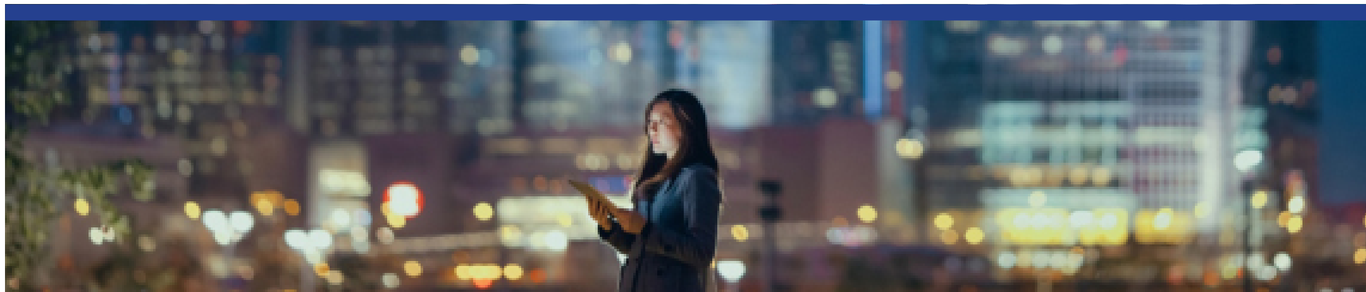

September 2, 2023

CIO Strategy Bulletin

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Why Bank Equities Price in Recession While Credit Markets See Expansion

- US banks have been tightening lending standards for about five quarters now. The total return for the S&P Large Cap Bank Equities index has been about -7% this year and -19% for S&P Small Cap Bank index, both dramatically trailing the S&P 500's 19% return in the year-to-date. An equally striking contrast is the performance of high yield credit markets, with a 6.4% gain year-to-date.
- A sharp tightening of lending standards has been a traditional near-term leading indicator of US recession, but not in isolation. Current tight corporate bond spreads and other financial indicators show scant signs of stress. Profit declines have been minimal, and corporate debt servicing looks strong. The big expansion of debt in the past four years has been Federal borrowing, not private borrowing.
- The commercial real estate sector is a standout potential source of weakness after a 40% surge in lending by small banks since end-2019. Office properties are a well-discounted secular loser from "work at home" flexibility. A record high level of multi-family residential properties will also be delivered in the coming year, with financing costs sharply higher.
- We believe regulatory constraints on banks - including capital uncertainty - is the most significant factor in both the long-term underperformance of their shares and even their cyclical decline this year. Share price drops may prove exaggerated if credit markets are "right." However, we prefer investments higher up in capital structure for financials. Investment grade bank preferreds yield near 7.5% and have gained 4.5% on a total return basis in the year-to-date, outperforming common.

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Two Messages from Banks and Bonds

The tight Fed and inverted US yield curve continue to be a source of worry over the US economy. This is even as share prices have rebounded sharply this year, recouping most of 2022's loss. As inflation falls, real US policy rates are rising (**Figure 1**). While the US continues to see job gains at about half of last year's pace in August, the unemployment rate rose from 3.5% to 3.8%. Job openings have fallen by 2.6 million over the past year. This is Fed Chairman Powell's key metric for a labor market "cooling" (Figure 2).

Figure 1: US Real Fed Funds Rate and Rate Estimated with Bond Market Implied Future Inflation Rate

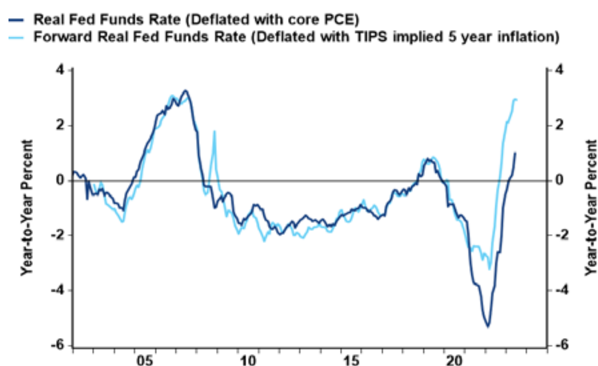
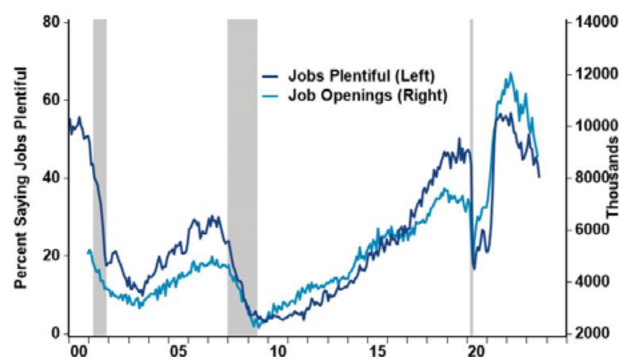


Figure 2: US Job Openings and Share of US Consumers Reporting "Jobs are Plentiful"



Source: Haver analytics through August 29, 2023. Grey areas note periods of recession.

We have long noted that the US yield curve is the single best performing long-term leading indicator of recession. Curve inversions have preceded each of the nine US recessions since 1960 with long and variable lags but only one false warning. Bear in mind, buyers of long-term bonds who sent the US yield curve to inversion in the first half of 2019 couldn't have known that a world-changing pandemic would crush the economy in 2020. They are still credited with being right.

We would emphasize that an inverted curve is a wager by bond investors that the Federal Reserve ("Fed") will cut policy rates in the future. As we've seen in periods such as 1995 and 2019, it is possible for the Fed to ease monetary policy in conditions short of a "standard" recession. Restrictive monetary policy leaves the economy more susceptible to shocks. We expect the Fed's desire to both lower inflation and protect the economic expansion favors a risk management approach that will lead to some easing steps in the coming year, even without a broad-based collapse in the economy.

Banks Feel Recession, But Not Credit Markets

Apart from the yield curve, more contemporaneous signs of recession are almost always felt in credit markets. Currently, signs of stress are very limited. With corporate profits off just slightly this year (our own full year 2023 estimate is now down just 2%), firms have a strong ability to service debt (**Figures 3-4**). This is true of even high yield issuers, who financed their stock of debt below 6% at the time they borrowed (**Figures 5-6**). A mere 2% of the US high yield bond market's securities mature in 2024.

Figure 3: US Non-Financial Corporate Debt as % of Pre-Tax Profits

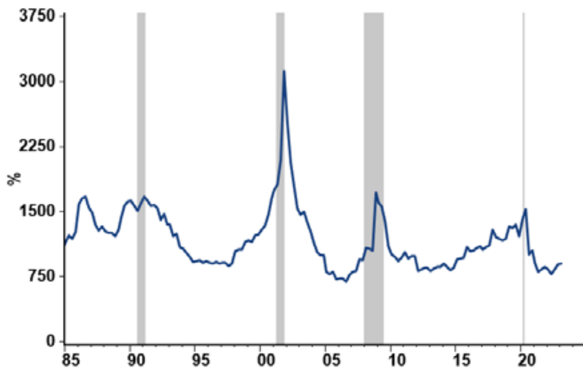
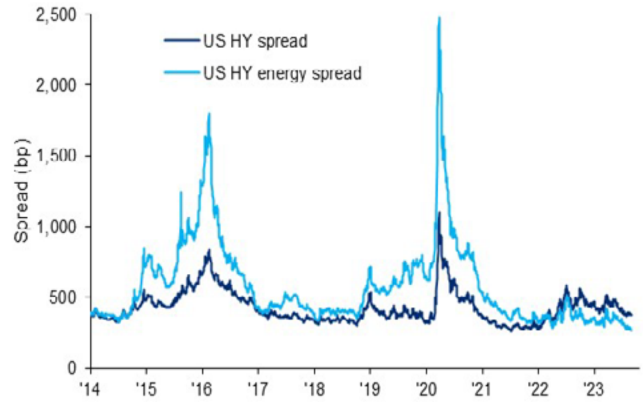


Figure 4: US High Yield and High Yield Energy Sector Spread Over US Treasuries



Source: Haver analytics and Bloomberg through August 29, 2023. Grey areas note periods of recession.

Figure 5: Conference Board's Leading Credit Index and BBB-Corporate Spread Above US Treasury

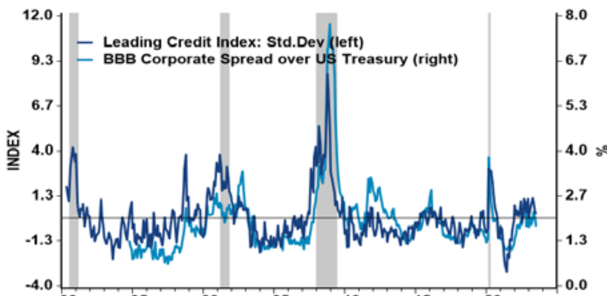


Figure 6: High yield bond Yield-to-Worst Relative to Coupon Yield (the yield now, vs cost at issue)

Source: Haver analytics, Bloomberg through August 29, 2023. Grey areas note periods of recession. The indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is not indicative of future results. Real returns may vary.

In contrast to the corporate bond market, bank lending standards are consistent with *immediate* recession. Banks have tightened standards at rising yields for almost every category of lending for five quarters now. This tightening of financial conditions contrasts markedly with the narrow credit spreads. And unlike past periods, many related measures of economic activity continue to show growth rather than contraction (**Figure 7-8**).

Figure 7: US High Yield Spreads vs Share of Banks Tightening Lending Standards for Commercial and & Industrial Loans

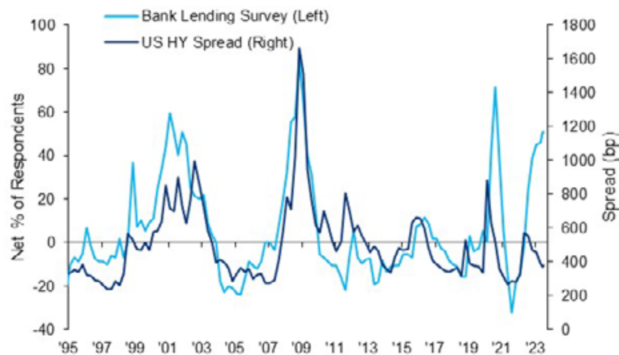
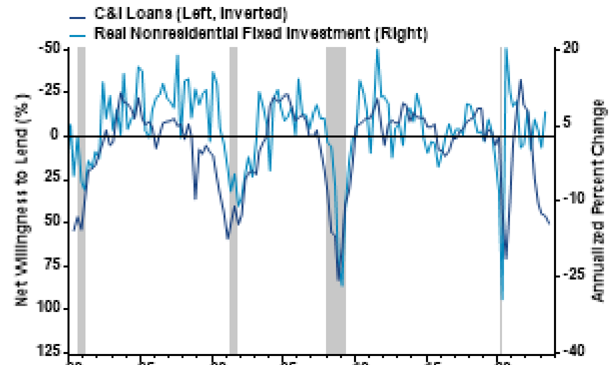


Figure 8: Real US Capital Spending vs Share of Banks Tightening Lending Standards for Commercial & Industrial Loans



Source: Haver analytics through August 29, 2023. Grey areas note periods of recession.

Could it be that the corporate bond market has too sanguine a view of US economic prospects? That's possible. At current pricing, we see relatively little reason to take high credit risks in corporate bonds for fairly little spread. But it is also possible that the banking sector's deep underperformance this year is about more than just economic risks (**Figures 9-10**).

Figure 9: S&P 500 Sector Year-to-Date Performance

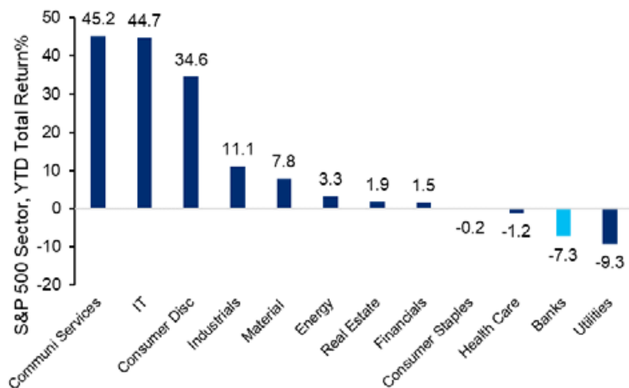


Figure 10: Large Diversified and Small Bank Total Return Indices Since 2007: Insignificant Difference in Performance

Source: Haver analytics, Bloomberg through August 29, 2023. Grey areas note periods of recession. The indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is not indicative of future results. Real returns may vary.

What Do Small Banks Have Beneath the Hood?

In March, when it became clear that some banks did not prepare adequately for rising Fed policy rates, investors feared a growing wave of bank failures. If so, history shows this can take a very long time to unfold. Between 1984 and 1993, a record 2,242 mostly small US banks failed in the Savings and Loan Crisis. Only one mild recession, sparked by a jump in oil prices, occurred during those 10 years.

In the present situation, we would contrast the sharp rise in lending to the commercial real estate sector by small banks to the relative restraint in *overall* private borrowing. Since end 2019 – prior to the COVID shock, small US banks have grown their commercial real estate ("CRE") loan book by 40%. This compares to a 3.6% increase in CRE loans by large banks (**Figure 11**). Total

private debt – including the CRE loans – grew a far more modest 19.4% during the 3 ½ years.[1] The big spender and borrower has been the US Federal government, with debt up 42.6% through 1Q 2023.

The CRE lending comprises 44% of the lending book of small banks compared to 13% for the large banks. For either, a good portion of the loans financed multi-family residential construction. As rising mortgage rates have "immobilized" housing turnover, it has led to both high prices and reduced affordability for prospective new homeowners. The National Association of Realtors single-family housing affordability measure is at the lowest level since 1985. And with it, the "absorption" of rental properties by the growing number of US households has continued to remain strong (**Figure 12**). While multi-family home construction will likely peak and plummet on the Fed's policy tightening of the past two years, we'd expect relatively minor credit distress as the roughly 1 million rental and purchase units will mostly find demand in the year to come.

Figure 11: Commercial Real Estate Loans Large vs Small Banks

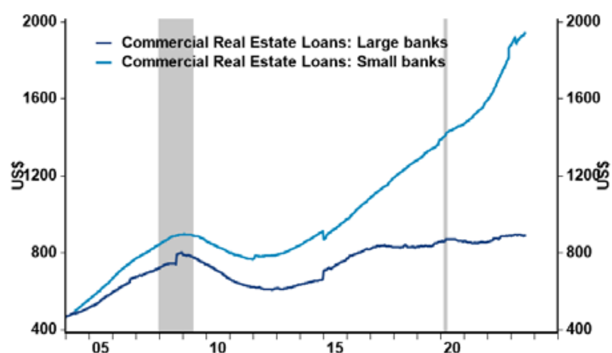
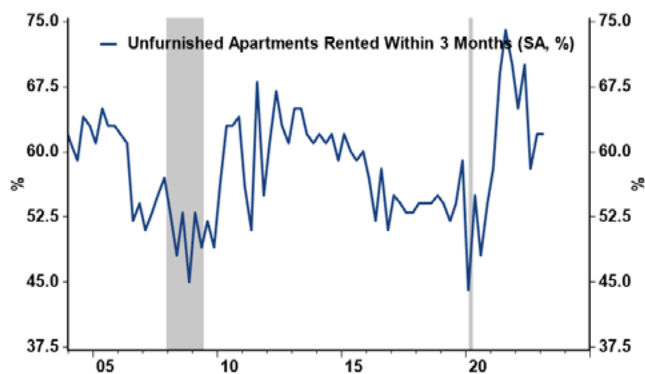


Figure 12: Absorption Rate of New Apartments over 3 months



Source: Haver analytics through August 30, 2023. Grey areas note periods of recession.

Of course, "the office" continues to suffer and will present credit strains for "off-prime" properties in the years to come. The capacity to work from home and save valuable commuting time and cost is a technology shock akin to e-commerce for retailing and "e-home-letting" for hospitality. However, this weakness seems significantly discounted in public REITS markets (**Figure 13**). In contrast, there has been far less dispersion of performance in bank equities as Figure 10 suggests. While broad data are unavailable, individual bank data show that office lending is a minority of CRE loans outstanding.

As noted, after the failure of Silicon Valley Bank in March 2023, investors initially became quite concerned about a wave of deposit flight and bank failures. Since then, nothing of the sort has occurred. Small banks even continued to grow CRE lending (**Figure 14**).

[1] The bank lending data are weekly, while the broader measures are quarterly, creating some distortions in direct comparisons.

Figure 13: Residential REITS vs Office REITS Total Returns

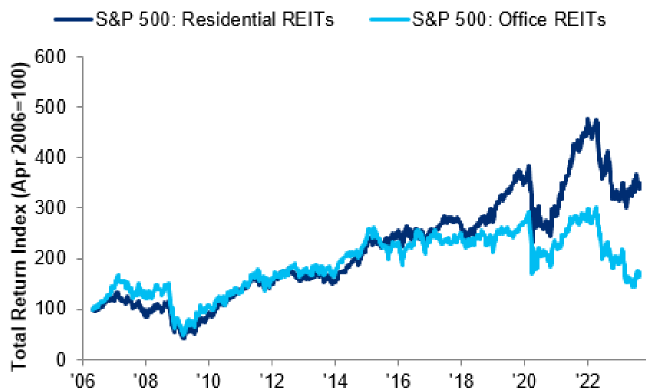
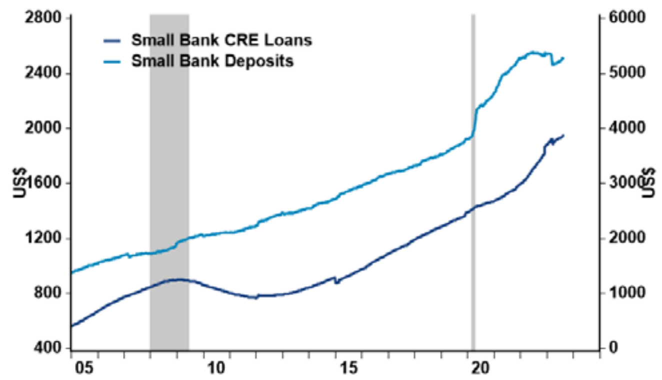


Figure 14: Small Bank Deposits vs CRE Loans: Both Recover Post Silicon Valley Bank



Source: Haver Analytics through Aug 29, 2023. Grey areas note periods of recession. The indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is not indicative of future results. Real returns may vary.

Regulation Counts

The Fed's sharp tightening - and consequent lure of T-bills yielding 5.5% - has pushed up the cost of deposits for banks. Yet a very large share of bank deposits remain far below bond yields (**Figure 15**). This means that bank net interest margins have actually risen in recent quarters. However, regulators are keen to make mid-sized US banks less dependent on short-term funding and instead issue more expensive long-term debt. Along with uncertainty as to how future Basel capital requirements will be applied to US banks, we believe these regulatory uncertainties have been a meaningful reason why bank shares have underperformed. This is no short-term problem. High and rising regulatory costs and growth restraints on the financial sector are the largest reason it has underperformed the S&P 500 since the Global Financial Crisis (**Figure 16**).

Figure 15: US Banks Cost of Funds vs Earnings Yield (%)

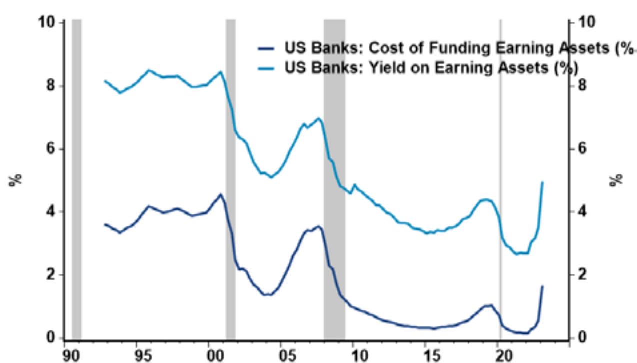


Figure 16: S&P 500 Banks Total Return Relative to S&P 500

Source: Haver analytics though August 21, 2023. Grey areas note periods of recession. The indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is not indicative of future results. Real returns may vary.

Figure 17: Regulatory Burdens for Private Firms Sink China Shares

Figure 18: US Investment Grade Preferreds vs High Yield Bond Total Return

Source: Bloomberg and Haver analytics through August 30, 2023. Grey areas note periods of recession. The indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is not indicative of future results. Real returns may vary.

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Bond rating equivalence
Alpha and/or numeric symbols used to give indications of relative credit quality. In the municipal market, these designations are published by the rating services. Internal ratings are also used by other market participants to indicate credit quality.

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Credit risk	**Moody's[1]**	**Standard and Poor's[2]**	**Fitch Ratings[2]**
Investment Grade			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

1 The ratings from Aa to Ca by Moody's may be modified by the addition of a 1, 2, or 3 to show relative standing within the category.
2 The ratings from AA to CC by Standard and Poor's and Fitch Ratings may be modified by the addition of a plus or a minus to show relative standing within the category.

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