EQUITY STRATEGY INSIGHTS

Banks Are in Much Better Shape One Year After the Crisis but May Not Be Great Investments Right Now

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EXECUTIVE SUMMARY

- Now more than a year removed from the failures of Silicon Valley Bank (SVB) and Signature Bank (SB), we revisit the country's banks to gauge how far they've come in shoring up their balance sheets.
- These select failed banks were outliers in terms of how they managed their balance sheets and their concentrated and cyclical customer bases that facilitated the runs.
- Our analysis of the interest rate sensitivity of bank balance sheet risks reveals a stronger foundation overall than in March 2023.
- From an investment merit perspective, there is little to get excited about in terms of bank stocks, though our technical analysis work and resilient estimates during earnings season thus far are encouraging.

Now more than one year removed from the failures of SVB and SB, we revisit the country's banks to gauge how far they've come in shoring up their balance sheets to move past that crisis. Some of you may be wondering if the latest increase in Treasury yields increases the risk of more trouble for banks. After diving into the numbers, it's clear to us that banks as a whole are in better shape than they were 13 months ago, for reasons we detail below.

Setting the Stage

After SVB failed in March 2023, our Chief Investment Officer Marc Zabicki presented a quantitative analysis of the largest publicly-traded banks and savings and loans to highlight the unique characteristics of the failed banks and why we believed these problems were not systemic. These select failed banks were outliers in terms of how they managed their balance sheets — very evident in the data — and with their concentrated and cyclical customer bases that facilitated the runs on these banks. These factors gave us the comfort to claim that these bank failures were not signs of deeper problems yet to come, and we stick by that view today.

Deep Dive

Last spring, to gather insight into the potential systemic risk posed by the SVB failure, LPL Research conducted quantitative analysis of all of the publicly-traded banks and savings and loan institutions in the Russell 3000 Index. We analyzed each company's deposits, deposit growth, unrealized losses, total assets, marketable securities positions, capital ratios, and marketable security positions relative to various balance sheet variables.

On the next page, we provide some of those data points (**Figure 1**), followed by some observations when we compare those data points with today's numbers to help demonstrate the improvement in the quality of bank balance sheets and reduction in interest rate sensitivity.

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1 Banks Are Well Capitalized Based on Data From the Top 25 Publicly-Traded U.S. Banking Institutions by Assets

	Name	Total Assets ($mil)	Unrealized Gain/Loss ($mil)	Total Deposits ($mil)	Deposit Growth YoY (%)	Total Equity ($mil)	Earning Assets ($mil)	Total FDIC Securities ($mil)	Securities as a % of Earning Assets	Securities as a % of Tot. Deposits	Securities as a % of Tot. Assets	Unrealized Gain/ Loss as a % of Tot. Equity	Tier 1 Capital Ratio (%)
1	JPMORGAN CHASE & CO	$ 3,875,393	$ 7,004	$ 2,400,688	2.6	$ 327,878	$ 3,452,674	$ 571,646	16.6%	23.8%	14.8%	2.1%	16.6
2	BANK OF AMERICA CORP	$ 3,180,151	$ 4,492	$ 1,923,827	-0.3	$ 291,646	$ 2,802,646	$ 861,240	30.7%	44.8%	27.1%	1.5%	13.5
3	CITIGROUP INC	$ 2,411,834	$ 3,322	$ 1,308,681	-4.2	$ 206,251	$ 2,195,691	$ 504,540	23.0%	38.6%	20.9%	1.6%	15.0
4	WELLS FARGO & CO	$ 1,932,468	$ 1,682	$ 1,358,173	-1.9	$ 187,443	$ 1,716,725	$ 393,249	22.9%	29.0%	20.3%	0.9%	13.0
5	GOLDMAN SACHS GROUP INC	$ 1,641,594	$ 1,245	$ 428,417	1.6	$ 116,905	$ 1,317,357	$ 118,987	9.0%	27.8%	7.2%	1.1%	16.6
6	MORGAN STANLEY	$ 1,193,693	$ 1,098	$ 351,804	-2.2	$ 99,982	$ 1,127,053	$ 154,851	13.7%	44.0%	13.0%	1.1%	17.1
7	US BANCORP	$ 663,491	$ 1,996	$ 512,312	-2.4	$ 55,771	$ 523,568	$ 153,751	29.4%	30.0%	23.2%	3.6%	11.5
8	PNC FINANCIAL SERVICES GROUP	$ 561,580	$ 3,056	$ 421,418	-3.4	$ 51,141	$ 498,615	$ 132,575	26.6%	31.5%	23.6%	6.0%	11.4
9	TRUIST FINANCIAL CORP	$ 535,349	$ 636	$ 424,773	-4.3	$ 59,253	$ 467,096	$ 121,473	26.0%	28.6%	22.7%	1.1%	11.6
10	BANK OF NEW YORK MELLON CORP	$ 409,953	$ 887	$ 283,669	1.7	$ 41,009	$ 242,332	$ 126,395	52.2%	44.6%	30.8%	2.2%	14.7
11	STATE STREET CORP	$ 297,258	$ 1,098	$ 220,970	-6.2	$ 23,799	$ 233,404	$ 101,644	43.5%	46.0%	34.2%	4.6%	13.4
12	CITIZENS FINANCIAL GROUP	$ 221,964	$ 762	$ 177,342	-1.9	$ 24,342	$ 195,938	$ 38,962	19.9%	22.0%	17.6%	3.1%	11.8
13	FIFTH THIRD BANCORP	$ 214,574	$ 621	$ 168,912	3.2	$ 19,172	$ 191,627	$ 49,698	25.9%	29.4%	23.2%	3.2%	11.6
14	FIRST CITIZENS BCSHS -CL A	$ 213,758	$ 163	$ 145,854	63.1	$ 21,255	$ 197,459	$ 29,913	15.1%	20.5%	14.0%	0.8%	13.9
15	M & T BANK CORP	$ 208,264	$ 240	$ 163,274	-0.1	$ 26,957	$ 189,140	$ 25,772	13.6%	15.8%	12.4%	0.9%	12.3
16	HUNTINGTON BANCSHARES INC	$ 189,368	$ 423	$ 151,230	2.2	$ 19,398	$ 173,168	$ 41,055	23.7%	27.1%	21.7%	2.2%	12.0
17	KEYCORP	$ 188,281	$ 1,066	$ 145,587	2.1	$ 14,637	$ 172,052	$ 45,761	26.6%	31.4%	24.3%	7.3%	11.7
18	REGIONS FINANCIAL CORP	$ 152,194	$ 558	$ 127,788	-3.0	$ 17,493	$ 131,803	$ 28,858	21.9%	22.6%	19.0%	3.2%	11.5
19	NORTHERN TRUST CORP	$ 150,783	$ 443	$ 116,164	-6.3	$ 11,898	$ 133,978	$ 48,726	36.4%	41.9%	32.3%	3.7%	12.3
20	NEW YORK COMMUNITY BANCORP	$ 114,057	$ 9	$ 81,526	38.8	$ 8,367	$ 96,352	$ 9,145	9.5%	11.2%	8.0%	0.1%	9.6
21	ZIONS BANCORP NA	$ 87,203	$ 420	$ 74,961	4.6	$ 5,691	$ 81,937	$ 21,161	25.8%	28.2%	24.3%	7.4%	10.9
22	COMERICA INC	$ 85,834	$ 361	$ 66,762	-6.5	$ 6,406	$ 76,421	$ 16,869	22.1%	25.3%	19.7%	5.6%	11.6
23	FIRST HORIZON CORP	$ 81,661	$ 184	$ 65,780	3.6	$ 9,291	$ 74,967	$ 9,714	13.0%	14.8%	11.9%	2.0%	12.4
24	WEBSTER FINANCIAL CORP	$ 74,945	$ 120	$ 60,784	12.5	$ 8,690	$ 68,380	$ 16,035	23.4%	26.4%	21.4%	1.4%	11.6
25	WESTERN ALLIANCE BANCORP	$ 70,862	$ 148	$ 55,333	3.1	$ 6,078	$ 65,992	$ 12,594	19.1%	22.8%	17.8%	2.4%	11.5
								Average:	24.7%	30.1%	21.4%	2.76%	12.8

Source: LPL Research, Bloomberg 04/22/24
Company data is as of most recently reported quarter.
Silicon Valley Bank, Signature Bank, and First Republic Bank are excluded from this analysis.
Past performance is no guarantee of future results.

Observations from the Data:

- Of all the banks in the universe that we studied last spring, SVB had far more marketable securities relative to total earnings assets (60.4%), total deposits (67.8%), and total assets (55.4%) than any of the other largest institutions analyzed. The averages across these metrics for banks with over $25 billion in assets were 27%, 32.7%, and 23.1%, respectively. That meant SVB was running a balance sheet that was more susceptible to changes in market prices than its counterparts and therefore was more exposed to price pressures in the bond market.

- SVB's deposit growth in 2022 (-8.5%) was materially worse than the universe of banks with over $25 billion in assets, which averaged +5.6%. The lack of asset diversification made it uniquely difficult for SVB to manage against high withdrawal flows.

Unrealized gains/losses as a percent of total equity, on average, improved from a loss of 16% to a gain of 2.8% since SVB failed. That enormous improvement reflects banks' successful efforts to reduce interest rate sensitivity of their balance

- Securities as a percent of earning assets, then versus now: The average for the top 25 institutions has dropped from 27% in December 2022 to 24.7% in December 2023.

- Securities as a percent of total deposits, then versus now: The average for the top 25 institutions has dropped from 32.7% in December 2022 to 30.1% in December 2023.

- Securities as a percent of total assets, then versus now: The average for the top 25 institutions has dropped from 23.1% in December 2022 to 21.4% in December 2023.

- Perhaps most importantly, unrealized gains/losses as a percent of total equity, then versus now: The average improved from a loss of 16% (-16%) to a gain of 2.8%. That enormous improvement reflects banks' successful efforts to reduce the interest rate sensitivity of their balance sheets by selling securities, with an assist from the calendar (maturing bonds) and market conditions.

- Finally, these banks improved their tier one capital ratios, on average. The ratio improved from an average of 12.3% in December 2022 to 12.8% in December 2023.

Investment Merits for the Banks

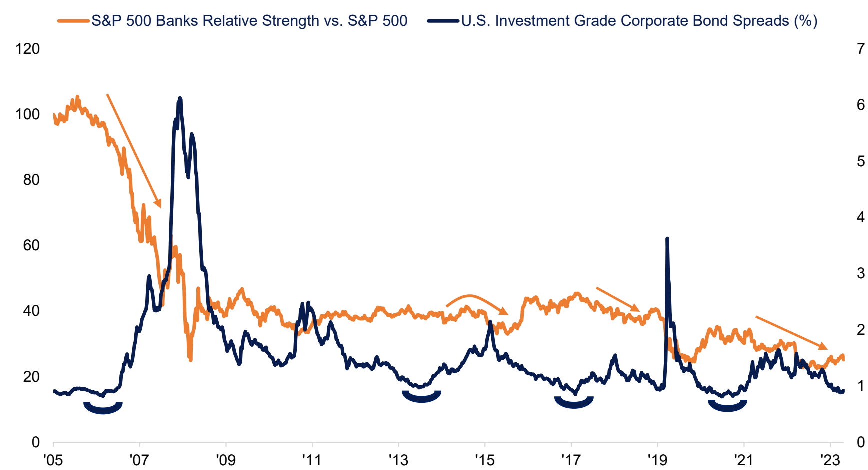
The LPL Research STAAC currently rates financials neutral. The Committee does not believe the growth outlook is strong enough to offset the headwinds.

The LPL Research Strategic and Tactical Asset Allocation Committee (STAAC) currently rates financials neutral, with banks making up about one quarter of the sector. Simply put, the Committee does not believe the growth outlook is strong enough to offset the headwinds, including the inverted yield curve, rising capital requirements, the latest upward pressure on rates, tepid loan growth, commercial real estate weakness, and increasing — though we admit still relatively low — consumer loan delinquencies.

Let’s dig deeper into some of these factors, starting with capital requirements. According to a recent analysis by the credit team at Bloomberg, midsized regional banks may collectively need to issue more than $20 billion of debt annually through 2027 to comply with new regulatory requirements resulting from last year’s banking crisis. The largest banks seem to be in a better position, suggesting staying up in market cap is prudent if investing in the banks.

Turning to credit conditions, when credit spreads are this tight — investment grade corporate bond yields are less than 0.9% above comparable Treasuries — it’s typically not a good time to invest in the banks. Spreads were tightest in 2006–2007, 2014, 2018, and 2021, with the post-2007 and post-2021 periods especially inopportune times to go long bank stocks (**Figure 2**).

2 Banks Lagged After Tight Credit Spreads in 2006, 2014, 2018, and 2021



Source: LPL Research, Bloomberg 04/19/24
Indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

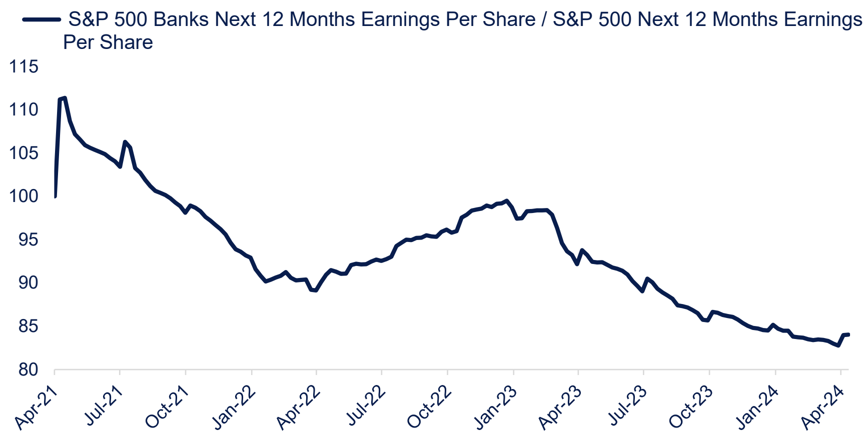
Of course, we don’t know when this cycle will turn, but when it does, more loans will go bad and banks will likely underperform. It’s not quite picking up pennies in front of a steamroller, but the opportunity in regional banks does not seem very enticing given the amount of credit risk that must be assumed over the next 12 to 18 months.

Other areas of the financials sector, including capital markets, insurance, and digital payments, are expected to grow earnings faster than the banks.

Growth Outlook

The banks are expected to grow earnings by a solid 9% in 2024 based on the latest consensus estimates from analysts. That is pretty good for a group where growth typically doesn’t reach double digits, but it probably won’t do any better than the S&P 500. Other areas of the financials sector, including capital markets, insurance, and digital payments, are all expected to grow earnings faster, as are most other sectors. Earnings momentum has also shown some life after the first batch of quarterly results from the big banks (**Figure 3**). Moreover, estimates for the banks have held up well over the past two weeks as some of the biggest banks reported first quarter results, which is an encouraging sign. Communication services, which may grow earnings by 20% this year and trades at a below-market price-to-earnings ratio (P/E), and energy, which remains very attractively valued in our view, both seem like better opportunities to us currently.

3 Bank Earnings Estimate Revisions Have Lagged the S&P 500 Recently



Source: LPL Research, FactSet 04/22/24
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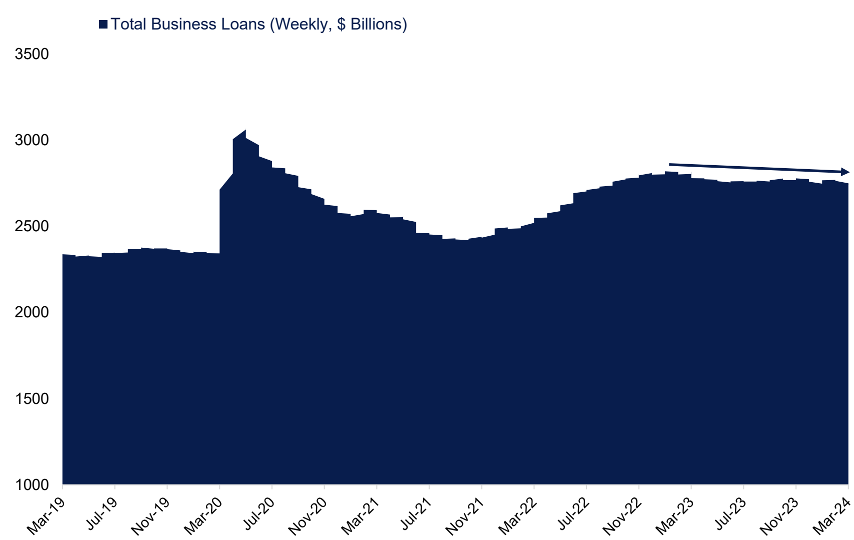
Estimates may not materialize as predicted and are subject to change.

In an encouraging sign, the Fed's Senior Loan Officer Survey has shown improving loan demand since last spring, though more financial institutions are saying demand is weaker rather than stronger.

Business loan demand, a primary source of growth for banks, remains fairly subdued, running at a 4% annualized pace in February, according to data from the Federal Reserve (Fed). Consumer loan demand is a bit better, with a 5.8% increase last month on an annualized basis, but with the recent uptick in credit card delinquencies, the risk-reward does not look especially compelling. In an encouraging sign, however, the Fed's Senior Loan Officer Survey has shown improving loan demand since last spring, though more financial institutions are saying demand is weaker rather than stronger by a still-wide margin of 25%. Capital markets activity is also improving, offering another sign of better growth ahead.

4 Business Loan Demand Has Tapered Off in Recent Quarters, Post-SVB Crisis



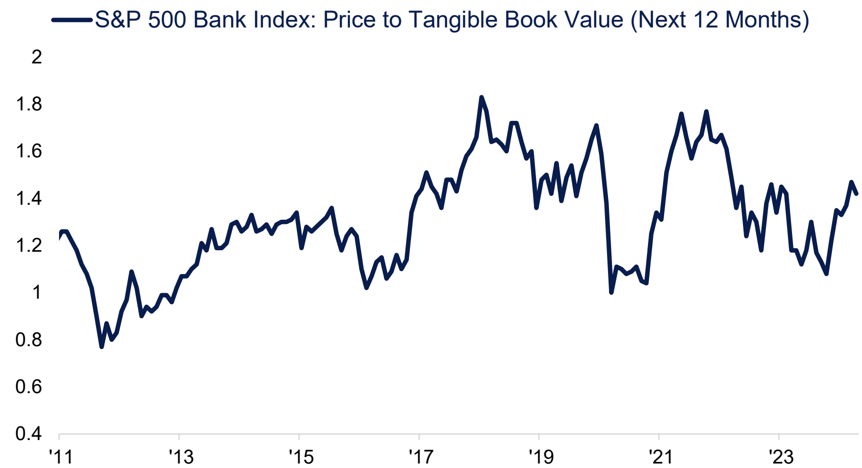
Source: LPL Research, Federal Reserve Bank of St. Louis (FRED) 04/10/24

Valuations Are Reasonable but Not Compelling

For the next three quarters, bank earnings are likely to drop, including an estimated 12.5% decline in the first quarter.

A potential 9% increase in earnings this year is fine, but most of it is coming from fourth quarter estimates, thanks to easy comparisons from the SVB crisis last spring. For the next three quarters, bank earnings are likely to drop, including an estimated 12.5% decline in the in-progress first quarter, limiting how much investors should be willing to pay for the group. If valuations were compelling, we'd be more interested. At a multiple of 1.5 times tangible book value, investors are paying a somewhat typical valuation for an outlook that is probably no better than average. While book value is most commonly used as a valuation metric for banks, the P/E for the group, now at 11.1, is also in line with long-term averages. In other words, bank valuations are fair, not compelling.

5 Reasonable but Not Compelling Valuations Given the Challenging Backdrop



Source: LPL Research, FactSet 04/22/24
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Conclusion

The largest regional banks are in good shape as a group. Our analysis of the interest rate sensitivity of bank balance sheet risks reveals a stronger foundation overall than in March 2023. That doesn't mean no banks will run into trouble if rates keep rising, but the top end of the system is in good enough shape to weather another storm, likely with a lot less damage than in 2023.

In terms of the investment merits of the group, there is little to get excited about in terms of bank stocks. Valuations are not compelling. Earnings are falling — and likely will continue to fall until the fourth quarter amid subdued lending demand and a challenging rate environment. Our technical analysis work is somewhat encouraging but not quite enough to recommend the group, so the STAAC remains neutral on financials, with a slight preference for the large money-center banks over regional banks for their stronger balance sheets and exposure to the nascent capital markets recovery.

On the fixed income side, the selloff in the banking sector last year provided an opportunity to invest in preferred securities. These senior securities possess higher credit quality among the riskier fixed income options and offer attractive yields. They are supported by generally sound fundamentals for large, money-center banks. The environment favors active management.

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The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

All index data from FactSet.

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