Market Update from Thrivent

April 22, 2020

Banking Industry: Early reports on impact from COVID-19

Mark Simenstad, CFA
Chief Investment Strategist,
Thrivent Asset Management

The banking industry is the most unique of the major industries in the functioning of the global economy. Banking is at the nexus of the economy, the capital markets and the functioning of the global payment system. In times of financial crises, it's the industry that is most closely monitored and most closely targeted for government policy response and regulation.

Bank earnings, and more importantly what banks are doing to reserve for expected loan losses, provide real-time insight into the current and expected future state of the economy. Banking is traditionally one of the first industries to release quarterly earnings announcements. In the past few weeks many large banks have released earnings announcements for the first quarter of 2020. They provide some early indication of how this crisis is impacting the economy, corporations and consumers.

The banking industry's first quarter results have thus far been primarily challenged by higher-than-expected loan loss reserve provisions in light of the economic impact of the COVID-19 virus. Banks are required to estimate costs in terms of expected losses due to credit defaults and impairments. These higher loss estimates are an indication of the severity of this crisis. Bank profit margins from lending activity (net interest margins) were also negatively impacted as the cost of funding loans rose. Commercial loan volumes surged as credit lines were drawn by borrowers in a frenzied scramble for cash. However, interest rates earned by banks on these short-term loans were not immediately commensurate with rising short-term bank funding costs. Although quarterly banking results have thus far been challenging overall, it is important to note that the large banks that have reported thus far remain profitable and continue to have access to capital and to pay dividends to shareholders.

Banks with large trading desks benefited from the sharp increase in market volatility. Volatile markets can contribute to trading profits for banks that have large broker/dealer businesses. However, profits from these businesses can quickly and significantly diminish once volatility and trading volumes decline.

The main concerns for investors are: 1) how severe will loan losses ultimately be, 2) will lending profitability (net interest margin) improve, and 3) how well positioned is the industry to weather this crisis?

Banking industry fundamentally more sound than financial crisis of 2008

Despite the challenging operating conditions, the banking industry enters this downturn in a much stronger position compared to the financial crisis of 2008. Thanks to a decade of Federal Reserve stress testing, banks have much lower leverage, cleaner balance sheets, and higher levels of liquidity that should help them exit this downturn in much better shape than in prior recessions. Yet, even bank managements admit the lack of modern global pandemic precedents makes forecasting loss rates much more challenging. As a result, the largest banks boosted reserves in the first quarter by about 65%, or 2-3% of their loans, to cover estimated potential losses, representing approximately 60% of the losses forecast in prior Fed stress test scenarios. The reserves are large, but more will likely be needed in the coming quarters as more information is gathered about the severity of the COVID-19 impact on the economy and the potential benefit of the government's support programs on credit losses. Despite this uncertainty, the banks appear to be positioned to be part of the solution in this 'Great Lockdown' recession rather than a source of the problem as they were in the Great Financial Crisis.

One of the keys to longer term profitability (net interest margin) for the banking system is having access to low-cost funding. As the financial crisis has driven short-term interest rates to approximately 0%, consumers have increased their savings deposits. This is an attractive source of low-cost funding for banks.

Banks have also taken advantage of the stability in the bond market (thanks to unprecedented Federal Reserve policies) by issuing large amounts of longer maturing bonds. As an example, JP Morgan was able to issue $10 billion in bonds, the largest amount ever by a bank, at an interest cost of about 2.5%. This would not have been possible at this stage of the 2008 financial crisis. Confidence in the banking system, as manifest in this low-cost combination of funding, is an important element to recovery in the economy, the banking industry financial profile, and the capital markets.

Banking Industry: Outlook

The banking industry is positioned to weather the economic storm caused by the coronavirus crisis. However, returns to investors in bank securities will be more uncertain than other industries given the vagaries surrounding ultimate credit losses, interest rates and net interest margins. Year to date, the banking sector has been one of the worst performing sectors, down more than 40% as measured by the KBW Bank Index. This same index shows that banks are now trading at about 80% of book value, a historically "cheap" valuation. This reflects the uncertainties around the assets on bank balance sheets. However, as opposed to the Great Financial Crisis, when many bank balance sheets contained esoteric securities that led to excessive losses, the impact of the current recession will center on the financial health of each bank's loan customers, which is being supported, to some extent, by new and expanded government programs.

For an income investor, the banking industry provides numerous investment alternatives. The lowest-risk source of income from bank securities is from bonds. The JP Morgan issues mentioned previously are a good example of bond yields available on the highest quality banks, at approximately 2.5-3.00%. Moving up the risk spectrum are preferred stocks issued by banks. Although banks could cut or eliminate these dividends if severe credit losses materialize, it does not appear that the industry is contemplating this move as of now even after taking relatively significant reserves for losses. Currently the average preferred stock dividend yield is approximately 6% as measured by the ICE Preferred Securities Index. An income investor in bank preferred stocks should be aware that there are frequently call provisions with these securities which make their ultimate maturities uncertain. The final and highest risk income option for investors is bank common stock. The average common stock dividend yield, as measured by the KBW Bank Index, is approximately 4.5%. These dividends are even more at risk than preferred stock dividends if credit losses become more serious and/or regulators demand their omission. However, if bank stocks recover, meaningful capital gains are possible.

Media contact: Samantha Mehrotra, 612-844-4197; samantha.mehrotra@thrivent.com

3054727-042220