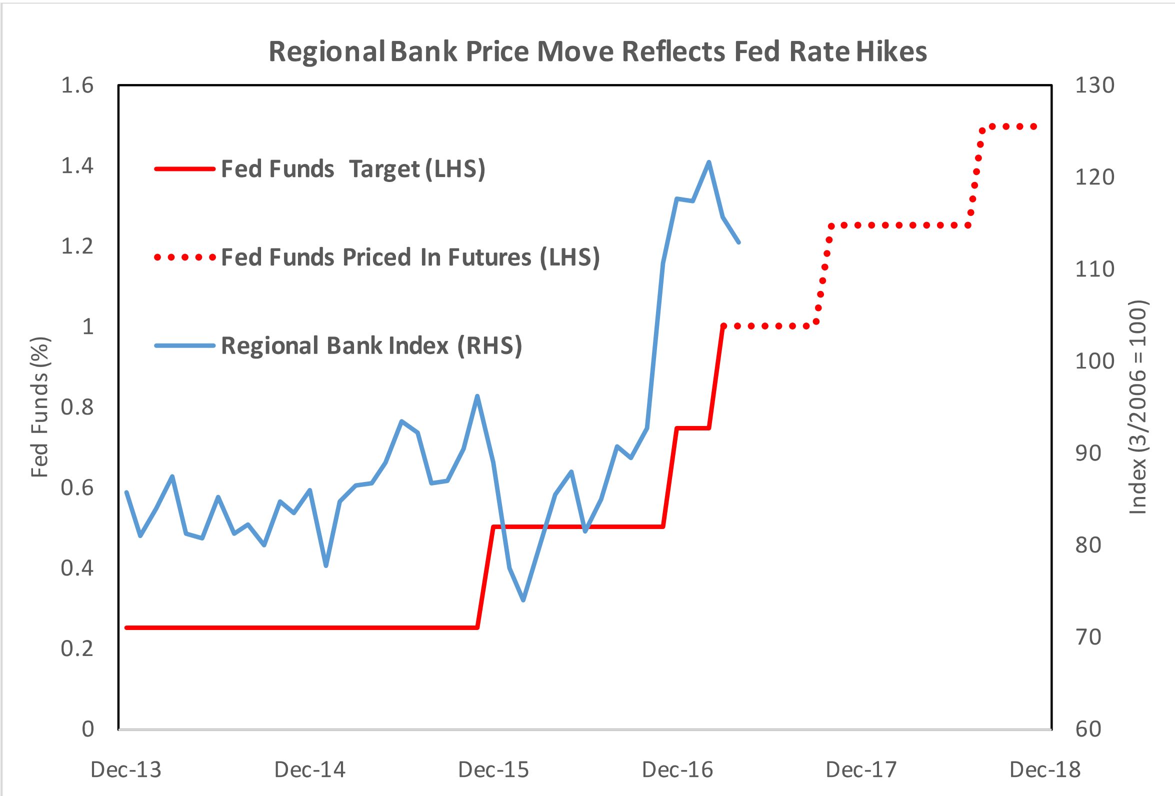
Given the timing of the bank sector rally, I am not surprise that investors look at the upswing in bank prices and associated it with the market pricing in Trumpanomics positive factors. What else could explain the move? As shown in Figure 2, nothing appears to have changed in the fundamental factors that should drive bank pricing, and certainly nothing that would suggest pricing above the levels of 2006. Net interest margins are down substantially, and ROEs are roughly 60% of the levels of 2006. So, what could explain the rally…Trump. Then if Trumpanomics is dead-on-arrival, bank prices fall back to earlier levels.

Figure 2. Regional Bank NIM and Return on Common Equity[2]



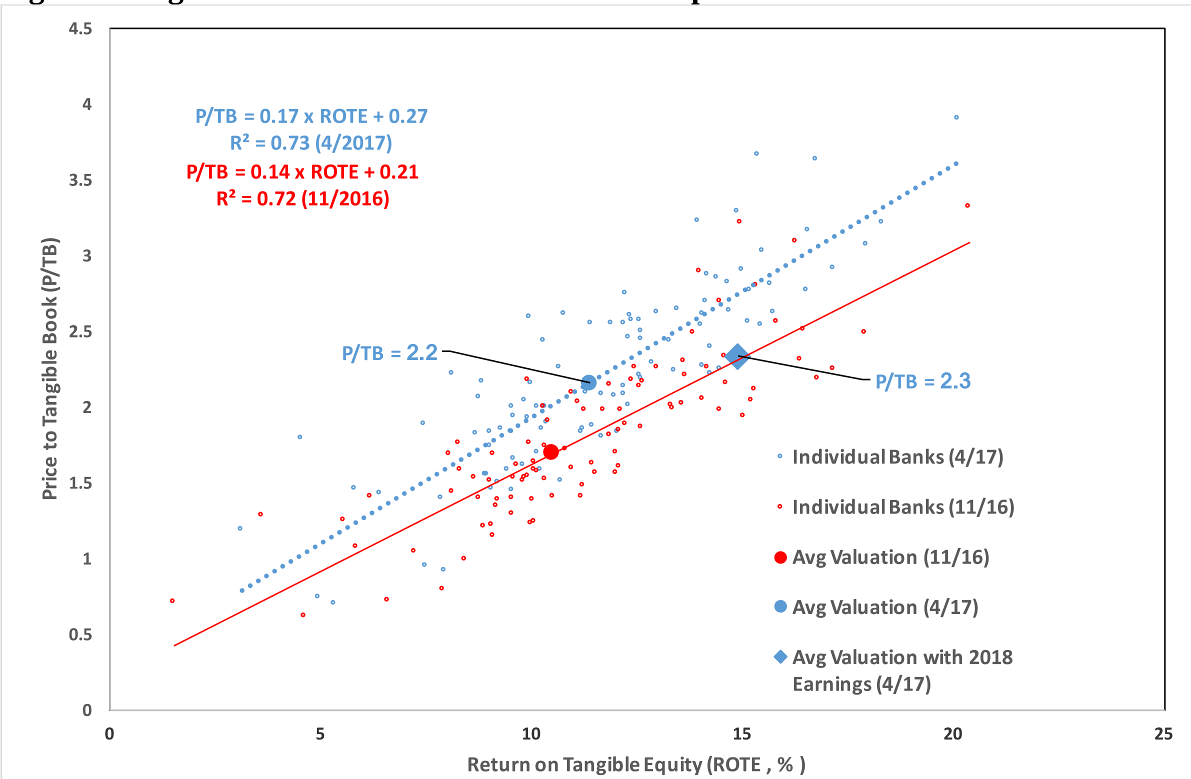
While Trumpanomics could explain part of the move, the larger component was likely the market just pricing in the impact of recent and potential Fed rate hikes. As shown in Figure 3, the rally in bank stocks since November coincides with fundamental change in Fed policy moving to a cycle of rising rates from a policy of ZIRP. Trailing ROE and NIM are lagging indicators of fundamental factors that drive bank pricing that do not reflect recent and potential future Fed rate hikes. Over the next year, however, ROTE will rise reflecting the impact of rising rates.

Figure 3. Bank Pricing and Fed Rate Policy[3]



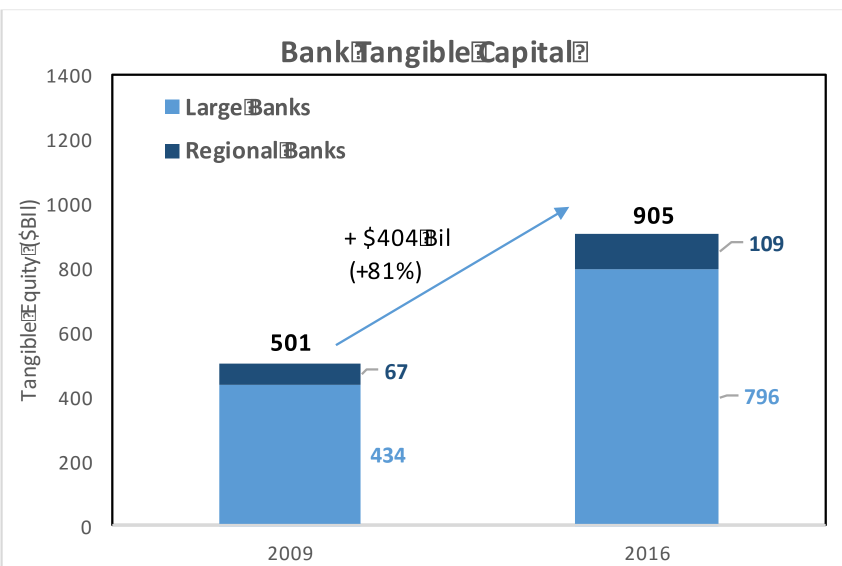
Now let's look at relative pricing of regional banks both now and versus 11/2016. I use a pricing metric of price per tangible book (P/TB) versus return on tangible equity (ROTE). In Figure 4 below, I show individual regional bank pricing on this metric in 11/04/2016 (small red dots) vs 4/08/2017 (small blue dots). The rally in bank equities is evident in the relatively higher levels of individual bank pricing on a P/TB for 4/17 vs 11/16. I also show the regression lines from the pricing data on individual banks from the two periods. The higher valuations of 4/17 is also reflected in the steeper slope of its regression line vs the slope of the line from 11/16. The big solid blue dot is the weighted average valuation currently, while the big solid red dot is the weighted average valuation in 11/16. Yes, average valuations are higher, but plugging in the expectations of 2018 earnings (I am assuming 14.9% ROTE) given current and future Fed funds rates moves current weighted average valuations to the blue diamond, which is on the regression line from 11/16. I am also assuming that bank pricing from 11/16 is fair. Not, I think, and unreasonable assumption give how long the market has had to price in the impact of lower ROE, Leverage and ZIRP. That would suggest current regional bank valuations are fair, and reflect mainly the impact of the change in Fed rate policy. Potentially, even without Trumpanomics, there could be upside to current bank pricing if the Fed raises rates from current projections. Accordingly, regional banks are fair if not cheap after incorporating the impact of the recent rise in interest rates. But does that imply that valuations should be higher than in 2006? The answer again is yes. And once you understand that you can see why fair is cheap.

Figure 4. Regional Bank Valuations Nov 2016 vs April 2017 [4]



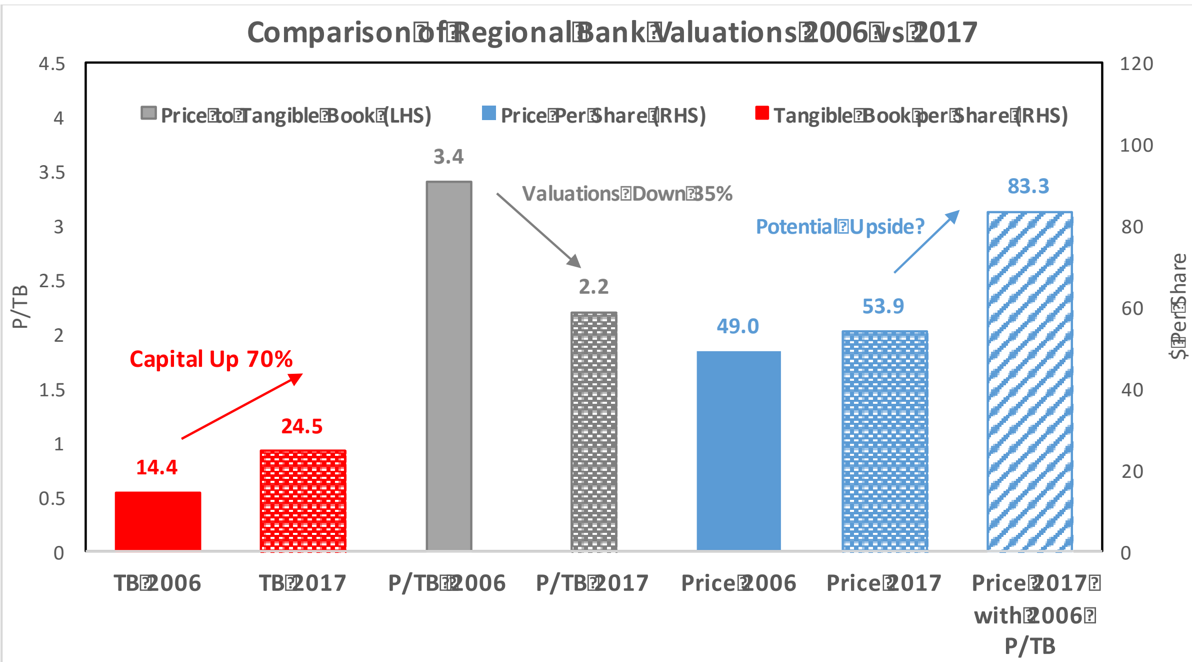
A lot has happened in the banking sector since 2006. After their near-death experience and driven by Dodd frank, banks raised a lot of capital. As shown in Figure 5 below, since 2009—when they first started raising capital--banks have increased their tangible capital base by over 80%.

Figure 5. Bank Tangible Capital 2009 vs 2016[5]



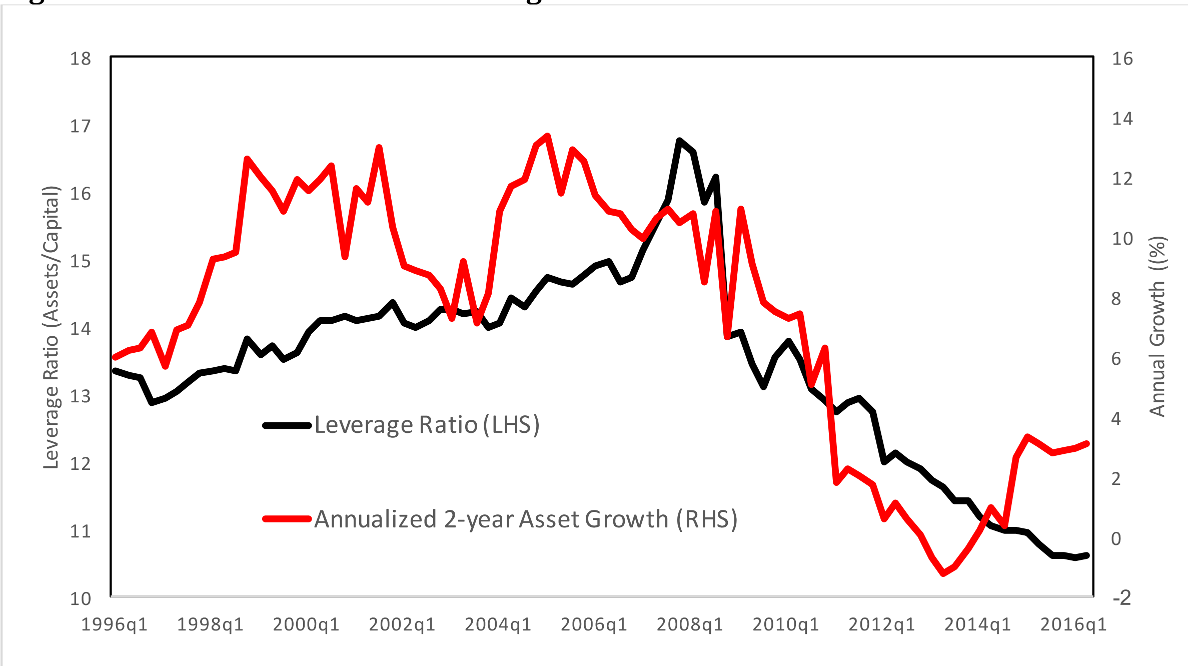
This means that all else held equal, bank prices per share should be higher today than in 2006 reflecting the higher amount of capital per share. However, as shown in Figure 6 below, the potential upward pricing due to higher tangible capital is offset by lower market valuations of P/TB. However, if valuations could move back to those 2006, banks have substantial upside from current levels. The key to this move is, of course, ROTE. And that means Trumpanomics.

Figure 6. Regional Bank Pricing [6]



I am going to focus on two key elements of Trumpanomics that could provide a significant lift to current bank pricing: the marginal corporate tax rate cut to 15% and Dodd-Frank reform. The cut in corporate tax rates could push up bank prices by raising their ROTE, given that regional banks have an effective marginal tax rate close to 30%. Dodd-Frank could also push up bank pricing by lifting ROTE by allowing banks to increase their asset leverage. Leverage has fallen as banks have been force to raise capital levels in order to survive the stress tests of Dodd-Frank, Figure 7. Banks to increase leverage, either by adding assets or giving capital back to investors, which in turn could push their ROTE back to levels of 2006. I pitch regional over money center banks because I believe it is more likely that DF reform helps smaller banks not necessarily the bigger banks.

Figure 7. Banks Have Reduced Leverage and Asset Growth [7]



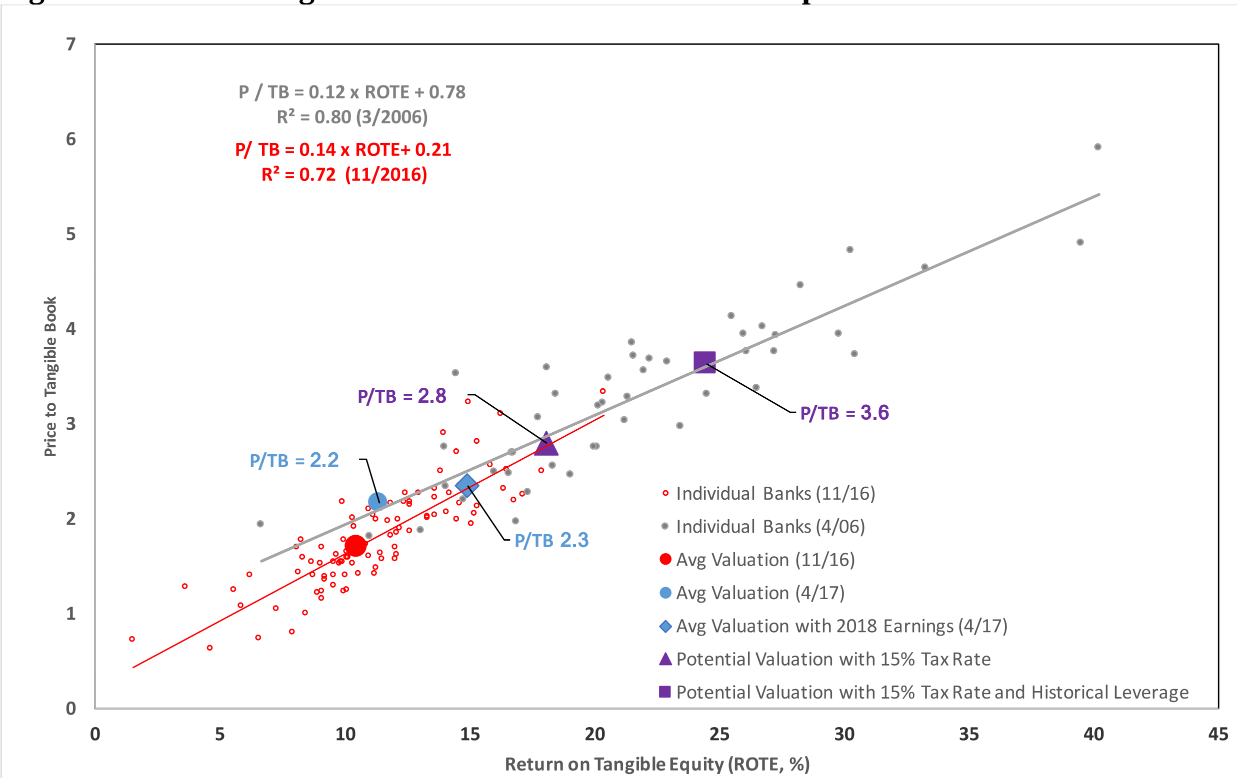
The importance of corporate tax rates and leverage on bank returns is shown in Table 1 below.

Table 1. Valuation Metrics for Regional Banks [8]

	Tangible Book Per Share	Price to Tangible Book	Leverage (tangible Assets/Tangeble Equity)	NIM	Effective Tax Rate	ROTE
Mar-06	14.4	3.4	15.8	3.9	31.3	21.3
Mar-17	24.5	2.2	10.5	3.5	29.7	11.4
Change	70%	-35%	-34%	-10%	-5%	-46%

In Figure 8 below I show the potential impact of tax cuts and DF reform on bank pricing. (All of these calculations are very rough and results for individual banks could differ.) The three points from Figure 3 are shown to give a guide of where we are now. I again use the regression line from the data on regional valuations from 11/16 for fair valuation. In addition, I use the regression from the data on regional bank valuations from 3/2006 to provide a guide to where valuations could move as ROTE start to move above current levels and back to those in 2006. As a rough approximation, the cut from an effective rate of 30% to 15% could push ROTE of banks to 18.1% [14.9% * (1 – 15%)/ (1 - 30%). Using the regression line from 11/16, P/TB would increase to roughly 2.8, the purple triangle, from the current 2.2. That would imply that banks could rally another 20 to 30% from current levels. Next, if leverage goes back up to 15.8, ROTE could increase to the low to mid 20% area, 24.5% [18.1% * (0.3 + 0.7 * (15.8/10.5)]. I am assuming asset driven ROTE is roughly about 70% of total ROTE. This would bring ROTE to levels last experienced in 2006. Using the bank valuation regression line from this period, P/TB would increase to around 3.5s, given an ROTE of the low to mid 20%, represented by the purple square in the figure. That could push bank prices up another 20 to 30%. or a total of about 40 to 50% from both factors versus current fair levels.

Figure 8. Potential Regional Bank Valuations Under Trumpanomics[9]



So, do I think banks could rally another 40 to 50% and get back to valuation levels of 2006? No, not with a high probability. However, I do believe there is a high probability that some aspects of Trumpanomics will get implemented and that gives banks substantial convexity to the upside from current levels. For example, some parts of Dodd-Frank can be changed without congressional approval. That could allow Trump, for example, to change the stress tests, or change what is a SIB. Both changes could give a tail wind to ROTE through leverage, M&A, or a lower cost of regulations. In addition, the downside of banks is offset by the impact of higher interest rates. Bottom line I am still pitching regional banks even after the rally. For more see my entire bank pitch on my web site: SOMmacro.com

1. Bloomberg regional bank index
2. Federal Reserve Bank of St. Louis, access through FRED
3. Bloomberg regional bank index and Fed funds future pricing
4. Bloomberg regional bank index and authors calculations. Expectation of 2018 ROTE comes from Goldman Sachs
5. Goldman Sachs
6. Bloomberg regional bank index and authors calculations
7. FDIC

8. Bloomberg regional bank index
9. Bloomberg regional bank index and authors calculations

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