Market Commentary Blog

Cash Flow *and Carey*

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This chart is for illustrative purposes only and not indicative of any actual investment. The illustration excludes the effects of taxes and brokerage commissions or other expenses incurred when investing. Investors cannot invest directly in an index.

The S&P 500 Index is an unmanaged index of 500 companies used to measure large-cap U.S. stock market performance. The S&P 500 Banks Index is a capitalization-weighted index. The S&P Banks Select Industry Index comprises stocks in the S&P Total Market Index that are classified in the GICS Asset Management & Custody Banks, Diversified Banks, Regional Banks, Diversified Financial Services and Commercial & Residential Mortgage Finance sub-industries. The S&P Regional Banks Select Industry Index is comprised of stocks in the S&P Total Market Index that are classified in the GICS regional banks sub-industry.

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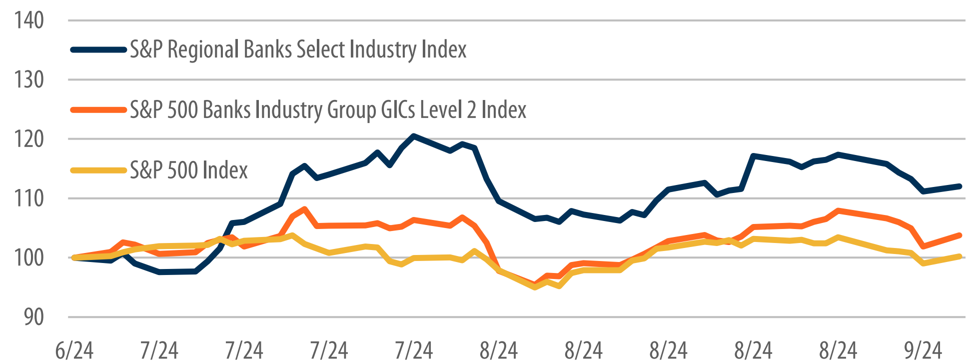
Regional Banks | Strong Start to the Third Quarter

Price Returns 6/28/24 – 9/9/24



Source: Bloomberg. S&P Dow Jones Indices. Daily price returns, normalized to a factor of 100.
Past performance is no guarantee of future results.

View from the Observation Deck

In 2023, regional banks lent a total of $3.47 trillion, accounting for 28% of total loans outstanding in the U.S. banking industry, according to the American Bankers Association. That same year, regional banks employed 502,909 Americans and were home to $5.99 trillion in total assets. Since the unexpected demise of Silicon Valley Bank in March 2023, the profitability of regional banks, which the Federal Reserve ("Fed") defines as organizations with total assets of $10 billion to $100 billion, has been the topic of much debate. For today's post, we set out to examine several potential catalysts behind the recent surge in equity valuations within the regional banking subsector and discuss potential barriers to near-term growth.

Since the start of the third quarter, the S&P Regional Banks Index increased by 12.65% on a total return basis (thru 9/9). For comparison, the S&P 500 Banks and broader S&P 500 Indices saw total returns of 4.43% and 0.46%, respectively, over the same time frame.

From our perspective, expectations that the Federal Reserve ("Fed") could cut the federal funds target rate multiple times in 2024 have been a key catalyst in the recent surge in regional bank valuations. As many investors are likely aware, banks earn profits on the spread between interest paid and interest earned on deposits. In the first half of 2024, the net interest margin (the difference between interest and dividends earned on interest-bearing assets and interest paid to depositors and other creditors) of all FDIC-insured community banks declined to 3.27% from 3.44% over the same period last year.

The yield on the 10-year and 2-year Treasury notes (T-note) stood at 3.71% and 3.65%, respectively, at market close on 9/6/24.

Prior to this, the yield curve between these two benchmarks had been inverted for a record 783 consecutive days (including weekends and holidays). In our estimation, if this normalization continues, bank profitability is likely to improve. Over the 20-year period ended 9/9/24, the yield spread between the 10-year and 2-year T-notes averaged 102 basis points.

Regional bank valuations are attractive compared to their peers and the broader market.

The S&P Regional Banks Index's price to earnings (P/E) ratio was 13.39 on 9/9/24, far below its 20-year quarterly average of 23.85. The P/E ratios for the S&P 500 Banks Index and the broader S&P 500 Index stood at 11.85 and 23.40, respectively, as of the same date, compared to their 20-year quarterly averages of 15.22 and 18.55.

Despite positive developments, risks remain for the banking sector.

Bloomberg reported that under impending regulation related to Basel III, the largest U.S. banks could face a 9% increase to their capital requirements. While significantly lower than the 19% increase originally proposed, the updated total represents a significant reduction in capital assets that could be utilized to generate profit. For regional banks, continued declines in commercial real estate valuations remain a stubborn headwind. That said, lower interest rates could benefit commercial real estate borrowers in the form of lower interest payments on their debt.

Takeaway

The S&P Regional Bank Index staged a stunning turnaround to start the second half of the year, surging by 12.65% on a total return basis from 6/28/24 to 9/9/24. For comparison, the same index shed 4.63% on a total return basis over the first six months of the year. From where we stand, the spike in regional bank valuations is related to the increased likelihood of multiple rate cuts in 2024, the subsequent narrowing and elimination (for now) of the longest yield curve inversion in history, and potential regulatory action against the largest U.S. banks. While headwinds to continued growth exist, regional banks are pivotal to the economic growth of the locales they serve and are vital to a competitive and resilient banking system. We expect regional banks to benefit through increased profitability should the yield curve continue to normalize over the coming months.