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Marketing Material

BANKS THIS RECESSION VS. LAST: FROM PATIENT TO MEDIC

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IN A NUTSHELL

_ Shape of the earnings recovery is in hot debate: bank profits key uncertainty
_ Low rates will challenge the recovery in bank earnings for several years
_ Credit costs are the chief uncertainty for banks in any recession

SHAPE OF THE EARNINGS RECOVERY IS IN HOT DEBATE: BANK PROFITS KEY UNCERTAINTY

We are just weeks from the second quarter earnings season, which starts with the banks and is preceded by this year's Comprehensive Capital Analysis & Review (CCAR) exam results of U.S. banks by the U.S. Federal Reserve (Fed) to be released this week. Second quarter earnings will establish the base for the sequential earnings recovery.

We expect a sharp 50% plus year-over-year decline in the second quarter S&P 500 earnings-per-share (EPS) to set the third quarter up for a strong sequential bounce, but a recovery in the fourth quarter to EPS of 42. Our past notes address our S&P 500 EPS recovery outlook, but here we focus on banks because they are a key uncertainty for S&P 500 EPS troughs and the trajectory of recovery. Last year, banks were 9.5% of S&P 500 EPS and Financials 18%. Below their peaks of 12% and 24% in 2006, but still large (energy was only 4% in 2019 vs. 15%-20% in 2006-07) and these earnings are cyclical. Bank profit drivers include loan loss provisioning, interest rates, asset growth/mix, leverage and fees.

LOW RATES WILL CHALLENGE THE RECOVERY IN BANK EARNINGS FOR SEVERAL YEARS

Banks were in need of rescue last recession. This time they are part of the emergency response. But in both recessions they will suffer high credit costs and be challenged by near zero interest rates. While loan book credit costs are likely similar to last recession (but not securities write-downs, which were huge costs to banks last time), low interest rates will challenge Banks more in the early cycle years than last time.

This is because there will be less benefit from old loans in place, with higher yielding rates maturing over time. Also, there is a sudden loss of substantial interest income this time on excess reserves and less curve steepness. The federal funds rate was cut 525 basis points (bps) late 2007 to late 2008, but cut only 225bps from the third quarter of 2019 to the first quarter of 2020. Last recession's larger cut, provided more pre-credit cost profit cushion from a quick cut in funding vs. the lagged decline in loan yields. Prior to last recession, banks did not earn interest on excess reserves (IOER). But the Fed paid 25 billion dollars in IOER in 2019 and five billion dollars in the first quarter of 2020. Near nothing will be paid in the second quarter through 2022. The yield curve had about 300bps of steepness in the first two to three years of recovery, this time we expect maybe 100bps. Thus, even as loss provisions fade the rebound in pre-provision bank profits should be limited.

CREDIT COSTS ARE THE CHIEF UNCERTAINTY FOR BANKS IN ANY RECESSION

When credit costs are in a recession-driven upswing they dominate the outcome for bank profits. Despite disciplined lending standards before this recession, we expect high unemployment and strains on many service businesses and

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related real estate as well as exacerbated strains on energy and industrial-goods producers to keep bank quarterly loan loss provisioning at first quarter of 2020 levels on average well into 2021.

Inside, we chart loan loss provisions, charge-offs, and loss reserves through the first quarter. We also track loan delinquencies and bankruptcies, which are rising but not surging. It is normal for loan deterioration to lag an economic shock. But given the extraordinary fiscal stimulus programs and forbearance directives, we expect a steady climb in loan stress indicators through 2020, rather than the quick surge and peak already seen in unemployment. Provisions lag shocks and charge-offs (last peaked in 2010) lag provisions, thus banks have much discretion in booking loss reserve build in the second quarter.

Our second quarter 2020 estimated (E) S&P 500 EPS assumes provisions as large or larger than in the first quarter, but it could be less if banks choose to wait. We think the biggest banks should be similar to the first quarter, but others should be higher. This along with strong second quarter capital-markets activity, suggests positive surprises are more likely at the largest S&P 500 banks with disappointment risk at regionals and small-cap banks. Our 2020E financials profit is 180 billion dollars (-28% year-over-year) vs. bottom-up now 167 billion dollars with the second quarter of 2020 now at 33 billion dollars (likely beaten); first quarter 2020 was 39 billion dollars. Our 2021E financials profit is 212 billion dollars, as loss provisions recede, vs. 250 billion dollars in 2019.

FORBEARANCE: WHO BEARS THE COST?

In this pandemic recession, banks are facing high credit costs but not shrinking their balance sheet. They are tightening standards in spots, but maintaining decent credit availability and providing distressed borrowers forbearance. Loans in forbearance programs are not categorized as non-performing or charged-off even if no payments are being made. Missed payments accrue to the loan balance. This delays charge-offs and raises risks, watch asset-to-equity ratios, and squeezes cash flow, but likely mitigates ultimate credit costs. We expect these conditions to keep overall S&P 500 bank dividends flat this coming year post CCAR announcements. Flat dividends or token hikes at the biggest S&P 500 banks with dividend cuts, some significant, at other banks.

FEDERAL RESERVE BALANCE-SHEET AND LIQUIDITY INDICATORS

The Fed's balance sheet now exceeds seven trillion dollars, up three trillion dollars from the start of this year. The asset surge is mostly Treasury securities purchases, mirrored by increases in the Treasury Department's cash account from 0.4 trillion dollar to 1.6 trillion dollars and bank excess reserves from 1.5 trillion dollars to 3.1 trillion dollars. The 135 billion dollars increase in cash in circulation is small relative to other liabilities, but a high growth rate. So far, the liquidity created by the Fed is held by the Treasury Department and banks, but cash in circulation will rise as the Treasury deficit spends. This complicates the longer-term outlook for inflation.

GLOSSARY

A balance sheet summarizes a company's assets, liabilities and shareholder equity.

One basis point equals 1/100 of a percentage point.

The business cycle is the oscillating movement of gross domestic product around ist long-term trend during expansions and contractions

A company's cash flow is comprised of its inflows and outflows which arise from financing, operational or investing activities.

A charge-off is a debt that is deemed unlikely to be collected by the creditor, since the borrower has become increasingly delinquent.

The Comprehensive Capital Analysis & Review (CCAR) is United States regulatory framework by the Federal Reserve to assess, regulate and supervise large banks.

A dividend is a distribution of a portion of a company's earnings to its shareholders.

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Excess reserves are the capital reserves held by a bank or financial institution in excess of what is required by regulators.

The federal funds rate is the interest rate, set by the Fed, at which banks lend money to each other, usually on an overnight basis.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

The U.S. dollar (USD) is the official currency of the United States and its overseas territories.

The U.S. Federal Reserve, often referred to as "the Fed", is the central bank of the United States.

Yield is the income return on an investment referring to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

A yield curve shows the annualized yields of fixed-income securities across different contract periods as a curve. When it is inverted, bonds with longer maturities have lower yields than those with shorter maturities.

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