Truist Advisory Services, Inc.

Special Commentary *from the Investment Advisory Group*

Banking on continued volatility

May 8, 2023

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What happened

Banking stocks, especially mid- to smaller-sized companies, have generally seen large declines this year. Their stock prices experienced significant fluctuations, and this volatility has remained elevated following the failures of Silicon Valley Bank and Signature Bank in March, and most recently, First Republic Bank. Even though there was uniqueness to their business models, other bank stocks have come under pressure as investors try to decipher the potential impact of increased regulatory requirements, the future earnings power, and the competitive landscape.

Taking a step back, the root cause behind some of today's banking challenges is a byproduct of the pandemic. The unprecedented government stimulus and increased saving rates caused bank deposits to balloon during the pandemic, providing a low-cost source of funding.

- Banks invested these deposits in securities, such as bonds, with higher yields than those paid on deposits, in order to earn the difference between these yields.
- Goods demand, combined with supply chain issues and labor shortages caused inflation to increase to levels not seen in decades. To cool inflation, the Federal Reserve (Fed) raised interest rates at a faster pace than any time in recent history – from near zero to 5%-5.25%

Generally, higher interest rates are a positive for banks. However, pandemic dynamics coupled with the size and pace of interest rate hikes caused **three major stresses on banks**:

1. Deposits migrated to investment vehicles that supplied higher interest rates, like money market funds. As a result, funding costs significantly increased for banks if they wanted to keep or grow deposits.
2. Investments made during the low interest rate environment lost value as interest rates rose, creating substantial unrealized losses in banks' securities portfolios.
3. Higher rates, and secular changes in the office market, have pressured the commercial real estate (CRE) market. Higher inflation has increased operating costs while higher rates have increased financing costs for an industry whose business model is based on significant amounts of leverage. Banks, particularly smaller ones, are significant lenders to the CRE industry.

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Our take

Recent downward price performance appears divorced from fundamentals and looks like it's based on fear and speculation.

We expect the aforementioned challenges to continue to weigh on the banking sector and volatility to remain elevated. That said, the move down in banking stocks over the past week, before Friday's rebound, appeared to be an overshoot based on fear and speculation as opposed to new information.

What started as concerns about bank liquidity and capital issues transitioned to an earnings issue and then, over the past week, capital concerns resurfaced because of the sharp decline in bank equity prices.

Initially, banking stocks fell on concerns around deposit outflows as well as the likelihood of increased regulation. The largest banks that have over $700B (billion) in assets must include unrealized losses in their available-for-sale investment portfolio in their regulatory capital ratio (CET1). **In our view, a portion of banks below the $700B asset level will no longer be able to opt out of this requirement.** Several bank management teams have indicated that stock repurchases will be curtailed or halted until there is more clarity on regulation.

While increased regulation and higher capital requirements should equate to lower earnings, these regulations will take time to implement. There will be a comment period and implementation will be phased over time. We think larger banks will be able to organically accrete capital over this same period eliminating the need for external capital raises or dividend cuts.

Notably, first quarter earnings for banks were generally better than expected given the low bar caused by the recent bank failures.

- Deposit outflows did increase but were better than feared. Managements expect further deposit outflows but think we are towards the latter stages of the migration.
- Unrealized losses in the securities portfolios improved due to lower interest rates compared to the previous quarter and because as the investments move closer to maturity, prices also move closer to par.
- Credit continues to normalize but is still considered strong. Loss reserve policy is forward looking so banks are building reserves with the expectation of a looming recession. Most banks did reduce revenue guidance for the year. Put simply, low-cost deposits will likely continue to migrate to higher-yielding instruments which should increase funding costs of banks, and in turn cause margin compression.

Over the last week, First Republic Bank, perceived as the bank most likely to fail next, went into receivership and then the majority of the bank was acquired by JPMorgan. Many investors thought this would boost confidence in the banking system and that the pressure on banks would subside. This sentiment was short-lived. The market began questioning why any larger banks looking to acquire weaker banks would pay any amount for the equity. There was speculation that instead, investors could wait for the weaker bank to fail for the acquirer to get a better deal, including financing and loan loss agreements, from the FDIC. Bank prices plunged before partially gaining back some of the losses on Friday as the group was oversold.

Bottom line

The road ahead for banking stocks is likely to remain bumpy given the potential of additional regulations, higher funding costs, and a slowing economy. Still, our view is the most recent leg

down was more of an overshoot based on fear as opposed to a fundamental shift. This view is also supported by a notable decline in the use of the emergency lending facilities by the banks and deposits that have been relatively stable. Larger market capitalization banks should fare better during periods of financial stress. Scale matters and the largest banks have more diversified business mixes and less commercial real estate exposure. While some banks may appear to be long-term values, the near-term environment will likely remain challenging, and we expect volatility to remain elevated.

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CN5673996.1 EXP052024