Spotlight on: The Banking Sector

From the TD Epoch Investment Team

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What is the outlook for large, global banks?

We expect large, diversified financial institutions to remain resilient throughout this transitional economic environment. While inflation, rates and cyclicality are impacting their ongoing cash flow generation, we believe most U.S. and European banks with a global presence have strong balance sheets. This includes adequate liquidity, matched or hedged asset-liability duration, sufficient capital and the ability to dynamically reserve for losses. Recent events are likely to put near-term pressures on funding costs that are, however, expected to alleviate over time, as front-book pricing (prices charged to new customers) stabilizes margins. Deposits and wholesale funding are also likely to float into the appropriate pricing structures but aggregate liquidity is likely to decline only gradually and in-line with economic activity. We believe that central banks and regulators have the tools to ensure just that.

In the coming months, banks might experience near-term margin pressures while tightening conditions for their loans to certain businesses with marginal profitability. Loan growth could continue to slow down and certain less-transparent segments like private debt and private equity could prove to be problematic. Commercial real estate segments and some local businesses might also experience stress, but we expect that meaningfully poor credit developments are more likely to develop outside of the banking system. Accordingly, while unexpected shocks and black swans are always possible, we believe that banks remain well positioned to benefit from the stimulus-driven economic growth in the U.S. and Europe once the cycle turns and inflation as well as interest rates reach a steadier state.

What is the outlook for U.S. Regional and Small Banks?

The collapse of two U.S. banks in March has placed significant pressure on U.S. regional and community banks that supply credit to a large percentage of the nation's entrepreneurs and businesses. Within days deposits flooded into megabanks, whose failure the U.S. government would almost certainly prevent. The

25 biggest U.S. banks gained $120 billion in deposits in the days after the first bank collapsed, according to Federal Reserve data. All of the U.S. banks below that level lost $108 billion over the same period. It was the largest weekly decline in smaller banks' deposits in dollar terms on record. The deposit swings could have long-lasting repercussions for the communities served by smaller banks. Banks need deposits to make loans; if deposits fall, lending is almost sure to follow. What's more, the recent turmoil could spur banks to have to start paying depositors higher interest rates, crimping earnings, and further cutting into their lending capacities. All of this could result in a decline in the competitive position of smaller regional banks. An equally likely result, analysts and central bankers say, is a potential credit crunch.

Regional banks, both large and small-cap ones, drove system-wide loan growth in recent years, taking share from their systemically important peers and smaller community banks. They represented 28% of the industry's loan book as of the end of 2019 and sourced more than 60% of the growth in it in the three subsequent years according to Empirical Research Partners. The more heavily scrutinized, systematically important, large banks represented 37% of the base and only 21% of the growth over that same period. The other 4,500 or so banks accounted for 35% of the base and only 18% of the growth. The regional banks are central to providing business credit, accounting for about a third of the industry's lending. Their share of the commercial & industrial (C&I) category is similar, and they control three-quarters of the small business segment. They are also the leading lenders on commercial properties.

It stands to reason then that any sustained decline in deposit funding and competitive status could have important ramifications for both lending conditions in general and the financial performance of these companies in particular. This perhaps depends in large part on the further actions of the Federal Reserve. The further (and longer) the tightening cycle goes on, the greater the potential for disintermediation amongst large and smaller banks. Conversely, diminishing bank contagion risk combined with an economic soft-landing scenario could restore the competitive profile and lending capabilities of the regional bank group.

How do recent events impact return on capital?

Banking is a highly competitive industry with low barriers to entry, which tends to drive down returns on capital. In fact, that is one reason our Quality Capital Reinvestment strategies have traditionally been underweight banks since they seek companies with high returns on invested capital. Recent events in the sector were largely driven by the Fed raising rates by 4.25% in less than 10 months following years of persistently low rates. There are likely to be further casualties on account of central bank tightening worldwide. In addition, the banking industry may become an even more heavily regulated sector, likely with higher liquidity requirements in the form of an increased level of shorter-term, lower-yield securities on bank balance sheets. This will probably lead to lower earnings and ROE. In terms of capital allocation, it is unlikely that larger banks will be permitted to buy smaller banks, but mid-tier banks may consolidate to absorb higher regulatory costs.

While banks in general tend to have lower returns on capital, there are, of course, banks that are more attractive in that sense. These banks generally have something that is unique about their business model: targeting underserved niches on the lending side, or being extraordinarily savvy gatherers of deposits, for example. Going forward, we believe those companies with high returns on capital and sound balance sheets are durable enough to withstand financial market volatility. We believe these banks should be able to sustain their higher returns on capital and their conservative balance sheets should lead to far lower earnings volatility than the volatility in current stock prices. It is fair to say these businesses' earnings will be negatively impacted by a lower level of short-term interest rates (as is now currently expected), but this should not meaningfully impact their returns above and beyond their exposure to rates.

What will the effect be on shareholder yield?

Although we do not believe the fundamental issues at the two collapsed U.S. banks are common to most healthy regional banks, as mentioned, the recent crisis is likely to have real implications on near-term earnings, as market and regulatory attention to issues such as liquidity and asset-liability matching may cause funding costs and capital levels to increase. As a result, while we believe dividends will remain well-covered, we do expect share buybacks to be deferred over the next year and shareholder yield could become marginally more challenged in the near-term. However, in our view, market prices have overreacted to these concerns and now imply overly pessimistic expectations as P/E ratios and dividend yields for the overall sector have moved to valuation extremes.

In our Shareholder Yield strategies, we seek to invest in banks distinguished by low-cost deposit bases primarily comprised of core transactional accounts. Historically, the high customer switching costs associated with these deposits provide a stable source of long-term funding at below-market interest rates. We believe the institutions that derive the majority of their funding from low-cost transactional deposits, when matched with a diversified loan portfolio and well-capitalized balance sheet, benefit most from rising interest rates and can earn sustainably high returns on equity over the course of an economic cycle. We expect these banks to grow earnings over time, maintain capital above regulatory requirements, and reward shareholders with attractive, growing dividends as well as periodic share repurchases.

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