U.S. Bank Update Amid an Economic Turn

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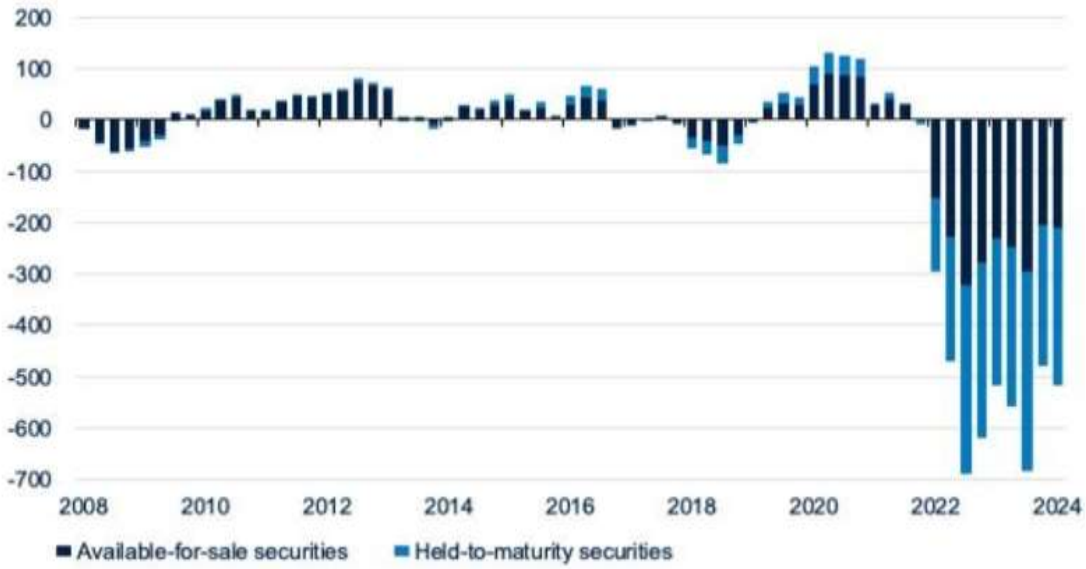
In March 2023, three banks - Silicon Valley Bank, Signature Bank, and First Republic Bank - failed over the course of just a few days, with losses at SVB triggering the largest single-day bank run in U.S. history. The panic exposed flawed risk management practices, weakness in regulatory oversight, and the vulnerability of certain concentrated business models - particularly those reliant on uninsured deposits. It also highlighted the interconnectedness of the global financial system and potential for rapid contagion in times of stress.

More than one year later, we find this an apt time to reflect on the sector's investment portfolios, liquidity, and profitability conditions amid our structural overweight to the industry and our expectations for moderating economic growth (see our Quarterly Outlook for our economic base case and our credit preferences). The banking industry has proved resilient and the outlook is generally favorable, though idiosyncratic opportunities are expected to emerge for active investors.

Stemming from large unrealized losses in banks' investment portfolios, the banking panic of early 2023 highlighted the vulnerability of the sector to a sudden, sharp rise in interest rates. The losses eroded banks' capital, fueled depositor panic, forced some banks to sell at a loss and, ultimately, led to contagion risk.

During the Fed's recent tightening cycle, the U.S. banking system went from unrealized gains of $29 billion in Q3 2021 to unrealized losses of $684 billion at their peak in Q3 2023 (Fig 1). While unrealized losses remained elevated at $516 billion in Q1 2024, security values should continue to trend higher under a more stabilized rate environment while cooling inflation paves the way for potential rate cuts and faster capital accretion.

FIGURE 1: Unrealized Gains (Losses) on Investment Securities ($ billions)

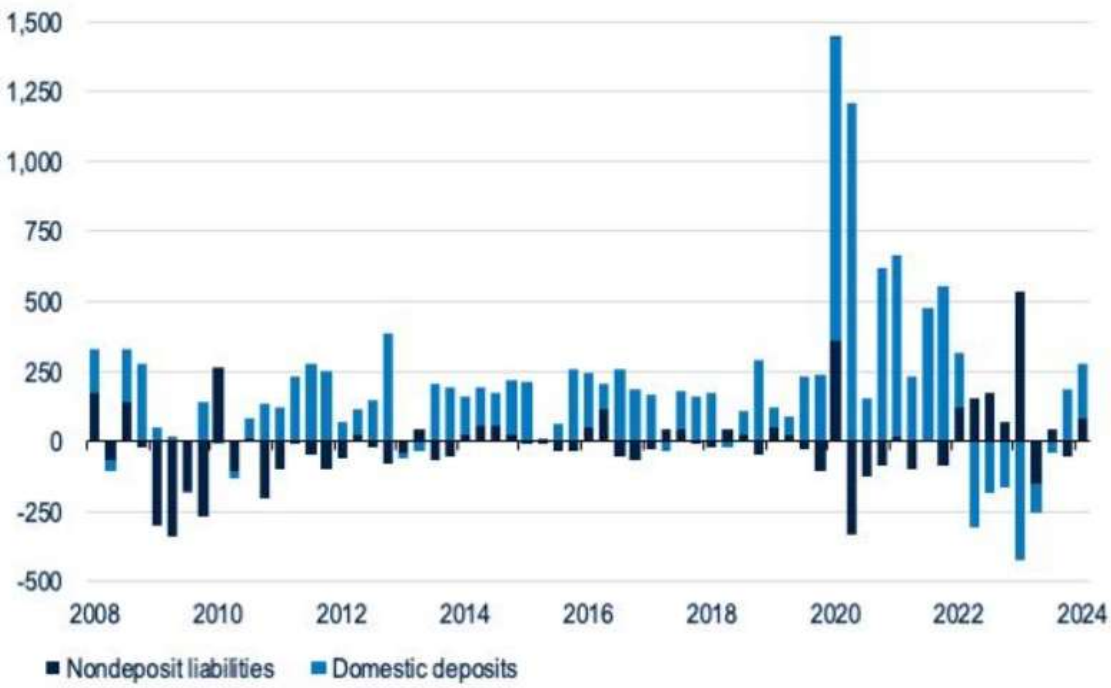


Source: FDIC as of May 2024.

Liquidity Risk

Bank deposit growth soared during the pandemic. However, deposits declined as customers shifted into higher yielding alternatives after the Fed initiated its tightening cycle in early 2022. Upon the banking failures, banks raced to increase liquidity buffers against uninsured depositors and Treasury teams managed cash balances well above 100% of uninsured deposits to alleviate investor concerns. Shortly after regulators and the government intervened, depositors returned to more normalized activity (Fig 2).

FIGURE 2: Quarterly Deposit Trends ($ billions)



Source: FDIC as of May 2024.

Net Interest Margins

These liquidity actions drove up funding costs which, along with deposit repricing from higher rates, pressured profitability and resulted in net interest margin (NIM) compression through the first half of 2024. Despite these margin pressures, returns on equity (ROE) have remained healthy and above the long-term average, demonstrating the resilience of the system. However, individual banks' performance has varied widely, sparking idiosyncratic spread movements and ratings actions (Fig 3).

FIGURE 3: Quarterly NIM Trends (%)

Source: FDIC as of May 2024.

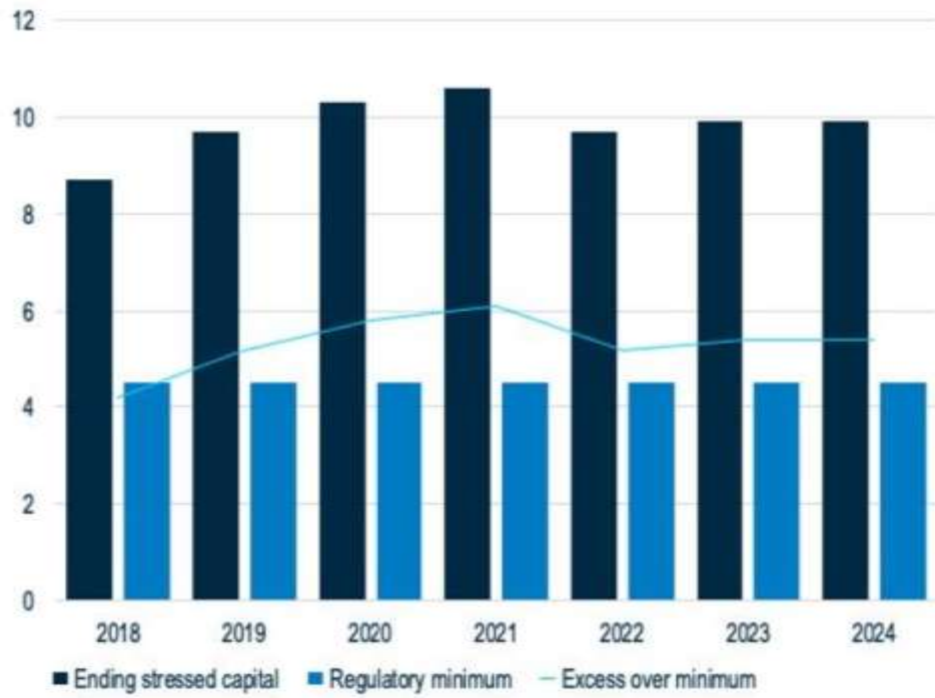
Outlook for the Banking Industry

We now believe the industry is in the late stages of profitability pressures. As deposit costs peak and the yield curve normalizes, banks should benefit from the gradual repricing of fixed-rate assets. This should lessen the impact of incremental funding pressures and support a trough for net interest income.

Banks generically expect net interest income to decline to the mid- to high-single digits in 2024, before returning to growth in 2025. Profitability is padded by an improving outlook for fee income across the industry, with a pickup in investment banking and strong capital markets disproportionally benefiting money-center banks.

This year's Federal Reserve Stress Test (DFAST) results included all large Category I-IV ($100 billion or more in total assets) banks and again demonstrated the resilience of the industry to extreme shocks. In aggregate, the system was able to withstand severe losses with ending common equity tier 1 (CET1) capital at 9.9%, well above regulatory minimums of 4.5% and consistent with 2023's results (Fig 4).

FIGURE 4: DFAST Excess Capital



Source: U.S. Federal Reserve as of June 2024.

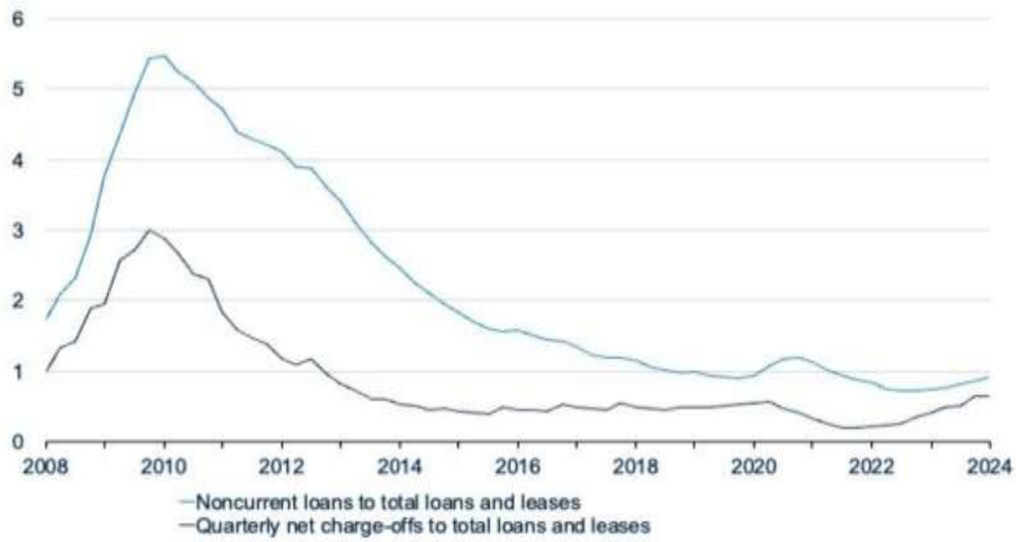
Though DFAST results have become a relative non-event for markets, we view it as a crucial input for credit investors, especially in periods of elevated credit risk. DFAST is one of the key differences in regulation for banks above and below the Category IV threshold as it provides insight into a bank's unique asset risk profile and underlying earnings power.

Credit Risk

Looking forward, the largest risk to the banking sector is a traditional asset quality cycle, with credit risk top of mind for investors. Commercial real estate (CRE) remains the focus, although idiosyncratic situations have also begun to increase in commercial and industrial (C&I) lending. Our base case incorporates manageable levels of deterioration largely in line with industry guidance and concentrated in pockets of CRE and the subprime consumer. Risks to the industry are outside these known problematic areas and would be caused by a weakening economy and broadening pressures across C&I and the consumer.

We expect the CRE cycle to be elongated given differing maturity schedules and borrowers' ability to stay current on loans originated under the zero interest-rate policy environment. Larger banks with lower exposures have been more proactive in addressing problematic CRE loans by pre-emptively selling exposures resulting in higher charge-offs to date, though still at healthy levels historically (Fig 5).

FIGURE 5: Asset Quality Trends (%)



Source: FDIC as of May 2024.

However, most banks will wait until maturity to address underlying issues which could create lumpy surprises and become spread widening events. Banks are mitigating this risk by maintaining elevated allowance coverage for the troubled office CRE sector despite actively managing down exposures.

Relative Value Considerations Amid a Structural Overweight

The banking industry has proved resilient since the banking panic of early 2023, and the outlook is generally favorable as profitability improves, capital builds, and asset quality remains manageable. However, risks remain, with credit risk top of mind. As indicated by the Fed's recent stress test, the industry should be able to withstand severe pressures, though idiosyncratic opportunities are expected to emerge for active investors. Lasting impacts from the banking panic (including business model vulnerabilities, funding challenges, and regulatory uncertainties) continue to drive relative-value considerations. We prefer large bank holding company debt, with a particular focus on diversification of revenues, granularity and stability of deposit bases, and minimal asset concentrations.

The March 2023 bank failures again highlighted the risks of concentrated business models. We look for banks with strong fee income, including exposure to capital markets and advanced Treasury capabilities, which tends to increase the stickiness of commercial clients and, thus, deposit funding. CRE concentrations including office and multifamily exposures have been in focus, though outsized exposures in leveraged lending or pockets of unsecured consumer lending are worth monitoring.

The capital structure of bank holding companies is crucial for bondholder recovery in defaults, with holding company bonds of regional banks preferred over bank-level bonds given the extra spread-pickup and absence of practical structural subordination in the current regulatory framework. Interest rate risk and prudent asset liability management is also critical. Pending Basel 3 rules encourage shortening durations of securities books and a further build of economic capital for banks with assets of above $100 billion. This solidifies another gap between large and small banks and further supports our preference for banks with assets of above $100 billion, which adhere to higher capital and liquidity standards and are subject to DFAST on an annual or biennial basis.

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