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MAKING SENSE OF INVESTING

U.S. Banks Are Better Prepared This Time Around, and Capital Levels Support Dividends

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ANALYST(S)

James Shanahan, CFA

Kyle Sanders, CFA

John Nako, CFA

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- **Bank of America** (BAC –Buy; $21.60)
- **Bank of New York Mellon** (BK –Hold; $32.54)
- **Citigroup** (C –Buy; $43.80)
- **Fifth Third Bancorp** (FITB –Hold; $16.06)
- **JP Morgan Chase** (JPM –Buy; $91.13)
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- **Regions Financial** (RF–Buy; $9.26)
- **State Street** (STT –Buy; $48.66)
- **Truist Financial** (TFC –Buy; $32.32)
- **U.S. Bancorp** (USB –Hold; $34.92)
- **Wells Fargo** (WFC –Buy; $30.28)

Source: Reuters. Prices and opinion ratings as of market close on 3/27/20 and are subject to change.

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- The S&P 500 is down over 25% year-to-date, driven by concerns related to the continuing coronavirus crisis and the impact on the economy. Financial services stocks have underperformed the broader market **(Figure 1 below)**, which we believe can be attributed, at least in part, to memories of the sector's performance during the financial crisis of 2008-09. Unlike during the financial crisis, however, when banks were part of the problem, we believe banks can be a part of the solution.

- Following years of robust stress testing under severe economic scenarios devised by regulators, larger regional and national banks are very well-capitalized and are now positioned to lend support to the economy by providing loans and liquidity to individuals and businesses.

- While lower interest rates and higher credit losses will be headwinds to earnings in the near term, we believe that this pullback presents a compelling opportunity for long-term investors. Dividend yields have risen due to the decline in share prices. However, we do not expect dividend reductions for the large banks that we follow, given their solid balance sheets and cash flow generation.

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 66 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 3/23/20.*

A Look Back: The Great Recession of 2008

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

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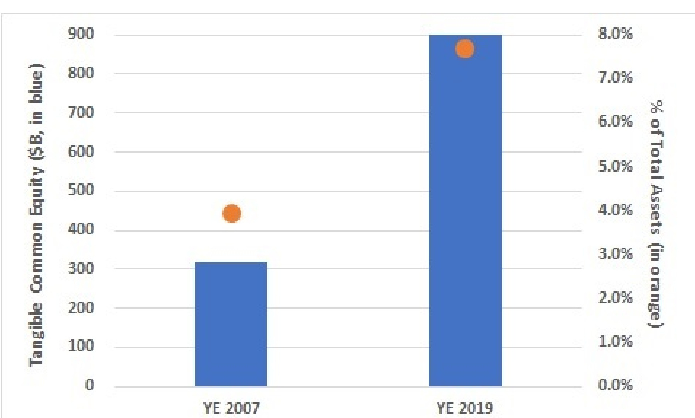
and mortgage loans exposed excessive risk-taking by the banks. Many banks failed, and even larger banks were tested, as governments eventually provided bailouts to keep the global financial system afloat. The meltdown of the financial system soon led to a deep recession for the broader economy.

This Time Is Different

Currently, countries across the globe are coping with the health and economic effects of COVID-19 (the novel coronavirus). Unlike in the financial crisis of 2008, when banks were part of the problem, we believe banks can be a part of the solution this time around. Through the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR) and stress-testing under the Dodd-Frank Act, banks' financial strength is annually (or biannually) tested on both a qualitative and quantitative basis. For example, a bank may have to model the impact of an 8% decline in gross domestic product, a 10% drop in the employment rate, and a 50% drop in the stock market. The banks we cover have consistently passed these simulated tests devised by regulators, demonstrating that they have ample buffers of capital to withstand periods of economic stress. In our view, the large banks maintain a strong financial position and can lend support to the economy by providing loans and liquidity to individuals and businesses in need.

The large banks that we follow have considerably improved financial strength. Just prior to the financial crisis, these 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. At 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

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 virus' impacts on the global economy are still somewhat uncertain at this point. However, we believe that consumer lending will slow and credit losses will rise as businesses close down and people stay at home due to precautionary actions and government mandates to slow the spread of the virus. We are particularly cautious on bank exposure to loans in the travel, hospitality and energy industries. We believe fiscal stimulus measures could help soften the blow employers and employees are facing.

- Suspended share buybacks. Share buybacks, which have been an incremental contributor to earnings, have been temporarily suspended through at least June 30. This will help to strengthen balance sheets, but will be a 1%-3% hit to earnings per share.

The average large bank in our coverage is trading at less than 1.0 times tangible book value, 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 any of our large banks given their solid balance sheets and cash flow generation. 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 high-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. Some of the 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 and John Nako, CFA

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