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U.S. Banks Remain Resilient Despite Coronavirus Headwinds

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KEY TAKEAWAYS:

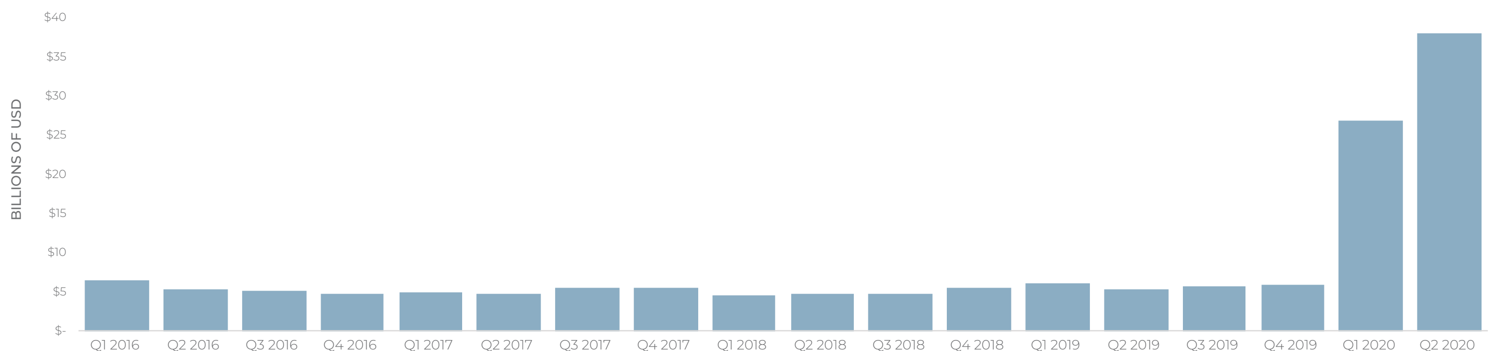
- Despite the economic impact of the Covid-19 Pandemic, we view commercial paper and corporate notes issued by large U.S. banks as safe and viable investments for our public fund clients.
- Our view is driven by the banks' diverse business lines and strong balance sheets, suggesting a stronger and more resilient financial sector. This is true for each of the large U.S. banks, including JP Morgan, Bank of America, Citigroup, and Wells Fargo.
- We are monitoring bank earnings, specifically lower net interest margins resulting from a lower, flatter yield curve and higher loan loss reserves due to expected increases in loan losses. As always, we will endeavor to adjust our portfolios as circumstances change.

The largest US banks each reported second-quarter results last week. While first-quarter results landed in the early stages of the Covid-19 Pandemic, this round gave us more insight into how the banks are holding up four months into this unprecedented economic environment. We continue to favor debt issued by these banks, as buying these securities allows us to enhance the portfolio yield given the spread they typically trade at relative to agency bonds and treasuries.

1. DIVERSE REVENUE STREAMS SUPPORT THE BANKS' CREDIT PROFILES

Similar to the first quarter, record trading revenues and other noninterest income sources continue to support the banks' bottom line and counterbalance the large reserve build. At JP Morgan, fixed income trading revenues increased 99% YoY, marking a record company for the bank. Similarly, U.S. Bank's mortgage banking revenue increased 64% QoQ as mortgage applications soared as rates continued to set record lows. Though these are just anecdotes from the results last week, they illustrate the sector's ability to remain resilient in the face of shrinking net interest margins and increased loan loss provisions.

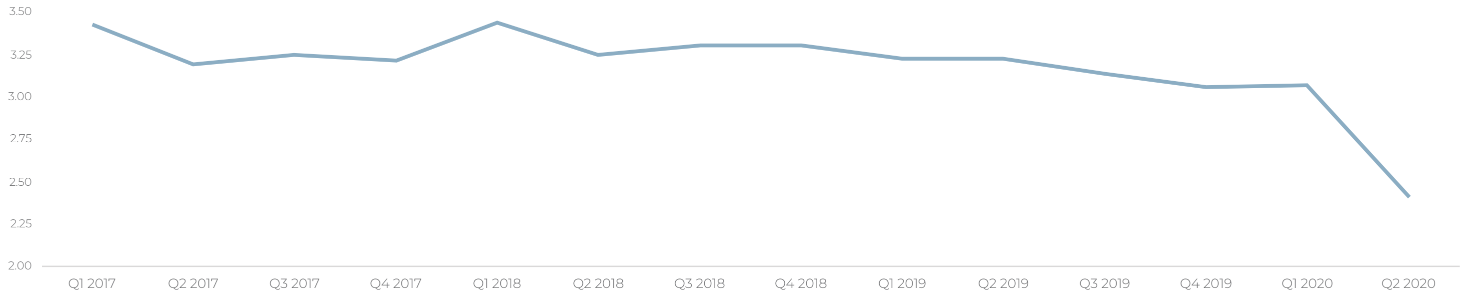
FIGURE 1: QUARTERLY PROVISION EXPENSES FOR US BANKS



Source: Bloomberg Peer group includes JPM, BAC, C, WFC, USB, PNC, and TFC

Combining a weak economic outlook and a federal funds rate at the zero bound for the foreseeable future, the US yield curve has shifted lower and flatter over the last few years, compressing the banks' net interest margins. Likewise, with the US economy still at the beginning of this pandemic, the fallout and uncertainty ahead have steered each of the banks to build substantial loan loss reserves ahead of anticipated losses over the next few years. For example, so far in 2020, JP Morgan has set aside $18.8 billion for loan losses, though actual loan losses so far in 2020 total only $1.3 billion. But loan losses take time to develop, as provisions generally front-run actual losses.

FIGURE 2: AVERAGE NET INTEREST MARGIN FOR US BANKS

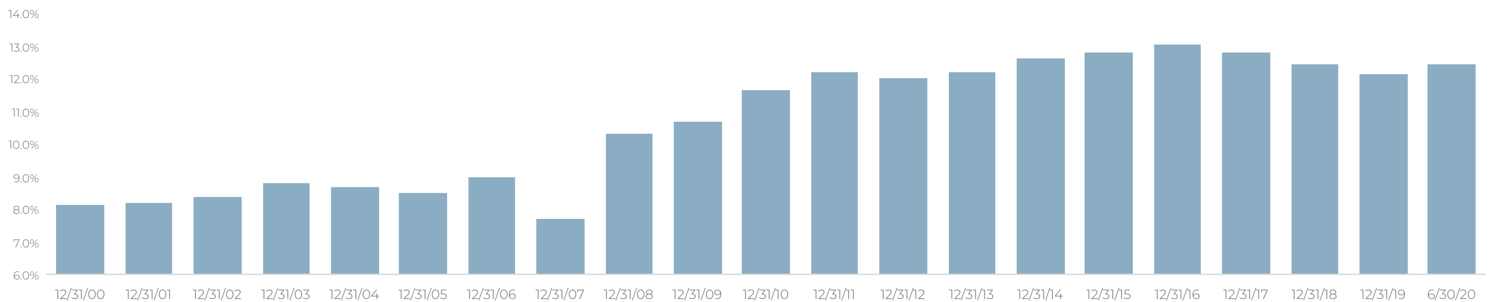


Source: Bloomberg Peer group includes JPM, BAC, C, WFC, USB, PNC, and TFC

2. CAPITAL BUILDS SHIELD THE BANKS FROM THE COVID-19 FALLOUT

After the 2008 Financial Crisis, Congress passed the Dodd-Frank Act that, along with several other changes, increased the amount of capital that banks have to carry. Whereas the largest US banks had average Tier 1 capital ratios below 9% before 2008, these ratios now exceed 12%. Most banks' capital ratios increased in the second quarter as they suspended their share repurchases earlier in the year. Over the last three years, banks returned more than 100% of their net income out via dividends or repurchases given the large capital builds. But with the Covid-19 Pandemic creating an uncertain future path for the US economy, banks are starting to retain more capital to prepare for increased credit costs.

FIGURE 3: AVERAGE TIER 1 CAPITAL RATIOS FOR US BANKS

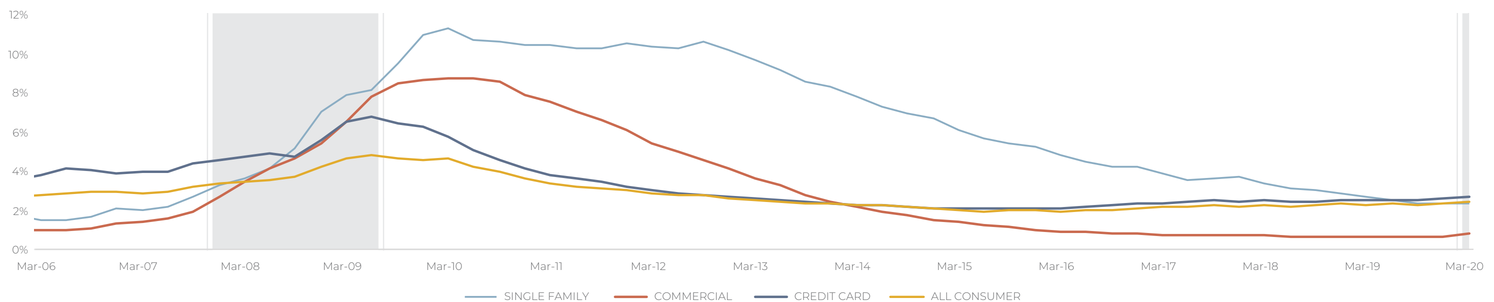


Source: Bloomberg Peer group includes JPM, BAC, C, WFC, USB, PNC, and TFC

3. ASSET QUALITY METRICS ARE HOLDING UP—FOR NOW

The plethora of government stimulus targeting the unemployed, small businesses, and financial markets have likely suppressed what credit losses would have been. So far, banks are reporting minor increases in nonperforming loans and charge-offs. But as the recession develops, they are likely to continue. History shows us that delinquencies increase during a recession and take time to return to prerecession levels. Enhanced unemployment benefits expire at the end of the month, and less money in consumer's pockets could lead consumer loan portfolios to sour quicker. Likewise, the fallout in demand for travel, energy, and other goods will continue to pressure loan portfolios backing these businesses. Longer-term, the potential impact on working from home on the commercial real estate market will take years to play out.

FIGURE 4: FEDERAL RESERVE DELINQUENCY DATA



Source: Bloomberg

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