U.S. Banks: Capital Levels Strong, but Capital Return to Remain Limited in the Near Term

Financial Services Sector Report

Companies mentioned in this report:

Followed by Edward Jones

- **American Express** (AXP –Hold; $117.51)
- **Bank of America** (BAC –Buy; $28.67)
- **Bank of New York Mellon** (BK –Hold; $40.79)
- **Capital One Financial** (COF –Hold; $91.57)
- **Citigroup** (C –Buy; $59.06)
- **Fifth Third Bancorp** (FITB –Hold; $26.63)
- **JP Morgan Chase** (JPM –Buy; $119.08)
- **Morgan Stanley** (MS –Hold; $64.18)
- **PNC Financial** (PNC –Hold; $144.91)
- **Regions Financial** (RF–Buy; $15.26)
- **State Street** (STT –Buy; $70.66)
- **Truist Financial** (TFC –Buy; $45.90)
- **U.S. Bancorp** (USB –Hold; $44.86)
- **Wells Fargo** (WFC –Buy; $29.01)

Source: Reuters. Prices and opinion ratings as of market close on 12/18/20 and are subject to change.

For more information:

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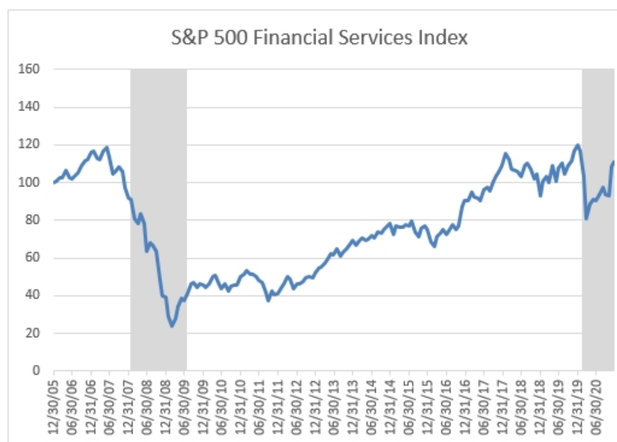
Investment Summary

- The S&P 500 has recovered from early pandemic levels to record highs; however, financial services stocks have underperformed the broader market **(Figure 1 below)**, due to a variety of concerns, including risks related to capital and liquidity. The outlook for bank earnings has weakened, due to low interest rates, slowing loan growth, and rising credit costs. Partially offsetting these negatives is that capital-markets activity has been relatively strong, particularly securities trading.

- Following years of robust stress testing under severe economic scenarios devised by regulators, larger regional and national banks are very well-capitalized and are positioned to continue to provide lending support to individuals and businesses. The banks we follow passed two separate rounds of 2020 stress tests: one in June and one in December. We expect the banks that we follow to maintain their current dividends. Share buybacks, which were suspended in early 2020, will be allowed, subject to limitations beginning in the first quarter of 2021.

- In spite of earnings challenges, the pullback presents a compelling opportunity for long-term investors, in our view. We recommend that investors be selective, focusing on large and diversified banks.

Figure 1. S&P 500 Financials Index



**Shaded area represents a recession. Source: FactSet. The S&P 500 Index is based on the average performance of 500 widely held common stocks. The S&P Financial Services Index consists of 65 financial services companies within the S&P 500 Index. Past performance is no guarantee of future results. Indexes are not managed and unavailable for direct investment. Data as of 12/18/20.*

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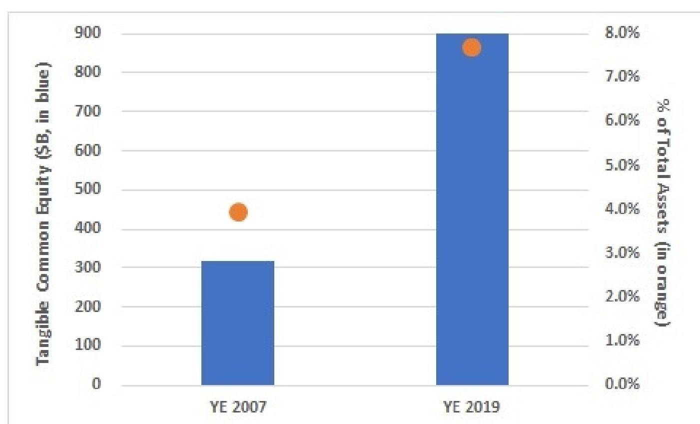
The Great Recession of 2008 was marked by a severe financial crisis with rippling effects across the global economy. While the causes of and events leading into the financial crisis are still being debated to this day, defaults in subprime (lower quality) consumer and mortgage loans exposed excessive risk-taking by the banks. Many banks failed, and even larger banks were tested, as governments eventually provided bailouts to keep the global financial system afloat. The meltdown of the financial system soon led to a deep recession for the broader economy.

Financial strength for large U.S. banks has improved significantly since then, however. Just prior to the financial crisis, large banks held more than $300 billion in tangible common equity (assets - liabilities - goodwill and other intangible assets), which represented less than 4% of total assets. By the end of 2019, the banks had almost tripled their capital, to $900 billion, or almost 8% of total assets.



Source: Company Reports and Edward Jones Estimates

Countries across the globe continue to cope with the economic impact of the COVID-19 pandemic. In the United States, the economy has contracted sharply and unemployment remains near 7%, despite some recent improvement. For large U.S. banks, 2020 earnings so far have been pressured by lower interest rates and higher credit costs. Through the three quarters of 2020, the traditional banks that we follow increased loss reserves by $74 billion, and loss reserves are roughly 2.8% of total loans on average as of September 30, 2020. Everything else held constant, a higher loss reserve is better. However, the composition of a bank's loan portfolio is also an important consideration. Unsecured consumer loans, such as credit cards, require higher loss reserves. Other loans, such as those secured by real estate, do not require very high loss reserves, since the bank can recover significant value by liquidating the asset.

The Federal Reserve released its second round of 2020 stress-test results in mid-December, concluding that large U.S. banks had sufficient capital levels (buffers to absorb against losses) to remain strong in the face of even the harshest economic shocks. While historically banks are subject to one stress test annually, the Fed conducted a second round of tests this year due to the continued economic uncertainty from COVID-19. Similar to prior tests, each of our banks is very well-capitalized, and we believe the banking system will remain a source of strength during this crisis.

Another unique consequence of COVID-19 was the Federal Reserve's June announcement that banks would be required to preserve capital by suspending share buybacks for the third quarter. In addition, third-quarter dividends were limited to the amount paid in the second quarter (in other words, no increases), and a new rule was instituted that quarterly dividends cannot exceed the average of the firm's net income for the preceding four quarters. The Fed has extended the cap on dividend increases through year-end 2020, but have allowed banks to repurchase shares on a limited basis beginning in the first quarter of 2021.

Both Wells Fargo (WFC) and Capital One (COF) lowered their third-quarter dividends. All other banks in our coverage maintained their current quarterly dividends for the third quarter. Given the trailing-four-quarters earnings test outlined by the Federal Reserve, it is possible that other banks could still reduce their quarterly dividends in future quarters, particularly if fourth-quarter earnings are particularly weak.

This year, the Federal Reserve introduced a new methodology for determining required capital levels. Among the banks that we follow, minimum capital requirements increased this year for several banks, including JPM and MS. However, all of the banks maintain capital ratios above minimum requirements.

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Figure 2. Dividend Payout Ratios Based on Trailing Four Quarters Ended September 30, 2020

Ticker	Company	Div Outlook	Div Yield	Trailing 4Q Payout Ratio
JPM	JPMorgan Chase & Co.	Rising	3.0%	47%
BAC	Bank of America Corp	Rising	2.5%	36%
C	Citigroup Inc.	Rising	3.4%	40%
MS	Morgan Stanley	Rising	2.2%	24%
WFC	Wells Fargo & Company	Stable	1.4%	n.m.
AXP	American Express Company	Rising	1.4%	42%
USB	U.S. Bancorp	Stable	3.7%	56%
TFC	Truist Financial Corporation	Stable	3.8%	61%
PNC	PNC Financial Services Group, Inc.	Stable	3.2%	27%
BK	Bank of New York Mellon Corporation	Rising	3.1%	27%
COF	Capital One Financial Corporation	At Risk	0.4%	20%
STT	State Street Corporation	Rising	2.9%	33%
FITB	Fifth Third Bancorp	Stable	4.0%	54%
RF	Regions Financial Corporation	Stable	4.0%	80%
Average			2.8%	42%
Median			3.0%	40%

Sources: Dividend Outlooks - Edward Jones, Dividend Yields - FactSet, Payout Ratios - FactSet and Company Reports.

Near-term Earnings Challenged, but Long-term Opportunity Remains

- Interest rates -- In an effort to stimulate the economy, the Federal Reserve recently cut short-term interest rates to near zero, increased short-term lending available to banks, and has resumed its bond-purchasing program known as quantitative easing. While lower interest rates help to incentivize loan demand, they put pressure on banks' net interest margins, which represents the spread between yields earned on loans and securities, and costs associated with deposits and other borrowings.
- Slowing loan growth and rising credit losses -- The impact of the virus on the global economy has been significant, but uncertainties persist. We expect consumer borrowing will continue to slow. We also expect credit costs to remain elevated in the near term as businesses struggle to reopen. We are particularly cautious on bank exposure to loans in the travel, hospitality and energy industries. In addition, we are closely monitoring bank portfolios backed by commercial real estate, particularly office, retail and lodging properties. At this time, we believe that the banks that we follow are well-diversified, with manageable exposures.

The average large bank in our coverage is trading at approximately 1.3 times tangible book value (assets-liabilities-goodwill), compared with the low of 0.7 times reached during the financial crisis. As mentioned above, we think banks today have higher-quality balance sheets and stronger capital levels, and have demonstrated considerably more prudent underwriting. Dividend yields have risen due to the decline in share prices. However, we do not expect dividend cuts for most of the large banks that we follow. While near-term earnings may be pressured as a result of lower interest rates and increased credit losses, we believe that this virus-driven pullback presents a compelling opportunity for long-term investors to buy shares of quality companies.

Valuation Considerations for Bank Stocks. When valuing financial services companies, we use various methodologies. First, we often consider the current stock price relative to expected earnings per share, or the price-to-earnings ratio. A key consideration is that investors typically place a higher value on stocks with higher anticipated earnings growth. Another methodology is to compare the current stock price with the book value of equity (value of assets less the value of liabilities). With the price-to-book-value ratio, we often consider the company's return on equity in addition to the growth outlook. Everything else equal, a company with a higher return on equity and a higher growth rate is generally rewarded a higher price-to-book-value multiple.

Risks. Risks associated with investing in financial services companies include:

- Sensitivity to the health of the economy. In the event of a weaker U.S. economy or a prolonged recession, share prices could be negatively affected as credit risks become elevated and asset values decline;
- Sensitivity to the pace and magnitude of changes in interest rates; and
- Regulatory and legal risks.

Please see our opinion on each of the companies mentioned in this report for more information on the benefits, valuation, and risks of investing in these stocks.

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James Shanahan, CFA; Kyle Sanders, CFA; John Nako, CFA

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